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European Securities and Markets Authority
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Per Electronic Submission

COMMENTS ON THE EUROPEAN SECURITIES AND MARKETS AUTHORITY CONSULTATION PAPER ON THE UPDATE OF GUIDELINES ON THE APPLICATION OF THE ENDORSEMENT REGIME UNDER ARTICLE 4(3) OF THE CREDIT RATING AGENCIES REGULATION (ESMA33-1-159)

Moody's Investors Service ("**MIS**") wishes to thank the European Securities and Markets Authorities ("**ESMA**") for the opportunity to provide comments in response to the Consultation Paper on the Update of the Guidelines on the Application of the Endorsement Regime under Article 4(3) of the Credit Rating Agencies Regulation (the "**Consultation Paper**"). The Consultation Paper raises two questions:

1) Should the endorsement regime be restructured?

The CRA Regulation[1] establishes the endorsement regime so that EU financial firms can use ratings for regulatory purposes issued by non-EU CRAs.[2] In accordance with interpretive guidance provided by the European Commission,[3] ESMA developed a framework to implement endorsement, and at the core of that framework is the now well-established "as stringent as" assessment of third-country regulatory regimes. This framework and the "as stringent as" assessment have succeeded in providing certainty and stability for credit rating agencies (CRAs), third-country regulators and the users of credit ratings. While an update to the framework is

1 Regulation (EC) No 1060/2009 of the European Parliament and of the Council as amended by Regulation (EU) No 513/2001 and Regulation (EU) No 462/2013.

2 Paragraph 73, *CESR's Guidance on Registration Process, Functioning of Colleges, Mediation Protocol, Information set out in Annex II, Information set for the application for Certification and for the assessment of CRAs systemic importance* (4 June 2010) (*available at*: https://www.esma.europa.eu/sites /default/files/library/2015/11/10_346.pdf).

3 *See CESR's Guidance on Registration Process, Functioning of Colleges, Mediation Protocol, Information set out in Annex II, Information set for the application for Certification and for the assessment of CRAs systemic importance* (4 June 2010) (*available at:* https://www.esma.europa.eu/sites /default/files/library/2015/11/10_346.pdf).

required at this time to incorporate the most recent amendments to the CRA Regulation,[4] there is no publically available evidence to support such a fundamental change to the nature of the framework itself. In fact, we believe doing so would result in a number of unintended consequences. Instead, we would encourage ESMA to maintain the foundation of the existing framework and the stability it provides, and to focus on targeted measures that will improve its effectiveness.

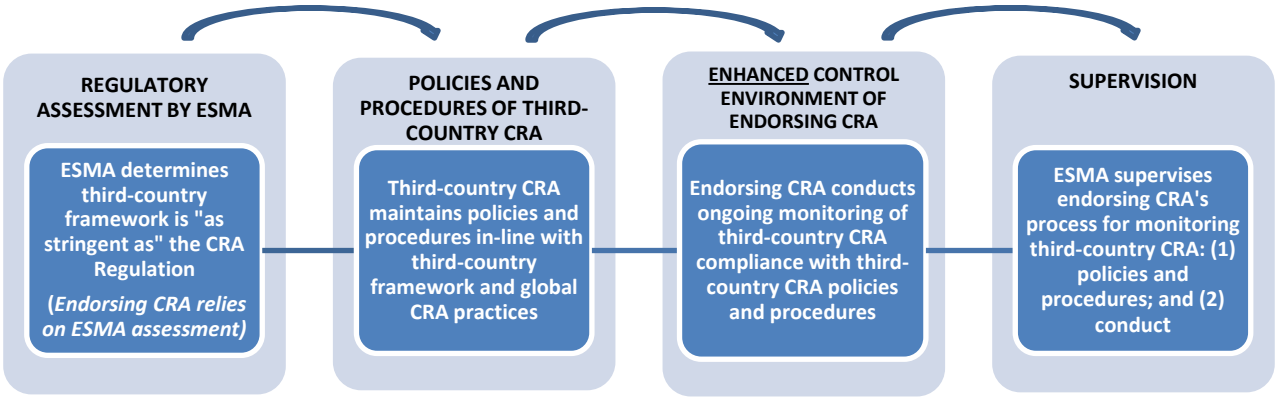
Such an approach would bolster the EU-based control environment and governance around the endorsement process, which, in turn, will provide a level of comfort regarding the quality of endorsed credit ratings and will ensure regulatory certainty. Therefore, the phased process laid out by ESMA would be modified as follows:

i. Assessment of third-country regulatory frameworks: ESMA would apply the "as-stringent-as" test to third-country regulatory frameworks to assess their comparability to the EU regime;

ii. Monitoring of third-country CRA[5] policies and procedures: Third-country CRAs would put in place policies and procedures that are consistent with the requirements of the third-country regime which, in turn, has been deemed "as stringent as" the EU regime by ESMA;

iii. Ongoing monitoring and reporting of third-country CRA ratings processes: The endorsing CRA[6] would establish a monitoring system to receive ongoing reports regarding the third-country CRA's control environment to be satisfied that the third-country CRA is complying with local requirements. To the extent such assurances are not provided, the endorsing CRA would be empowered to address consequences, up to and including cessation of endorsement;

iv. Supervision: ESMA would have access to the same information as that of the endorsing CRA to evaluate whether the endorsing CRA has an effective process to monitor endorsed credit ratings.



4 Article 21(3) of the CRA Regulation requires ESMA to issue and update guidelines on the application of the endorsement regime specified under Article 4(3) of the same Regulation.

5 A CRA which is registered and subject to supervision in a non-EU country or jurisdiction. Consultation Paper, Section 2, Definitions.

6 A credit rating agency which endorses or has endorsed one or more credit ratings in accordance with Article 4(3) of the CRA Regulation. Consultation Paper, Section 2, Definitions.

2) Should the "objective reasons" list for assigning ratings out of the EU be expanded beyond the location of the issuer/instrument?

We believe yes. As a practical matter, the majority of credit ratings will be elaborated in-region. Consistent with Article 4(3)(e) of the CRA Regulation,[7] the distribution of a CRA's portfolio of credits among its analyst population is generally a balance of four factors. How that balance is struck may be different on a sector-by-sector basis, and may result in objective reasons to elaborate credit ratings in a third-country. The four factors are:

- proximity to issuer, their agents, advisers and intermediaries;
- proximity to investors and other key market participants;
- proximity to intellectual capital; and
- need for establishing centres of excellence (knowledge sharing between team members).

In addition to these factors, CRAs also consider the administration of regulatory requirements, including, for example, how to effectively implement analyst rotation requirements.

In an effort to be as constructive as possible in responding to the Consultation Paper, in attached Annex I, we provide our views of the proposed updated guidelines, as well as our recommended modifications to endorsement framework. In attached Annex II, we respond to the specific questions raised in the Consultation Paper.

We would be pleased to discuss our views in more detail with you at your convenience.

Yours sincerely

/s/ Monica Merli

Managing Director
Regional Head: Europe, Middle East and Africa

[7] Article 4(3)(e) of the CRA Regulation states: "There must be an objective reason for the credit rating to be elaborated in a third-country".

ANNEX I

I. Endorsement Framework

The great majority of the provisions of the various regulatory regimes for CRAs around the world are largely similar, however, there are some differences. In this regard, the endorsement framework in the CRA Regulation remains fundamentally sound because it tolerates a certain amount of differences between jurisdictions. We agree that the framework could be enhanced, but we believe the proposed changes to the framework are not appropriately calibrated to address the specific concerns identified by ESMA. Those concerns are:

- Endorsing CRAs may have difficulty verifying and demonstrating fulfilment of third-country requirements because expertise regarding the third-country law typically lies with the third-country CRA.
- ESMA's ability to exercise its supervisory powers over endorsed credit ratings has been limited under the current guidelines.
- The requirements imposed on endorsed ratings have in practice been nearly indistinguishable from those imposed on credit ratings entering the EU market through the certification regime.

These concerns should be addressed to resolve any uncertainty about the quality of endorsed credit ratings, but we do not agree that the proposed changes to the endorsement guidelines are the appropriate remedy. To the contrary, we are concerned that they delegate a regulatory function (the "as stringent as" assessment) to private sector entities and imbue the endorsement process with significant uncertainty, including with respect to the nature and scope of supervisory enforcement.

A. Policy Objectives

The endorsement regime exists to enable public sector use of credit ratings in the EU, specifically the use of credit ratings for regulatory purposes. Consistent with this objective, the European Commission recognises the importance of a regulatory framework that includes recognition of foreign regulatory frameworks, in:

- Balancing the needs of financial stability with the benefits of maintaining open and globally integrated EU financial markets;
- Promoting regulatory cooperation and convergence around international standards; and
- Providing a trigger for establishing or upgrading supervisory cooperation with third-country partners.[8]

[8] European Commission Staff Working Document, *EU equivalence decisions in financial services policy: an assessment (SWD (2017) 102 final)* (2 February 2017) (*available at:* https://ec.europa.eu/info/sites/info/files/eu-equivalence-decisions-assessment-27022017_en.pdf).

When considering how to adjust the endorsement framework under the CRA Regulation and apply it going forward, we believe these policy objectives and outcomes should remain central considerations. Leveraging the endorsement regime to instead effectively export EU regulation would undermine the purpose of the endorsement regime itself.

B. The Existing Framework

Before embarking on a path that would introduce significant changes to the core components of the existing endorsement framework, we would also suggest careful consideration of its history and the benefits it has provided since its initial implementation.

1. The Existing Framework is Consistent with the CRA Regulation

We first note that the current approach is consistent with the European Commission's interpretation of the CRA Regulation, as well as with guidance provided by the Committee of European Securities Regulators (CESR)(as it then was) when the endorsement framework was established. Specifically, in adopting its guidance for the endorsement regime, CESR stated that the "as stringent as" assessment must be conducted on the basis of legal and regulatory frameworks and should not be conducted by CRAs:

> *The European Commission service's informal view communicated to CESR clearly states their understanding that the Article 4.3 (b) [of the EU Regulation]should be interpreted as requiring [a] local legal and regulatory system to impose requirements as stringent as those found in Articles 6 to 12 of the EU Regulation… This means that Article 4.3 (b) has been interpreted as requiring the local third country legal and regulatory system to impose requirements as stringent as those found in Articles 6 to 12 of the EU Regulation.*[9]

The guidance goes on to state that:

> *If the requirements for endorsement could be established on a voluntary basis the risk of non-compliance by the [T]hird-country CRA would be significantly higher as those requirements would not be subject to supervision by the third-country authority (if the law of that third-country does not include provisions as stringent as those set out in the EU Regulation).*[10] *Therefore, interpreting the endorsement criteria as not requiring local regulations and a legal structure at least as stringent as the EU Regulation could make it much more difficult to achieve the principal aim of the Regulation, i.e. to protect the stability of financial markets and investors.* [11]

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9 Paragraph 100, *CESR's Guidance on Registration Process, Functioning of Colleges, Mediation Protocol, Information set out in Annex II, Information set for the application for Certification and for the assessment of CRAs systemic importanc*e (June 4, 2010) (*available at* https://www.esma.europa.eu/sites /default/files/library/2015/11/10_346.pdf).

10 *Id.* at paragraph 102.

11 *Id.*

And finally, it states:

> *…the conditions set out in Art. 4.3 (b) will be evaluated via an objective based assessment. This means that authorities will assess that the crucial and core aspects of the EU Regulation – as considered in the equivalence assessment advice to the Commission – have to be fulfilled and met by law or regulation in the third country, but that an exact replication of all the EU Regulations requirements would not be necessary.*[12]

In the absence of a revised interpretation of the CRA Regulation by the European Commission, it is unclear what the legal basis is for such a fundamental shift in approach to the "as stringent as" test. It is true that the CRA Regulation requires that ESMA revisit the guidelines to incorporate provisions introduced by CRA3,[13] but there is no requirement or apparent legal authority to substantially alter the existing interpretation and application of "as stringent as" under the CRA Regulation.

2. Benefits of the Existing Framework

Although the existing endorsement framework may benefit from targeted changes that address specific concerns identified by ESMA, we believe its core components are fit for purpose and should continue to be leveraged going forward for the following reasons.

First, under the current process, the Methodological Framework[14] provides a clear, detailed roadmap of ESMA's criteria in evaluating specific aspects of a third-country framework to determine whether the framework is "as stringent as" the CRA Regulation. Applied at the front end of the endorsement process, this roadmap lays the foundation for a stable regulatory environment for CRAs, market participants, and third-country regulators.

Second, the Methodological Framework is applied consistently by ESMA and is guided by precedent. Consistent and transparent application of published standards by a single regulatory body provides regulatory certainty by establishing a predictable regulatory environment for CRAs and users of credit ratings.

Third, the framework has been applied to accept differences among CRA regulatory regimes. When ESMA conducts "as stringent as" assessments of third-country frameworks, it does not require exact replications of the CRA Regulation. Instead, the assessment provides formal recognition of regulatory regimes that achieve the same objectives of the CRA Regulation (i.e., the "spirit" rather than "black letter" approach). This aspect of the framework is consistent

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12 *Id.* at paragraph 111.

13 Article 21(3) of the CRA Regulation requires ESMA to issue and update guidelines on the application of the endorsement regime specified under Article 4(3) of the same Regulation.

14 The Methodological Framework for assessing a third-country legal and supervisory framework for the purposes of endorsement and equivalence as provided in Annex II to the final report of the 2011 Guidelines on Endorsement. ESMA carries out assessments of third-country legal and supervisory frameworks for the purposes of endorsement and equivalence based on the same Methodological Framework. Consultation Paper, Section 5, paragraph 19.

with the underlying objectives of integrated regulatory oversight, which accepts differences and tolerates them to enable the EU's participation in the global capital markets.

Fourth, ESMA's assessment provides certainty that the credit ratings produced in that jurisdiction are eligible for endorsement because they are produced in accordance with standards of equivalent quality as credit ratings that are produced in the EU. In turn, CRAs, market participants and third-country regulators are able to operate in a more efficient market environment.

C. The Proposed Changes will have Unintended Consequences

Although the existing framework is supported by the CRA Regulation and has served its underlying purpose, the Consultation Paper indicates that the proposed updated guidelines will entail changes to three phases of the endorsement process:

- **Phase 1: Assessment relating to the third country.** ESMA will no longer assess whether third-country legal and supervisory frameworks are "as stringent as" the CRA Regulation. Instead, the results of ESMA's assessment will determine whether the third-country framework meets minimum standards of investor protection and financial stability as a precondition for endorsement.[15]
- **Phase 2: Assessment relating to CRAs intending to endorse credit ratings.** Endorsing CRAs will need to assess third-country CRA internal requirements to determine whether they are at least "as stringent as" corresponding requirements of the relevant provisions of the CRA Regulation.[16]
- **Phase 3: Ongoing obligations of the endorsing CRA.** Endorsing CRAs will be expected to monitor on ongoing basis whether third-country CRAs comply, in practice, with policies and procedures that are "as stringent as" the CRA Regulation.[17]

We agree that the concerns identified by ESMA should be addressed, but we are concerned that the proposed revisions are overly broad and will result in a series of unintended consequences. These unintended consequences include added complexity, uncertainty and inconsistent approaches in the endorsement process. We address these concerns with respect to each of the three phases of endorsement below.

1. Phase One: Assessment relating to third-country.

An important change introduced by the proposed guidelines is that ESMA will no longer assess whether third-country regulatory frameworks are "as stringent as" as the CRA Regulation for endorsement purposes. This change in approach is not only inconsistent with the previous

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15 Consultation Paper, Section 6, paragraph 27.

16 Consultation Paper, Annex II, paragraphs 11-13.

17 Consultation Paper, Annex II, paragraph 13.

position taken by CESR on endorsement, it also destabilises the endorsement framework by introducing the potential for inconsistency, friction, and uncertainty.

a) Regulatory Inconsistency and Arbitrage

Even assuming a legal basis exists to shift the "as stringent as" assessment to endorsing CRAs, the risks would outweigh any potential benefits. By adopting guidelines that indirectly shift the third-country regulatory assessment to endorsing CRAs, the proposed updated guidelines eliminate a clear regulatory baseline from which both CRAs and market participant can operate.

At the outset, it is important to note that an assessment of third-country CRA internal requirements against the CRA Regulation is inherently an assessment of the third-country regulatory framework against the CRA Regulation. Meaningful assessments of third-country CRA policies and procedures cannot be entirely divorced from the regulatory requirements on which they are based.

The proposed updated guidelines intent is to eliminate uncertainty regarding the quality of endorsed credit ratings. Unilateral assessments by each endorsing CRA of the "as stringent as" test would result, however, in a patchwork of inconsistent outcomes that would foster uncertainty at best, and regulatory arbitrage at worst. There is nothing to prevent each endorsing CRA from taking different views of whether specific provisions of a third-country CRA regulatory framework are "as stringent as" the CRA Regulation. One CRA may determine that a third-country provision satisfies EU requirements, while another determines that it does not.

As discussed in more detail below, these determinations will lead to further complications as CRAs endeavor to implement policies and procedures that reflect the outcomes of their individual assessments.

b) Extra-Territorial Application

The proposed updated guidelines are likely to be interpreted as encouraging extra-territorial application – or exportation – of regulatory frameworks. This approach invariably introduces the potential for conflict and friction between regulatory regimes. Indeed, the proposed updated guidelines will likely place endorsing CRAs and third-country CRAs in the untenable position of navigating legal discrepancies while managing the intersection of global regulators and overlapping jurisdiction.

We recognise that as markets become increasingly global, regulatory oversight becomes more challenging as risks emanating from one jurisdiction may ultimately enter local markets. However, to address these concerns, we would encourage more coordination amongst global regulators and tolerance for discrete differences among regulatory regimes, as opposed to mandatory and overlapping national or regional regulatory reach. In fact, this is the very purpose of the existing endorsement and equivalence regimes.

2. Phase Two: Assessment relating to CRAs intending to endorse credit ratings.

At its core, the assessment of CRA internal requirements under the proposed updated guidelines is subjective. It will turn on whether an endorsing CRA insists on a verbatim "black letter" alignment with EU's rules or tolerate an "in-spirit" review of third-country CRA policies and procedures. This subjective assessment, resulting from delegation of "as stringent as" responsibility from ESMA to endorsing CRAs, would inevitably lead to interpretative and operational challenges, and ultimately to market confusion.

a) Interpretative Challenges

Under the proposed updated guidelines, the nature of the endorsing CRA's assessment of third-country CRA internal requirements is unclear. We understand the proposal calls for endorsing CRAs to assess internal requirements to determine if they are "as stringent as" the CRA Regulation, but the proposed updated guidelines do not specify what "as stringent as" means and how CRAs should assess it against internal requirements. This leaves open the question of whether an endorsing CRA should measure the third-country policy and procedure against:

- the third-country regulation;
- the CRA Regulation;
- the endorsing CRA's parallel policy or procedure;
- or some combination thereof?

The answers to these questions will determine how endorsing CRAs implement control environments to monitor third-country CRA conduct and compliance. Those decisions, in turn, will determine the processes by which endorsed credit ratings are produced by third-country CRAs for use in EU markets.

b) Operational Challenges

The proposed updated guidelines are also unclear with respect to how, in practice, endorsing CRAs are expected to reconcile regulatory differences to arrive at internal requirements that are "as stringent as" the CRA Regulation. The following serve as examples.

Similar, but not exactly the same: The provisions of CRA regulatory regimes around the world are similar in many respects, but there is rarely exact alignment. For example, the CRA Regulation includes a provision that requires CRAs to inform rated entities of the credit rating and the principal grounds on which it is a based at least one full working day before its publication.[18] A number of jurisdictions include provisions providing for issuer notification, but do not specify a mandatory timeframe. For the purpose of ESMA's "minimum threshold" test, the proposed updated guidelines recognise this difference, but do not offer specific guidance on

[18] Annex I, Section D, Subsection I, Paragraph 3 of the CRA Regulation states: "The credit rating agency shall inform the rated entity during working hours of the rated entity and at least a full working day before publication of the credit rating or the rating outlook. That information shall include the principal grounds on which the credit rating or rating outlook is based in order to give the rated entity an opportunity to draw attention of the credit rating agency to any factual errors."

how a third-country CRA policy or procedure may otherwise satisfy the requirement.[19] Instead, the updated Methodological Framework suggests that "other timeframes may be acceptable",[20] but the Consultation Paper contradicts by saying,

> "*to the extent there are difference between the policies and procedures of an EU CRA and a [T]hird-country CRA and/or the way in which these policies and procedures are fulfilled, the [E]ndorsing CRA will need to carry out additional work to ensure compliance."*[21]

No parallel language: The proposed updated guidelines are ambiguous with respect to instances where a third-country regulatory framework does not include a parallel provision to the CRA Regulation. For example, the CRA Regulation requires that CRAs use "a clearly distinguishable different colour code" for credit ratings that were both unsolicited and did not involve the participation of the rated entity.[22] If a third-country regulatory framework does not contain a similar provision, then the third-country CRA is unlikely to have an internal requirement to colour code its credit ratings. An endorsing CRA would need to make a judgement call about whether the third-country regulatory framework otherwise provides for measures that are, in substance, "as stringent as" the colour coding requirement.

Different CRAs may come to different conclusions and implement different approaches. Under the proposed guidelines, the Methodological Framework would identify the potential gap, but would not provide clear guidance on how a third-country CRA policy or procedure may otherwise satisfy the requirement.[23] Even if differences or gaps between third-country frameworks and the CRA Regulation are limited in number, the underlying challenge remains the same. Unless there are affirmative assurances that differences are tolerated and that identical matches are not required, endorsing and third-country CRAs will operate in an uncertain regulatory environment.

c) Market Confusion

This uncertainty will also impact the broader market and users of credit ratings. With ESMA disengaged at the front end of the endorsement process, users of credit ratings will not

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[19] Consultation Paper, Annex III, Item 21 of Table ("ESMA does not consider it necessary that there is a specific requirement that the CRA to inform the rated entity at least a full working day before the publication of a credit rating. Other timeframes may be acceptable as long as the CRA provides to the rated entity with the opportunity to draw attention to possible factual errors.")

[20] Consultation Paper, Annex III, Updated Methodological Framework, Table - Item 21.

[21] Consultation Paper, Section 6.1, Paragraph 26.

[22] Article 10(5) of the CRA Regulation states: "Where a credit rating agency issues an unsolicited credit rating, it shall state prominently in the credit rating, using a clearly distinguishable different colour code for the rating category, whether or not the rated entity or a related third party participated in the credit rating process and whether the credit rating agency had access to the accounts, management and other relevant internal documents for the rated entity or a related third party."

[23] Consultation Paper, Annex III, Item 13 of Table: Overview of material changes made to the Methodological Framework ("whilst required by the CRA Regulation, it is not necessary that it is a legal requirement in the third country that the latter is indicated using a clearly, distinguishable different colour code for the rating category.")

know whether different CRAs are applying the same standards to endorsed credit ratings, and whether those standards are in accordance with the CRA Regulation. This uncertainty is likely to persist until a fourth stage, not discussed in the Consultation Paper, whereby ESMA re-engages in the endorsement process through the supervisory process. Through supervision, ESMA may conclude that it disagrees with the endorsing CRA assessments, but only after the endorsed credit ratings have been used by EU market participants.

3. Phase Three: Ongoing obligations of the endorsing CRA

We understand the proposed updated guidelines require endorsing CRAs to monitor production of individual endorsed credit ratings regardless of the existing control environment in the third-country. This approach raises two concerns. First, it is disproportionate with existing EU requirements for credit ratings produced in the EU. Second, it is likely to frustrate broader policy efforts to reduce redundancy[24] and will instead create uncertainty with respect to supervisory enforcement.

a) Proportionality

The proposed requirements for ongoing monitoring of endorsed credit ratings are not proportionate with the CRA Regulation's requirements for monitoring credit ratings produced in the EU. Specifically, EU CRAs are not expected to conduct "basic checks" of "every" credit rating. Instead, the CRA Regulation requires that CRAs establish and maintain control environments designed to ensure the production of high quality credit ratings, and to promptly identify and correct issues as they arise. If this approach is satisfactory for credit ratings produced in the EU, it is unclear why something different is required for endorsed credit ratings.

b) Redundancy

The proposed guidelines do not ascribe value to the existing third-country CRA control environment. Third-country CRAs already have existing internal control mechanisms in place to monitor the production of credit ratings. Despite these internal controls, the proposed updated guidelines would require an additional layer of micro-monitoring by requiring the endorsing CRA to conduct a check of "every endorsed credit rating to ensure relevant requirements are met".[25] This redundancy is not likely to improve the quality of the endorsed credit ratings, but will likely create inefficiencies and operational complexity. Similarly, "periodical deep dive assessments of the compliance of a sample of endorsed credit ratings"[26] are duplicative of existing efforts of third-country CRAs with the support of the global CRA compliance infrastructure.

Finally, third-country CRAs are already subject to regulatory supervision in their respective jurisdictions. Rather than leverage this third-country regulatory expertise and

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[24] European Commission Staff Working Document, *EU equivalence decisions in financial services policy: an assessment (SWD (2017) 102 final)*(2 February 2017) *(available at*: https://ec.europa.eu/info/sites/info/files/eu-equivalence-decisions-assessment-27022017_en.pdf).

[25] Consultation Paper, Annex II, paragraph 13(b)(ii).

[26] Consultation Paper, Annex II, paragraph 13(b)(iii).

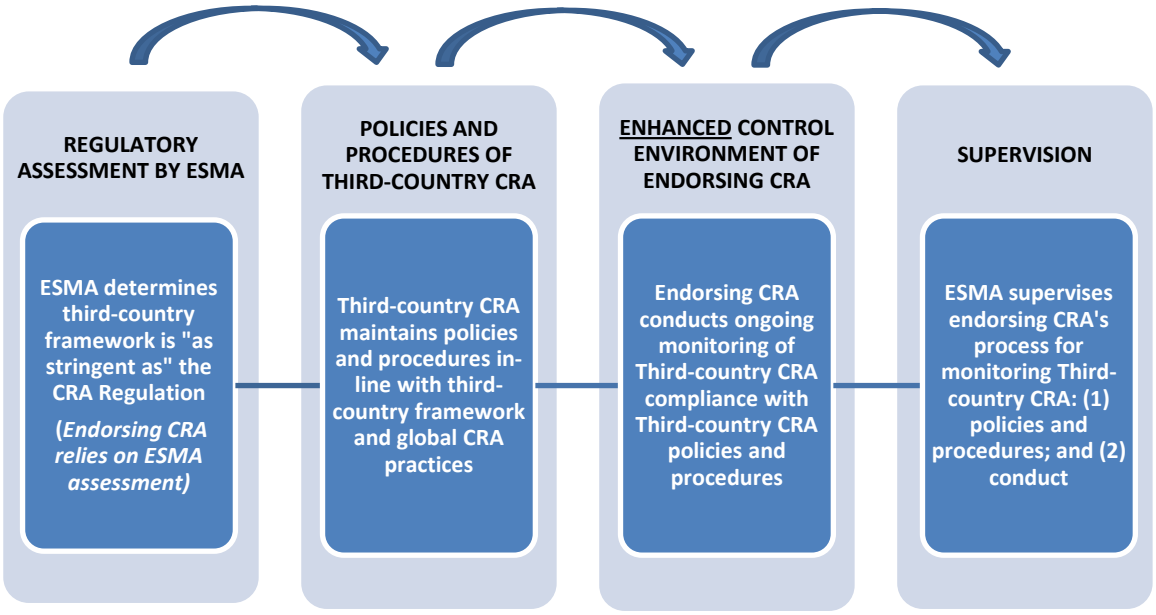
supervisory oversight, the proposed guidelines would appear to discount it or disregard it entirely. Whereas the existing guidelines currently recognise and rely on the third-country's regulatory supervision, the proposed updated guidelines ascribe little, if any, value to it. This approach is inconsistent with the purpose of the endorsement regime and CESR's adopting guidance, as well as with broader policy objectives to encourage reciprocity, proportionality and mutual recognition among global regulators.[27]

c) Regulatory Accountability

The proposed guidelines introduce the possibility of concurrent jurisdiction and conflicting enforcement, a highly concerning dynamic which the Consultation Paper does not address. For example, a third-country regulator may examine a third-country CRA and determine that its credit ratings are in compliance with the third-country regulation. At the same time, ESMA could conclude that while these credit ratings, which were then endorsed, may have been in compliance with the third-country regulation, they were not produced in accordance with standards "as stringent as" the CRA Regulation. The third-country CRA is regulated by and accountable to the third-country regulatory supervisor, and its conduct must therefore conform to third-country rules and regulations. However, under the proposed updated guidelines, it is unclear as to whom the third-country CRA would ultimately be accountable.

D. Recommended Approach for Reinforcing The Framework

ESMA's principle concerns with the endorsement framework can be addressed with targeted measures that will enhance oversight of endorsed credit ratings and will hold endorsing CRAs accountable for the quality of endorsed credit ratings. Importantly, these critical objectives can be achieved without disrupting the framework's core elements and the stability it provides.



[27] European Commission Staff Working Document, *EU equivalence decisions in financial services policy: an assessment (SWD (2017) 102 final)* (2 February 2017) (*available at*: https://ec.europa.eu/info/sites/info/files/eu-equivalence-decisions-assessment-27022017_en.pdf.)

Recommended Approach. This diagram shows the relationships and the lines of accountability between regulatory supervisors and CRAs involved in the endorsement process.

1. The first relationship is between the third-country CRA and the third-country regulator. Third-country CRAs are accountable to the third-country regulatory supervisor and must abide by its rules.

2. The second relationship is between the third-country CRA and the endorsing CRA. The third-country CRA must provide the endorsing CRA with the information that the endorsing CRA requires in order to make sure that the third-country CRA conduct is satisfactory in implementing local regulation and supports endorsement.

3. The third relationship is between the endorsing CRA and ESMA. The endorsing CRA provides information to ESMA regarding its oversight of the third-country CRA process, including any relevant underlying supporting material (e.g., compliance surveillance, internal audit reports).

1. ESMA Should Continue to assess "As Stringent As"

The detailed assessment of third-country regulation is most effective when it is conducted by a single regulatory authority, as is the case under the current endorsement framework. To avoid uncertainty and inconsistent application of the CRA Regulation, we would encourage ESMA to continue to assess third-country regulatory frameworks to determine whether they are "as stringent as" the CRA Regulation.

2. Endorsement Should be Contingent on Informational Reports and Assurances Received from third-country CRAs

In order to reinforce confidence in the quality of endorsed credit ratings, endorsing CRAs are accountable for the quality of the credit ratings and the processes by which they are introduced for use in the EU market. To that end, the endorsement framework should ultimately be focused on two objectives: (1) ensuring that the endorsing CRA's monitoring process is rigorous; and (2) ensuring that the endorsing CRA is equipped to identify problems and take corrective action when necessary.

a) Leverage Existing Infrastructure

As noted in the Consultation Paper, third-country CRAs are experts on local regulation and are uniquely positioned to assess compliance. In order to take full advantage of that expertise and insight, the endorsement framework should leverage existing third-country CRA internal control functions to support the endorsing CRA's ongoing monitoring of endorsed credit ratings.

First, we propose deploying the full suite of internal control resources available to the endorsing CRA, and that begins with the global control environment. At MIS, third-country CRAs are part of a global network of CRAs with comprehensive internal control resources and infrastructure to support the issuance of high quality credit ratings. In fact, the structure of the

control environment that supports the issuance of credit ratings in the EU is mirrored globally and comprises an effective three-tier structure of control where the business comprises the first line of defense, compliance the second and internal audit the third. The global compliance function's mandate is to prevent, detect and control breaches of regulation. This is executed through a global compliance programme with established policies and procedures, appropriate training over those policies and procedures, and an effective monitoring function that conducts surveillance and investigations that, in turn, leads to remediation efforts, where necessary. The control environment is also supported by the internal audit function, which engages in its own review of CRA practices globally.

In addition to the global control environment, additional measures are also embedded at the third-country CRA. For example, third-country CRAs have local compliance officers on-site and/or in-region that are knowledgeable about country-specific rules and regulations, as well as general compliance concerns. Local compliance officers provide guidance while interfacing with third-country CRA employees. The conduct and compliance of third-country CRAs are subject to surveillance and ongoing monitoring by the global compliance functions and that information is reported on by local compliance offers to both management and boards of directors. This overall control environment is subject to oversight by the third-country regulatory supervisor.

Together with additional enhancements to monitoring by the endorsing CRA, these mechanisms can also play a key role in providing information and assurances that third-country CRA credit ratings are of sufficient quality to be endorsed for use in the EU.

b) Accountability Through Enhanced Monitoring, Reporting and Governance

We agree that credit ratings should only be endorsed when they are produced in accordance with standards that ensure the credit ratings produced outside the EU are of the same high quality as those produced inside the EU. We believe those assurances can be provided through a rigorous and ongoing process that consists of regular reporting from the third-country CRA, enhanced monitoring by the endorsing CRA, and senior level responsibility and ultimate accountability for the quality of endorsed credit ratings. The three components of an effective monitoring process are:

1) Gathering of relevant information on a routine basis.

The proposed updated guidelines require that endorsing CRAs monitor relevant documents produced by the internal control functions within the third-country CRA, including but not limited to reports from compliance, internal audit, risk management, the board of directors and the review function.[28] We agree that reporting and collection of this type of material could be an effective means by which endorsing CRAs could monitor third-country CRAs and endorsed credit ratings. This approach would allow the endorsing CRA to monitor on an ongoing basis the process by which endorsed credit ratings are produced by the third-country CRA. To the extent reports identify potential issues at the third-country CRA, the material could also enable the

[28] Consultation Paper, Annex II, Paragraph 13(b)(i).

endorsing CRA to request additional information to further assess the nature and scope of the potential issue.

2) **The infrastructure established to analyse the information gathered.**

   The review of material collected through enhanced monitoring and reporting could be conducted within existing internal control functions, or alternatively, through a function focused solely on monitoring the endorsement process. In addition to reviewing the initial material reported, this function could also be tasked with taking steps to gather additional information or clarifications from the third-country CRA, as necessary.[29] Once this information is compiled and fully analysed, it would then be ready for further senior level review.

3) **Accountability and the authority to take deliberative action based on information and analysis.**

   Relevant information should be gathered, analysed, and distilled for evaluation by senior management of the endorsing CRA. Based on this information and in accordance with an established criteria, senior management of the endorsing CRA should decide whether endorsement is (or continues to be) appropriate. This process could occur at regular intervals throughout the year and could be subject to the oversight of the board of directors in the EU. To the extent the endorsing CRA identifies material or systemic failures impacting endorsed credit ratings produced by a third-country CRA, senior management of the endorsing CRA would make a decision on whether to suspend endorsement of credit ratings. In order to determine whether a material or systemic failure occurred at the third-country CRA, senior management would apply the same standards the endorsing CRA would apply in determining whether conditions for registration are satisfied. This senior management group would also be responsible for deciding whether and when to inform ESMA of potential concerns with endorsed credit ratings. In turn, the information on which the endorsing CRA makes its assessment and determination could also be made available to ESMA.

If taken, these actions would address ESMA's three principle concerns with the current framework. First, endorsing CRAs would have a process in place that would allow them to effectively verify third-country CRA compliance with appropriate standards. Second, ESMA would be able to access information related to the oversight and ongoing monitoring of endorsed credit ratings by endorsing CRAs. Third, the enhanced, ongoing monitoring by endorsing CRAs would distinguish endorsed credit ratings from those that enter the EU through the certification process. Together, these steps would provide ESMA and the market with additional confidence that endorsed credit ratings are of the highest quality and do not pose systemic risk to EU markets.

[29] Consultation Paper, Annex II, Paragraph 15.

II. Objective Reason

The Consultation Paper also introduces a proposed approach to the "objective reasons" provided by CRAs for elaborating credit ratings outside of the EU.[30] MIS agrees that there could be value in periodic assessments of whether the current approach to "objective reasons" is consistent with evolving market conditions. The proposed updated guidelines can serve as an important tool in ensuring that current and future market needs are addressed, while reinforcing the underlying objectives of the CRA Regulation. We propose an approach that strikes the appropriate balance between ensuring credit ratings quality and responding to market needs.

First, as capital markets become increasingly global and diverse, "objective reasons" should be dynamic and forward-thinking. Consistent with this approach, CRAs operate and deploy resources in locations that track to global market activity, in addition to locations where specific issuers or instruments may be located. It follows that the regulatory framework for those markets should similarly evolve without misplaced emphasis on geography. We would encourage ESMA to also take into account important market characteristics including: the location of investors and other key market participants; the location of market or sector activity and growth; and the current location of individual issuers, their agents, advisers and intermediaries.

Second, the CRA Regulation is intended to ensure that endorsed credit ratings are produced in accordance with highest standards and are of the utmost quality. This objective is also best served when the "objective reason" is applied in a forward-thinking manner that prioritises credit ratings quality over geographic location. Specific credit ratings may be assigned from a third-country for a variety of reasons all driven by credit ratings quality considerations, for example: issuer cohort (i.e., whether the issuer's cohort is an international or domestic group of companies); sector or industry-specific expertise of a specific analyst for a specific transaction or issuer; the location of relevant transaction assets and/or management groups; the location of a centralised hub of analytical expertise; and effective communication with issuers.

CRAs also make adjustments to credit rating assignments in direct response to regulatory requirements. For example, as analysts rotate on and off specific issuers over time in accordance with the CRA Regulation, new analysts are assigned on the basis of their sector or industry expertise.

There may also be other broader considerations based on credit ratings quality that would lead a CRA to elaborate a credit rating in a third country. These considerations may include, for example: credit rating methodology development, management of the availability of skilled resources and calibration of analyst workload. Each of these considerations may be tied to

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[30] The CRA Regulation requires that CRAs seeking to endorse credit ratings must provide an "objective reason" for the credit rating to be elaborated in the third country. The proposed updated guidelines indicate that ESMA considers it to be an "objective reason" within the meaning of the CRA Regulation where the rated entity or instrument is established or issued in the third country where the rating is elaborated. The proposed updated guidelines also indicate that ESMA will assess other reasons presented by CRAs on a case-by-case basis, and that ESMA expects that the endorsing CRA documents the objective reason for each endorsed credit rating. Consultation Paper, Section 6.3.

specific credit ratings, but are also relevant to the supporting the CRA's capability to produce high quality credit ratings more broadly.

In practice, the majority of credit ratings will be elaborated in-region, but the balancing of these factors may result in objective reasons to elaborate credit ratings in third countries. The decision to elaborate a credit rating in a third country is ultimately driven by efforts to produce the highest quality credit rating while also taking into account market needs. If these same considerations underpin the updated approach to "objective reasons" under the CRA Regulation, the endorsement framework can be an effective tool to ensure access to global capital markets and the production of the highest quality credit ratings. If a more restrictive view is adopted, these objectives could be compromised.

ANNEX II

Q1. Please indicate what you believe will be the impact of ESMA's change in approach, if any, on the groups of CRAs currently benefiting from the endorsement regime?

As discussed in more detail in attached Annex I, Section I.C, we believe the proposed change in approach could result in a number of unintended consequences.

First, ESMA's change in approach with regard to the assessment of third-country legal and supervisory frameworks will reduce stability and certainty in the endorsement process. By delegating the "as stringent as" assessment to endorsing CRAs, we believe the new approach could result in inconsistent interpretation of regulatory requirements, and might inadvertently foster regulatory arbitrage.

Second, the proposed updated guidelines could be interpreted as exporting EU regulatory requirements globally, which would potentially result in conflicting requirements across jurisdictions. This scenario puts CRAs in the difficult position of reconciling these conflicts without regulatory guidance.

Third, the change in approach creates uncertainty, and will result in difficult interpretative and operational challenges for CRAs and the users of credit ratings. For example, it is not clear whether CRAs should measure third-country CRA compliance directly against the CRA Regulation or local policy and procedure. It is also unclear how CRAs should address differences or gaps between the CRA Regulation and third-country CRA policies and procedures and the third-country regulation on which they are based.

Fourth, the proposed updated guidelines create redundancies with respect to internal controls. Rather than fully leverage existing internal control functions at third-country CRAs, the new approach appears to discount their role in the process. The endorsing CRA is tasked with examination of individual endorsed credit ratings, as opposed to focusing on efforts to monitor the third-country CRA process.

Fifth, the new approach creates uncertainty with respect to regulatory accountability. The proposed guidelines introduce the possibility of concurrent jurisdiction, conflicting enforcement, and different outcomes for the same credit rating or set of credit ratings.

Q2. Please indicate whether you consider the measures which the endorsing CRA should have in place to monitor the conduct of the third-country CRA will adequately ensure the quality and independence of endorsed credit ratings.

As discussed in more detail in attached Annex I, Section I.D, we support measures that promote enhanced reporting by third-country CRAs and monitoring by endorsing CRAs. In our view, however, the proposed measures to monitor the conduct of the third-country CRA are not properly calibrated to respond to the underlying concerns with endorsed credit ratings, as identified in the Consultation Paper.

For example, as discussed in Annex I, Section I.C.3, the proposed updated guidelines require that endorsing CRAs engage in reviews of "every endorsed credit rating". The CRA Regulation does not require checks of every credit rating produced in the EU. Instead, the CRA Regulation requires that CRAs establish and maintain control environments designed to ensure the production of high quality credit ratings, and to promptly identify and correct issues as they arise. Similarly, the endorsement guidelines should focus the efforts of endorsing CRAs on the control environment and the monitoring process.

Ultimately, the endorsing CRA should take responsibility for determining whether endorsed credit ratings are produced in accordance with standards that ensure the credit ratings produced outside the EU are of the same high quality as those produced in the EU. To achieve this objective most effectively and efficiently, endorsing CRAs should apply a heightened standard for monitoring the processes that produces endorsed credit ratings, rather than duplicating work that is already performed by the third-country CRA.

Q3. Do you agree with ESMA's understanding of points (c) and (d) of Article 4(3) of the CRA Regulation?

According to the Consultation Paper, ESMA's understanding of points (c) and (d) of Article 4(3) of the CRA Regulation is that: (1) Endorsing CRAs should make information available to ESMA, on an ad-hoc or periodic basis, that ESMA may need in order to assess third-country CRA compliance with the CRA Regulation; and (2) when requested, ESMA expects that the endorsing CRA provides any relevant information relating to the conduct of the third-country CRA.

MIS does not disagree with ESMA's understanding that the CRA Regulation provides ESMA with the ability to request and receive information from the endorsing CRA related to the endorsement process, including the endorsing CRA's monitoring of third-country CRA conduct. As discussed in more detail in attached Annex I, Section I.D, we propose an approach to the endorsement framework that provides ESMA with access to the information that endorsing CRA maintains and which enables its assessment of third-country CRA compliance with applicable policies and procedures. In addition to material related to the endorsing CRAs monitoring of the third-country CRA's compliance with policies and procedures, this material may also contain underlying reporting from the third-country CRA.

Q4. In your view, are there other reasons which could be considered "objective" within the meaning of Article 4(3)(e)? If so, please indicate which providing reasons.

As discussed in more detail in attached Annex I, Section II, there are other reasons which could be considered "objective" within the meaning of Article 4(3)(e) of the CRA Regulation. We would encourage ESMA to take a forward-thinking and dynamic approach to "objective" reasons which appropriately balances market needs with ratings quality. For example, in addition to proximity to the rated issuer or instrument, these "objective" reasons also may include: proximity to investors; proximity to talent; and the development of centres of excellence for knowledge sharing among credit analysts.

Q5. Do you agree that the endorsing CRA should comply with the general requirements as listed in this section?

Consistent with our comments in Annex I, Section I.D, MIS does not object to requirements that call on the endorsing CRA to monitor and verify on an ongoing basis that the conditions for endorsement remain fulfilled. Similarly, MIS does not object to requirements that call on the endorsing CRA to periodically report on the fulfilment of the conditions for endorsement in accordance with the CRA Regulation.