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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 GUIDELINES ON THE APPLICATION OF THE ENDORSEMENT REGIME UNDER ARTICLE 4(3) OF THE CREDIT RATING AGENCIES REGULATION – SUPPLEMENTARY GUIDANCE ON HOW TO ASSESS IF A REQUIREMENT IS "AS STRINGENT AS" THE REQUIREMENTS SET OUT IN CRAR (THE "CONSULTATION PAPER")

The Credit Rating Agencies Regulation[1] (CRAR) established endorsement to facilitate EU financial sector authorities' use of credit ratings issued by non-EU credit rating agencies (CRAs) for regulatory purposes.[2] Accordingly, ESMA developed an objectives-based framework to implement the endorsement regime, at the core of which is the "as stringent as" assessment.[3] Moody's Investors Service (MIS) shares ESMA's view that to help protect the soundness of the EU's financial system, a well-run endorsement regime can ensure ratings produced under the jurisdiction of third-country regulators meet the same high-quality standards as those produced under ESMA's jurisdiction. In this regard, MIS appreciates that an update to this framework is necessary.[4] We do not agree, however, with the approach ESMA has proposed in the Consultation Paper.

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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).

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).

4 Article 21(3) of the CRAR requires ESMA to issue and update guidelines on the application of the endorsement regime specified under Article 4(3) of the CRAR by 1 June 2018.

We are primarily concerned that ESMA has not provided sufficient transparency about its general principle[5] or underlying analytical rationale for why certain internal controls are viewed as "viable alternatives"[6] while other seemingly similar controls are not.[7] The Consultation Paper does not answer the fundamental question of what it means to be "as stringent as", but instead recommends that CRAs generally default to exporting EU rules. The Consultation Paper is also unclear as to whether ESMA or endorsing CRAs ultimately make the "as stringent as" determination with respect to third-country CRA policies and procedures. In an effort to be as constructive as possible, we have divided our submission into five parts.

In Part I, we discuss our principle concerns with the Consultation Paper, namely that it proposes an approach that is:

i. not aligned with the outcomes-based policy objectives of the endorsement regime;
ii. not based on a transparent, objective and rigorous framework; and
iii. unclear about its future applicability.

We also provide our views regarding the nature of the control environment that the endorsing EU CRAs can be expected to put in place.

In Part II, we discuss our specific concerns with the Consultation Paper related to the CRAR fee provisions. The rationale provided for exporting the CRAR fee provision through endorsement is among the most puzzling aspects of the Consultation Paper. According to the Consultation Paper, the EU approach should be imposed on third-countries with no regard to the fact that:

i. third-countries have requirements in place that meet the same conflict of interest objectives as this provision;
ii. CRAR provisions that relate to EU market structure should be excluded from the endorsement regime;[8]

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5 As described in Paragraph 8 of the Consultation Paper, its purpose is to:

a. clarify the general principle for assessing whether a requirement is "as stringent as"; and
b. provide an assessment of a set of concrete requirements based on information provided by CRAs.

6 Paragraph 14 of the ESMA Consultation Paper states, "Only those [provisions] for which viable alternative internal requirement was identified have been included in the Guidelines. The Guidelines are silent on the areas where ESMA does not consider that a CRA has identified an alternative internal requirement which is as stringent as the corresponding requirement in CRAR."

7 For example, third country disclosure requirements for the (SF) indicator are not viewed as viable alternatives, while third-country disclosure requirements for certain types of unsolicited credit ratings are considered viable alternatives.

8 "Some of the provisions introduced by this Regulation should not apply to the equivalence and endorsement assessments. This is the case for those provisions that only establish obligations on issuers but not on credit rating agencies. In addition, provisions that relate to the structure of the credit rating market within the Union rather than establishing rules of conduct for credit rating agencies should not be considered in this context." Recital 48, Regulation (EU) No 462/2013 of the European Parliament and of the Council of 21 May 2013 amending Regulation (EC) No 1060/2009 on credit rating agencies ("CRA3").

iii. ESMA has yet to decide how this provision should be interpreted, and therefore even the EU requirements remain in flux.

In Part III, we propose a simple and transparent four-part framework for the "as stringent as" analysis that can be applied consistently and coherently. This alternative framework will meet ESMA's goals of ensuring the quality of non-EU credit ratings while simultaneously providing CRAs with transparency and certainty.

In Part IV, we apply the four-part framework, and propose alternative "as stringent as" measures that are consistent with CRAR objectives.

In Part V, we highlight existing global, third-country and MIS measures that support these alternatives, satisfy CRAR objectives and should be viewed "as stringent as" their CRAR counterparts.

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

Yours faithfully,

/S/ Farisa Zarin

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I. MIS PRINCIPLE CONCERNS

"To meet the requirement in Article 4(3)(b), the endorsing CRA should verify that the third-country CRA, in addition to meeting the local regulatory requirements, fulfils the requirements set out in the relevant endorsement provisions of CRAR or has implemented and adheres to (different) internal requirements which are at least as stringent."[9]

By way of background, prior to ESMA's reinterpretation of the endorsement regime in the CRAR, ESMA bore the responsibility for assessing whether third country rules were as stringent as those of the EU. It would review the third-country regulatory regime's rules and determine, based on a transparent framework, whether they served the same purpose as those of the EU. This objectives-based framework and the "as stringent as" assessment had succeeded in providing certainty and stability for CRAs, third-country regulators, and prudential authorities (the users of endorsed credit ratings).

As we stated in our response to ESMA's Consultation Paper on the Update of Guidelines on the Application of the Endorsement Regime, transferring the assessment of "as stringent as" to CRAs would result in a number of inconsistent interpretations and haphazard global applications of rules and procedures.[10] MIS, therefore, had encouraged ESMA to retain the foundation of its existing framework, and to target its enhancements at improving the specific concerns it had identified.[11] ESMA did not accept our recommendation. Instead, ESMA has largely abandoned its reliance on third country supervisory regimes, and opted for exporting the EU regulatory framework, unless the CRAs can demonstrate that they have "viable" alternatives to satisfy the "as stringent as" test. [12]

"The aim of the proposed supplementary guidance is <u>not</u> to provide an exhaustive list of requirements which are as stringent as each requirement set out in the relevant endorsement provisions of CRAR. Instead, the aim of the CP is twofold:

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9 Paragraph 11, Consultation Paper.

10 MIS 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 (3 July 2017) (*available at* https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_196628)

11 *See* Paragraphs 23-25, ESMA Consultation Paper on Update of the guidelines on the application of the endorsement regime under Article 4(3) of the Credit Rating Agencies Regulation (4 April 2017) (ESMA33-9-159). The specific concerns listed by ESMA in changing its approach to endorsement were:

a. Endorsing CRAs may have difficult verifying and demonstrating fulfillment of third-country requirements because expertise regarding the third-country law typically lies with the third-country CRA
b. ESMA's ability to exercise its supervisory powers over endorsed credit ratings has been limited under the current guidelines;
c. 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.

12 Paragraphs 14-15, Consultation Paper.

a. *"To clarify the general principle for assessing whether a requirements is 'as stringent as'"; and*
b. *"To provide an assessment of a set of concrete requirements based on information provided by CRAs."* [13]

The Consultation Paper has not provided the general principle that would enable a consistent and coherent analysis for the "as stringent as" test. As a result, CRAs remain exposed to an *ad hoc* decision making process that is: i) not clearly aligned with the policy-level objective of the endorsement regime; ii) not based on a transparent, objective and rigorous framework; and iii) unclear about its future applicability.

A. Not clearly aligned with the policy-level objectives of the endorsement regime

The Consultation Paper seems to suggest that the endorsement mechanism is not tethered directly and solely to regulatory use, but that it applies more generally to all ratings available for view in the EU.[14] Certain provisions appear to serve fair market objectives,[15] others to serve investor transparency and protection objectives[16] while still others seek to mitigate conflicts of interest.[17]

Yet, the purpose of the endorsement regime is inextricably linked to regulatory use,[18] which triggers defined and discrete objectives.

> *"…[T]he privilege of having its services recognized as playing an important role in the regulation of the financial services market and being approved to carry out this function, gives rise to the need to respect certain obligations [on the CRA] in order to guarantee independence and the perception of independence in all circumstances."*[19]

Importantly, the CRAR explicitly excludes certain of its provisions from the endorsement assessment, in particular those which:[20]

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13 Paragraph 8, ESMA Consultation Paper. *See also* Paragraph 14, Consultation Paper ("…only those [provisions] for which viable alternative internal requirement was identified have been included in the Guidelines. The Guidelines are silent on the areas where ESMA does not consider that a CRA has identified an alternative internal requirement which is as stringent as the corresponding requirement in CRAR".).

14 Consultation Paper, *passim*.

15 Paragraph 21 and 23, Consultation Paper.

16 Paragraph 33 and 35, Consultation Paper.

17 Paragraph 69 and 71, Consultation Paper.

18 "It is desirable to provide for the use of credit ratings issued in third countries for regulatory purposes in the Community provided that they comply with requirements which are as stringent as the requirements provided for in this Regulation." Recital 13, Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit ratings agencies ("CRA1").

19 Recital 19, CRA3.

20 Recital 48, CRA3.

- "*only establish obligations on issuers but not on credit rating agencies*";[21] and
- "*relate to the structure of the credit rating market within the [EU].*"[22]

CRAR provisions that have been interpreted to serve objectives related to the structure of the CRA market in the EU, including those related to fair markets, logically should be excluded from the endorsement regime. Provisions that directly support "independence and perception of independence in all circumstances," in contrast, fall within its purview.

The EU approach in crafting a carefully tailored endorsement regime that is tightly connected with the purpose of regulatory use is rational. Systems regulators, who are the regulatory users, care about ratings quality – *i.e.*, whether credit ratings accurately predict default probabilities. This becomes increasingly clear when one reviews, by way of example, the recognition criteria for external credit assessment institutions for the banking industry (ECAIs).[23] Those recognition requirements target independence and quality of credit ratings.

B. Not based on a transparent, objective and rigorous framework

> *"It is important to recall in this respect that a third-country regulatory regime does not have to have identical rules as those provided for in this Regulation. As already provided for in Regulation (EC) No 1060/2009, in order to be considered equivalent to or as stringent as the Union regulatory regime, it should be sufficient that the third-country regulatory regime achieve the same objectives and effects in practice."*[24]

In changing its approach to supervising the endorsement regime, ESMA has made clear that the framework it uses to perform the equivalency assessment (of the third-country legal and supervisory framework) is not the same and, therefore, should not be relied upon for the "as stringent as" assessment (of the internal policies of third-country CRAs).

Unfortunately, no alternative framework has been offered. Instead, a number of rules have been identified that CRAs currently do not export outside of the EU. A more flexible approach has been suggested for some of these provisions,[25] while third-country CRAs have been advised to adopt the remaining CRAR provisions verbatim.[26] There is no common thread

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21 *See* Article 4(3)(b) of the CRAR.

22 Recital 48, CRA3.

23 *See e.g.* Basel III, Part I, Section(II)(B)(3) "Incorporation of IOSCO Code of Conduct for Credit Rating Agencies" (describing six eligibility criteria for ECAIs: objectivity; independence; international access / transparency; disclosure; resources, credibility) (December 2010); *see also* Basel III: Finalising post-crisis reforms, Section B, Paragraph 2 (Recognition of external ratings by national supervisors – Eligibility criteria") (an ECAI must satisfy eight criteria: objectivity; independence; international access / transparency; disclosure; resources, credibility; no abuse of unsolicited credit ratings; cooperation with the supervisor) (December 2017).

24 Recital 48, CRA3.

25 Provisions for which ESMA is envisioning a certain amount of flexibility relate to: analyst rotation; the 24-hour rule; initial and preliminary ratings; colour-coding of certain unsolicited credit ratings; inside information; and the transparency report.

26 Provisions for which ESMA is recommending verbatim adoption relate to: CRA fees (e.g., non-discriminatory and based on actual costs); CRA fee reporting; identification of structured finance instruments; conflicts of

that can be drawn to explain why ESMA will tolerate divergence in approach for certain provisions – treatment of inside information – while not in others – shareholding.

The CRAR does not require direct transposition of its requirements for endorsement purposes. To the contrary, the CRAR provides that

> *"… when endorsing a credit rating issued in a third country, CRAs should determine and monitor, on an ongoing basis, whether credit rating activities resulting in the issuing of such a credit rating comply with requirements for the issuing of credit ratings which are as stringent as those provided for in this Regulation, achieving the same objective and effects in practice."*[27]

This concept is recognised in both the 2017 Guidelines[28] and the Consultation Paper.[29]

Yet, throughout the process of changing its approach to the endorsement regime,[30] including in this Consultation Paper, ESMA has stated that the clearest path to achieving "as stringent as" status has been to "directly fulfil the requirements set out in the relevant endorsement provisions of CRAR".[31] Its approach is both inconsistent with the spirit of CRAR and "does not reflect the principle that the same outcome can be achieved through different means".[32]

If there is no transparency regarding the framework ESMA applies to the "as stringent as" test, then CRAs remain blind to ESMA's supervisory approach, and their ability to discuss the appropriateness or relevance of individual policies is effectively blocked. In this regard, we encourage ESMA to take an outcomes-based approach that is consistent with the CRAR, recognises that one size does not fit all, and focuses on the key attributes important to the endorsement regime.

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interest with respect shareholders and directors; the methodology review process; reporting methodological errors; the treatment of confidential information; the definition of "unsolicited"; look-back reviews, and record-keeping.

27 Recital 13, CRA1.

28 ESMA Final Report on Update of the guidelines on the application of the endorsement regime under Article 4(3) of the Credit Rating Agencies Regulation (17 November 2017)(ESMA33-9-205).

29 Paragraph 9, Consultation Paper.

30 *See* Paragraph 12, Consultation Paper on Update of the guidelines on the application of the endorsement regime under Article 4(3) of the Credit Rating Agencies Regulation (4 April 2017) (ESMA33-9-159).

31 Paragraph 13, Annex I, Consultation Paper; s*ee also* Paragraph 15, Consultation Paper ("Where no alternative internal requirement is provided in these Guidelines, ESMA recommends that the endorsing CRA ensures that the third-country CRA directly fulfils the requirements set out in the relevant endorsement provisions of CRAR."); Section 6 ("Cost Benefit Analysis"), Paragraph 6, Consultation Paper ("For those CRAs who currently endorse credit ratings from third-country CRAs by directly implementing all the requirements set out in the relevant endorsement provisions of CRAR, ESMA's Guidelines on Endorsement, and consequently these supplementary Guidelines will have no impact on initial or ongoing costs.").

32 Section III ("CESR's Approach to Assessing Equivalence") of CESR Technical Advice to the EC on Equivalence (2010).

C. Unclear about its future applicability

> *"Where no alternative internal requirement is provided in these Guidelines, ESMA recommends that the endorsing CRA ensures that the third-country CRA directly fulfils the requirements set out in the relevant endorsement provisions of CRAR."*[33]

It appears that unless explicitly identified in the Consultation Paper, all policies that are used in the EU, either now or in the future, will be assumed to be exported outside of the EU.[34] Arguably, therefore, provisions such as those that relate to CRA governance and discrete disclosure requirements - which are clearly dictated by local regulatory requirements – would need to be applied verbatim by the third-country CRA. Such an outcome would place CRAs in the untenable position of disregarding local requirements in favour of those of the EU.

Indeed, the Consultation Paper makes clear that the default position going forward is that the endorsing CRA should ensure that the third-country CRA directly fulfils all of the requirements set out in the relevant endorsement provisions of CRAR. This is tantamount to agreeing to export all future EU adjustments to CRA supervision, even in instances where such changes or modifications in rules either pose direct contradictions or where other jurisdictions have indicated a preference for their own approach. CRAs would find it hard to commit today to implement tomorrow changes that they neither know about nor understand, and that may put them at odds with their local authorities.

Alternatively, ESMA's language could be read as leaving the assessment of whether third-country CRAs' individual policies are "as stringent as" to the endorsing CRA. We assume this is not what ESMA intended. Such an interpretation would clearly obviate the need for this Consultation Paper, leaving uncertainty in the regulatory landscape with haphazard interpretation and implementation across the industry.

EU CRA CONTROL ENVIRONMENT

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 by the endorsing CRA for the quality of endorsed credit ratings. In turn, ESMA would be empowered to oversee the endorsing CRA's application of these standards.

Below, we provide our proposal regarding the control and monitoring framework for endorsement.

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[33] Paragraph 15, Consultation Paper.

[34] Paragraphs 14-15, Consultation Paper.

A. Endorsing CRA's Ongoing Monitoring and Reporting of Third-country CRA

Leveraging the endorsing CRA's global internal control infrastructure, the endorsing CRA[35] would establish a monitoring system to receive ongoing reports regarding the third-country CRA's control environment to be satisfied that endorsed credit ratings are produced in accordance with standards that are "as stringent as" the CRAR. To the extent such assurances are not provided, the endorsing CRA would be empowered to address consequences, up to and including cessation of endorsement. The three components of an effective reporting and monitoring process are:

1) Gathering of relevant information on a routine basis.

The endorsement guidelines[36] require that endorsing CRAs monitor the conduct of the third-country CRA through basic automated checks, periodic deep dive assessments of the compliance of a sample of endorsed credit ratings with specific requirements or areas of requirements and/or review of documentation produced by the key control functions of the third-country CRA.[37] 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 a potential material breakdown of control processes that support the underlying quality of independence of credit ratings produced by the third-country CRA, the reports could also enable the endorsing CRA to request additional information to further assess the nature and scope of the potential issue.

2) Establishing an infrastructure to analyse the information gathered.

The endorsing CRA's 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.[38] Once this information is compiled and fully analysed, it would then be ready for further senior level review.

3) Creating 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

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35 The Consultation Paper defines an "endorsing CRA" as 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.

36 ESMA Final Report on Update of the guidelines on the application of the endorsement regime under Article 4(3) of the Credit Rating Agencies Regulation (17 November 2017)(ESMA33-9-205).

37 Consultation Paper, Part 5, Paragraph 14(b).

38 Consultation Paper, Part 5, Paragraph 16.

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 oversight by the board of directors in the EU. To the extent the endorsing CRA identifies material or systemic failures impacting the quality of endorsed credit ratings produced by a third-country CRA, senior management of the endorsing CRA would make a decision on whether to validate or 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. The endorsing CRA 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.

B. Supervision

If taken, these actions would address ESMA's three principal concerns with the endorsement framework.[39] First, endorsing CRAs would have a process in place that would allow them to effectively verify third-country CRA compliance with standards that are as stringent as those of the EU. 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.

ESMA would, of course, 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.

[39] *See* FN11.

II. CRAR Requirements Relating to Fees Charged by CRAs

ESMA's position: ESMA recognises that it is currently the only jurisdiction with legislation in place to determine how fees should be charged for credit ratings and ancillary services. However, the overall objectives of these provisions, to mitigate conflicts of interest and foster fair competition in the CRA industry, are present in the legislation in force in many other jurisdictions. As such, ESMA believes that CRAs should already be monitoring the fees that they charge and ensuring that they achieve these objectives. As CRAs have not identified alternative internal requirements, ESMA recommends that endorsing CRAs should ensure that the third-country CRA fulfils the EU rules.[40]

MIS disagrees with ESMA's position.

The underlying objective of the CRAR fee provision[41] (the "Fee Provision") as relevant for endorsement purposes, is to mitigate conflicts of interest, and it is thoroughly and rigorously satisfied in the rules of every jurisdiction in which MIS operates. As a result, all of our third-country CRAs have appropriate alternative policies in place in the appropriate areas. Indeed, the proposed supplementary guidance for the CRAR fee provisions is the most confusing and difficult to reconcile provision addressed by the Consultation Paper for five reasons.

1. ESMA asserts that the EU's CRA legislation "determines *how* fees should be charged".[42]

This has not been our understanding. Price regulators determine how fees should be charged, and in numerous forums ESMA has stated unequivocally that it is not a price regulator. A shift in ESMA's oversight of the CRA industry from securities market regulation to price regulation would be consequential. Such a far-reaching change in approach demands a broader public policy debate and should not be relegated to a tangential discussion in a consultation paper aimed at providing supplementary guidance on the endorsement regime.

More pointedly, price regulation and the incentives it would create in our industry would be inconsistent with existing rules in other jurisdictions, and would not be transportable (see below, point 3).

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40 Paragraph 23, Consultation Paper.

41 Paragraph 3c of Section B of Annex I of the CRAR states: "A credit rating agency shall ensure that fees charged to its clients for the provision of credit rating and ancillary services are not discriminatory and are based on actual costs. Fees charged for credit rating services shall not depend on the level of the credit rating issued by the credit rating agency or on any other result or outcome of the work performed".

42 Paragraph 23, Consultation Paper ("ESMA recognises that it is currently the only jurisdiction with legislation in place to determine how fees should be charged for credit ratings and ancillary services".).

2. ESMA states that the overall objective of the Fee Provision is to mitigate conflicts of interest and to foster fair competition.[43]

The Consultation Paper cites recital 38 of CRA3 and explains that "this requirement aims to mitigate conflicts of interest and facilitate fair competition in the credit rating industry".[44] To the extent this provision is understood as a measure to mitigate conflicts of interest, it is appropriate to consider it in the endorsement context. Accordingly, the associated internal requirements must aim exclusively at managing conflicts of interest.

If, on the other hand, the intent of the provision is to regulate competition, pricing, economics of the CRA industry or other market structure issues, it would be beyond the bounds of the endorsement regime. Recital 48 of CRA3 makes clear that "provisions that relate to the structure of the credit rating market within the [EU]…should not be considered in [the endorsement] context."[45]

3. ESMA acknowledges that the objective of the Fee Provision is met by other jurisdictions.

> *"It is important to recall in this respect that a third-country regulatory regime does not have to have identical rules as those provided for in this Regulation. As already provided for in Regulation (EC) No 1060/2009, in order to be considered equivalent to or as stringent as the Union regulatory regime, it should be sufficient that the third-country regulatory regime achieve the same objectives and effects in practice."*[46]

It remains unclear why ESMA insists on exporting this specific CRAR provision when it accepts that the objectives are met by other countries. This is particularly problematic with respect to fair market rules. Those objectives are not under the exclusive domain of industry specific regulation or regulator. Rather, they fall to competition law and anti-trust regimes in the third countries.

Further, in interpreting the Fee Provision, ESMA states that it will also look to recital 38.[47] CRAs will encounter significant difficulties exporting this provision or its internal requirements if the recital and the provision together are taken as a means of:

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[43] It is worth noting that ESMA's Thematic Report on Fees Charged by Credit Rating Agencies and Trade Repositories (11 January 2018) (ESMA80-196-954) focuses almost entirely on pricing and competitive dynamics. It is not focused on the need to enhance or strengthen measures to prevent/mitigate conflicts of interest.

[44] Paragraph 21, Consultation Paper.

[45] Recital 48, CRA3 ("In addition [to those provisions that only establish obligations on issuers], provisions that relate to the structure of the credit rating market within the Union rather than establishing rules of conduct for credit rating agencies should not be considered in [the endorsement] context".).

[46] Recital 48, CRA3.

[47] Recital 38, CRA3 states:

"In order to further mitigate conflicts of interest and facilitate fair competition in the credit rating market, it is important to ensure that the fees charged by credit rating agencies to clients are not discriminatory. Differences in fees charged for the same type of service should only be justifiable by a difference in the actual costs in providing this service to different clients. Moreover, the fees charged for credit rating services to a given issuer

- denying customers' the right to negotiate, and / or
- skewing the incentive structure of the CRA industry away from investing in its systems, increasing efficiencies, or otherwise decreasing costs.[48]

Such an outcome would contradict existing laws in a number jurisdictions, as well as create practical and operational hurdles for CRAs and their customers. For example, U.S. law not only permits, but in fact encourages price competition and individualised price negotiations between sellers and buyers of goods.[49] Any requirement that CRAs charge inflexible fees, regardless of the customers' demands, would impinge upon both the CRAs' and the customers' rights under U.S. competition laws.[50]

4. Notwithstanding the above, ESMA states that CRAs have not identified alternative internal requirements.

It is inaccurate to say that third-country CRAs do not have policies or procedures to mitigate conflicts of interest. As ESMA notes, *"CRAs should already be monitoring the fees that they charge and ensuring that they achieve these objectives."*[51]

Indeed, CRAs are required to monitor the interaction of fees and the independence of credit ratings. Surveying the current global regulatory environment illustrates the clear expectations imposed on CRAs in managing the potential conflicts of commercial activities upon analytical activities. First, the *IOSCO Code of Conduct Fundamentals for Credit Rating Agencies* includes, at a minimum, six provisions directly achieving the objectives of the CRAR[52]. Notwithstanding the approach proposed by ESMA here, EU policymakers typically consider application of IOSCO standards highly relevant when assessing the

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should not depend on the results or outcome of the work performed or on the provision of related (ancillary) services. Furthermore, in order to allow for the effective supervision of those rules, credit rating agencies should disclose to ESMA the fees received from each of their clients and their general pricing policy."

48 As discussed on previous occasions with ESMA, if this rules were to be interpreted so that CRAs could only increase fees in lock-step with cost increase, a very corrosive incentive will be introduced into the industry's market structure whereby some CRAs will be disinclined to decrease costs (e.g., by replacing old or inefficient systems) and in turn negatively impact ratings quality.

49 In a line of cases re-affirmed in 2009, the US Supreme Court has recognized a broad right of individual business to price their products as they choose—so long as those prices are above cost. See, e.g., Pac. Bell Tel. v. linkLine Comm., 129 S. Ct. 1109, 1118 (2009) ("As a general rule, businesses are free to choose the parties with whom they will deal, as well as the prices, terms, and conditions of that dealing."). Indeed, even the US law that is specifically directed at price discrimination, the Robinson-Patman Act, which prohibits price discrimination only with respect to goods and does not apply to services such as credit ratings, "does not 'ban all price differences charged to different purchasers of commodities of like grade and quality'" but rather prohibits price discrimination "only to the extent that it threatens to injure competition". Volvo Trucks N. Am., Inc. v. Reeder-Simco GMC, Inc., 5546 U.S. 164, 176 (2006) (quoting Brooke Group Ltd. v. Brown & Williamson Tobacco Corp., 509 U.S. 209, 220 (1993)).

50 EU law may reach extraterritorial conduct only if it "has anticompetitive effects liable to have an impact on the EU market". Case C-413/14 P Intel v Commission, ¶ 45.

51 Paragraph 23, Consultation Paper.

52 IOSCO Code of Conduct Fundamentals for CRAs: 2.2, 2.3, 2.4, 2.5, 2.6, and 2.13.

stringency of regulatory requirements.[53] Importantly, the IOSCO provisions have been incorporated into the CRA regulatory frameworks of the third-countries currently eligible for endorsement.[54]

Second, third-country CRA regulatory frameworks also include additional specific measures designed to eliminate, manage or disclose potential conflicts of interest. In fact, the Consultation Paper acknowledges that many other jurisdictions have legislation in force "to mitigate conflicts of interest and foster fair competition in the CRA industry".[55]

Finally, for MIS's part, we have a comprehensive set of global internal requirements, policies and procedures that together work to ensure fees charged of customers do not impact the independence of our analytical process. Despite previous assurances to the contrary[56], ESMA has adopted an approach that discounts these measures.

For a full list of the relevant IOSCO Code provisions which have been incorporated in the third-country legislation, examples of additional third-country provisions, and MIS's internal policies and procedures, please see Part V.

5. ESMA makes a leap of logic that CRAs should nevertheless export the Fee Provision; however, ESMA has yet to decide how it should be administered.

As ESMA indicates, it "has recently published a Thematic Report on Fees charged by Credit Rating Agencies and Trade Repositories",[57] but it has not yet articulated how it expects CRAs to interpret the Fee Provision. Indeed, ESMA has made clear that its administration of the Fee Provision is a work in progress, and that it will engage market feedback as well as gathering additional information from CRAs to better understand the fee practices of the industry.[58] Consequently, to recommend that CRAs export a provision and associated internal requirements that have yet to be determined is at best premature.

In summary, by declining to issue a guideline and instead recommending direct application of a CRAR provision, ESMA has taken a different approach for this provision than from other areas where CRAR provisions are also known by ESMA to be different from and super-equivalent to

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53 *See e.g.* Articles 30 and 32 of the Regulation (EU) 2016/1011 of the European Parliament and of the Council of 8 June 2016 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds and amending Directives 2008/48/EC and 2014/17/EU and Regulation (EU) No 596/2014 (Text with EEA relevance).

54 These third-countries include Argentina, Australia, Brazil, Canada, Hong Kong, Japan, Mexico, Singapore, South Africa, and the United States.

55 Paragraph 23, Consultation Paper.

56 "For groups of CRAs which have implemented global policies and procedures and for whom divergences across CRAs in different jurisdictions are minor and of the same level of stringency, ESMA does not expect that these guidelines will have a material impact." Paragraph 21, ESMA Final Report on the Update of the guidelines on the application of the endorsement regime under Article 4(3) of the Credit Rating Agencies Regulation (17 November 2017) (ESMA33-9-205).

57 Paragraph 24, Consultation Paper.

58 Paragraphs 69-74, ESMA Thematic Report on Fees Charged by Credit Rating Agencies and Trade Repositories (11 January 2018) (ESMA80-196-954).

rules in third-countries.[59] Indeed, for a third-country requirement to be interpreted by ESMA as "as stringent as", nothing in ESMA's 2010 founding regulation,[60] or under EU law more broadly, either:

(i) compels ESMA to determine that the third-country requirement has to be textually identical to the corresponding EU rule; or

(ii) prevents ESMA from determining that a third-country requirement that ESMA considers "as stringent as" ostensibly sets a "lower" standard on paper as compared with the corresponding EU requirement, provided that a similar outcome is produced and the fundamental and overarching objectives are adequately safeguarded.

ESMA's own approach to guidelines on analyst rotation and the 24-hour rule amply demonstrates that ESMA does understand this to be the case, and that ESMA can interpret the "as stringent as" requirement with an outcomes-based perspective. We would recommend that ESMA apply similar logic to the question of guidelines concerning fees and conflicts.

[59] ESMA has put forward guidelines on "as stringent as" in areas where ESMA knows that third country provisions are often lighter and more flexible than EU provisions but where outcomes are similar. *See* Paragraph 64, Consultation Paper ("CRAs do not undertake rotation of analysts outside the EU using the same policy/procedure as in the EU…the EU rules on analyst rotation are more restrictive and detailed than in most third-country regimes, in particular regarding the timing of rotation and the type activities that can be performed by analysts during the cool off period".); *see also* Paragraph 80, Consultation Paper (describing 24-hour rule implementation outside of the EU).

[60] Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC.

III. Alternative Four-Part Framework

Below, we offer a simple and transparent four-part framework that can be applied consistently and coherently for those EU provisions, and in turn CRA internal controls, that must meet the "as stringent as" test under the CRAR.

1. **Is the rule in question important from a prudential / systems perspective?**

   Endorsed ratings are used for regulatory purpose by EU's prudential authorities to oversee the safety and soundness of the financial system. The quality of credit ratings is the key – possibly the only – attribute that is relevant for the purposes of the endorsement regime. CRAR makes clear that only a subset of it is relevant in the endorsement context. Those that support independence are of primary relevance, presumably because they work together to support ratings quality. Importantly, rules that address EU market structure (and by extension other industry-level market operations aspects) should be explicitly excluded.

   Depending on the answer to this question, ESMA would next ask,

2. **Does the third-country regulation have a corresponding or similar provision?**

   The independence and quality of credit ratings are at the heart of the regulations under which CRAs operate globally. However, securities regulators have adopted slightly different versions of the provisions. The great majority of the specific rules are very similar, but there are some differences. To the extent there are differences, ESMA should assess whether – and if so, how – the differences undermine CRA independence and ratings quality.

   Depending on the answer to this question, ESMA would next ask,

3. **Does the third-country CRA have alternative internal requirements that are supportive of the key attribute relevant to the endorsement regime?**

   There are many permutations of policies and procedures that bolster independence, and in turn, ratings quality. A one-size-fits-all approach should not be the default.

   CRAR clearly and specifically envisions an outcome-based / principles-based approach for the endorsement regime. ESMA can look to whether the third-country CRA has alternative policies and procedures that, while not directly on point with respect to the specific rule in question, would nevertheless address the rule's objectives within the context of the endorsement regime.

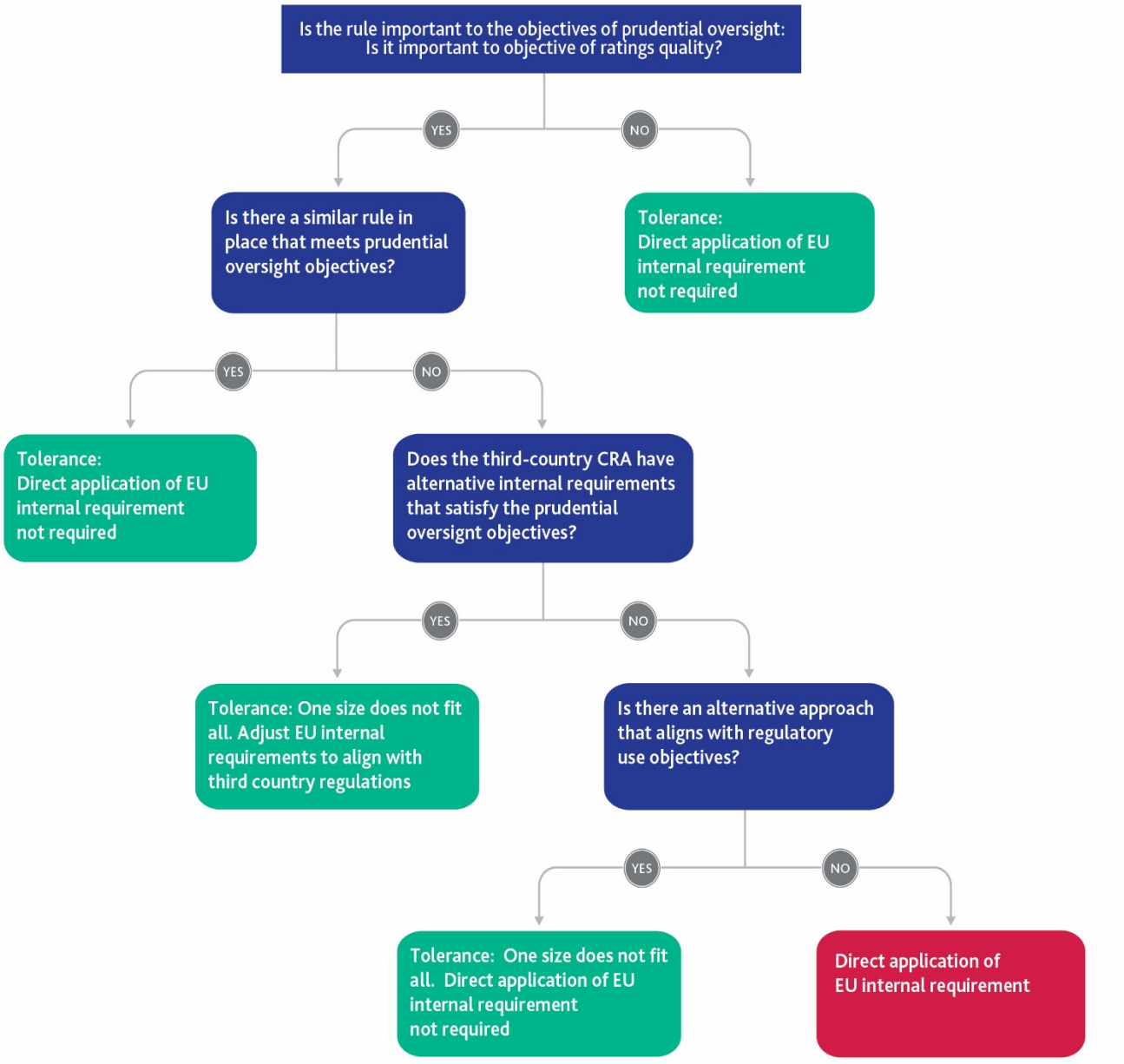
   Depending on the answer to this question, ESMA would next ask,

4. **Is there an alternative approach that aligns with regulatory use objectives?**

   To the extent an alternative approach is not currently in place, ESMA can look to whether the third-country CRA can implement an alternative approach that is consistent with the purpose of the endorsement regime and regulatory use objectives, namely ratings quality.

If the alternative approach meets those objectives, direct application of the EU provision should not be required.

By using this decision tree, ESMA will be able to meet its stated goal of appropriately supervising the endorsement regime, while simultaneously providing CRAs with a tool to understand why direct and verbatim exportation may be appropriate for certain CRAR provisions but not for others.



IV. Application of MIS' Suggested Four-Part Framework

✓ **Applies** — **Somewhat applies** X **Does not apply**

EU Provision	EU Objective	ESMA Recommends	1. Does the rule support regulatory use objectives?	2. Does 3rd country rules have same objective?	3. Does MIS have policies supporting objective	4. CRAR Application / Alternative Suggestion	Rationale for Application / Alternative Suggestion
Fees Charged to be Non-Discriminatory and Based on Actual Costs	1) Conflict of interest 2) Fair competition	Verbatim application to third-country	✓ Conflict of interest X Fair competition	✓ Conflict of interest	✓ Conflict of interest	**Not applied globally** **Alternative Suggestion:** Adoption of relevant Conflict of Interest provisions, rules and policies. See Part V.	See discussion in Part II.
Reporting of Fees and Pricing Policy	To support above	Some variability in information reported	✓ Conflict of interest X Fair competition	✓ Conflict of interest	✓ Conflict of interest	**Not applied globally** **Alternative Suggestion:** Adoption of relevant Conflict of Interest provisions, rules and	See discussion in Part II.

EU Provision	EU Objective	ESMA Recommends	1. Does the rule support regulatory use objectives?	2. Does 3rd country rules have same objective?	3. Does MIS have policies supporting objective	4. CRAR Application / Alternative Suggestion	Rationale for Application / Alternative Suggestion
						policies. See Part V.	
SF Indicator	1) Investor Transparency[61] (awareness of structured finance complexities) 2) Market Structure (indirectly increase competition among CRAs)	Verbatim application to third-country	X Investor Transparency X Market Structure	✓ Investor Transparency	✓ Investor Transparency	**Not applied globally** **Alternative Suggestion:** Disclose whether the instrument qualifies as a structured finance instrument under EU regulation.[62]	1) Direct adoption would be inconsistent with similar third-country requirements. 2) Market structure reasons are inappropriate.
Solicitation	1) Regulatory Transparency (no abuse of unsolicited ratings)[63]	Verbatim application to third-country	✓ Regulatory Transparency	✓ Regulatory Transparency	✓ Regulatory Transparency	**Applied Globally[64]** **Alternative Suggestion: N/A**	In line with the Basel Committee requirements regarding disclosure of

[61] MIS notes a distinction between transparency intended to serve regulatory use objectives and transparency intended to serve capital market investor protection objectives. MIS fully supports measures intended to serve investor protection objectives, but the endorsement regime is specifically intended to support regulatory use of credit ratings and ratings quality, rather than bespoke EU transparency requirements intended for capital market investor protection (e.g. the SF indicator; colour-coding).

[62] Disclosure provided in rating announcement or other publicly available disclosure document.

[63] See FN 23.

[64] Note that Japan's unique criteria for defining unsolicited credit ratings may require specific disclosures.

EU Provision	EU Objective	ESMA Recommends	1. Does the rule support regulatory use objectives?	2. Does 3rd country rules have same objective?	3. Does MIS have policies supporting objective	4. CRAR Application / Alternative Suggestion	Rationale for Application / Alternative Suggestion
							unsolicited ratings.
Participation Status (Colour Code)	1) Investor Transparency (awareness of CRA/rated entity relationship)	Not applied to third-country	X Investor Transparency	✓ Investor Transparency	✓ Investor Transparency	**N/A**	**N/A**
Transparency Report	1) Investor Transparency 2) Regulatory Transparency	Endorsing CRA should include information about its endorsed credit ratings in its own transparency report	X Investor Transparency ✓ Regulatory Transparency	✓ Investor Transparency – Regulatory Transparency	✓ Investor Transparency – Regulatory Transparency	**Applied Globally**[65] **Alternative Suggestion: N/A**	Endorsed credit ratings will be made available in the EU by the endorsing CRA; appropriate for certain information to be made available in the endorsing CRA's transparency report.
Initial Assessments and	1) Ratings Quality (Prevention of	Not applied to third-country, provided steps are taken by	✓ Ratings Quality	✓ Ratings Quality Prevention of rating shopping	✓ Ratings Quality Prevention of rating shopping	**N/A**	**N/A**

[65] The endorsing CRA will include relevant information about endorsed credit ratings from third-country CRAs.

EU Provision	EU Objective	ESMA Recommends	1. Does the rule support regulatory use objectives?	2. Does 3rd country rules have same objective?	3. Does MIS have policies supporting objective	4. CRAR Application / Alternative Suggestion	Rationale for Application / Alternative Suggestion
Preliminary Ratings	rating shopping)	third-country CRA to mitigate rating shopping					
Review of Methodologies	1) Ratings quality	Verbatim application to third-country	✓ Ratings quality	– Ratings quality	– Ratings quality	**Applied Globally** **Alternative Suggestion: N/A**	The EU approach to methodology review supports ratings quality objective.
Reporting Errors in Methodologies	1) Support above objective	Verbatim application to third-country, but reportable by endorsing CRA or third-country CRA	✓ Ratings quality X Investor transparency	✓ Ratings quality	✓ Ratings quality	**Modified Global Application** Endorsing CRA reports to ESMA material errors related to endorsed credit ratings.[66]	MIS agrees that ESMA should be notified when there are methodological errors that result in assigning wrong credit ratings.
Analyst Rotation	1) Ratings quality (fresh perspective) 2) Conflicts of Interest	Modified application to third-country	✓ Ratings quality (fresh perspective) ✓ Conflicts of Interest	– Ratings quality (fresh perspective) ✓ Conflicts of Interest	– Ratings quality (fresh perspective) ✓ Conflicts of Interest	**Modified Global Application** Lead analyst will rotate on a periodic basis	Analyst rotation is supportive of ratings quality because it provides a fresh perspective.

[66] A "material error" is a methodological error that results in a change to the credit rating.

EU Provision	EU Objective	ESMA Recommends	1. Does the rule support regulatory use objectives?	2. Does 3rd country rules have same objective?	3. Does MIS have policies supporting objective	4. CRAR Application / Alternative Suggestion	Rationale for Application / Alternative Suggestion
						to ensure fresh perspective (e.g. 6 years).	
Shareholding	1) Conflicts of interest	Verbatim application to third-country	✓ Conflicts of Interest	– Conflicts of Interest	– Conflicts of Interest	**Modified Global Application** Third-country CRA will disclose when a shareholder holds more than 10% of its capital or the voting rights.	CRAR explicitly excludes obligations placed on third parties.
Look-Back Reviews	1) Conflicts of Interest	Verbatim application to third-country	✓ Conflicts of Interest	– Conflicts of Interest	– Conflicts of Interest	**Applied Globally** **Alternative Suggestion: N/A**	Not all countries have this provision; MIS agrees that the EU approach is supportive of conflict management objectives.
24-hour Rule	1) Ratings Quality	Modified application to third-country	✓ Ratings Quality	✓ Ratings Quality	✓ Ratings Quality	**N/A**	**N/A**

EU Provision	EU Objective	ESMA Recommends	1. Does the rule support regulatory use objectives?	2. Does 3rd country rules have same objective?	3. Does MIS have policies supporting objective	4. CRAR Application / Alternative Suggestion	Rationale for Application / Alternative Suggestion
Inside Information	1) Conflicts of Interest	Not applied to third-country	✓ Conflicts of Interest	✓ Conflicts of Interest	✓ Conflicts of Interest	**N/A**	**N/A**
Protection of Confidential Information	1) Conflicts of Interest	Verbatim application to third-country	✓ Conflicts of Interest	✓ Conflicts of Interest	✓ Conflicts of Interest	**Applied Globally** **Alternative Suggestion: N/A**	The EU approach is supportive of conflict management objectives.
Record Keeping	1) Conflicts of Interest 2) Ratings Quality	Verbatim application to third-country	✓ Conflicts of Interest ✓ Ratings Quality	✓ Conflicts of Interest ✓ Ratings Quality	✓ Conflicts of Interest ✓ Ratings Quality	**Applied Globally** **Alternative Suggestion: N/A**	The EU approach is consistent with those of other countries and is supportive of ratings quality and conflict management objectives.

V. Current Measures that Address CRAR Objectives

For those provisions that MIS recommends not applying EU's rules and policies, below please find existing code provisions, regulatory rules, and MIS policies that we believe satisfy the EU's underlying endorsement-relevant objectives.

EU Rule and Objectives	Existing International, Third-Country[67] and MIS Measures
Fees charged to be non-discriminatory and based on actual costs ➢ Conflict of interest	IOSCO Code of Conduct Fundamentals for CRAs: Paragraphs 2.2, 2.3, 2.4, 2.5, 2.6 and 2.13 United States: SEC Rule §240.17g-5(c)(8) Argentina: Article 83(b)(2) of CNV Regulation Hong Kong: Provision 2.2 of the Code for Persons Licensed by or Registered with the SFC MIS Code of Professional Conduct: Paragraphs 2.2, 2.3, 2.4, 2.5, 2.11 and 2.12 MIS Policy for Fee Discussions MIS Procedure for Handling Receipt of Fee Related Information MIS Policy for the Separation of Credit Rating Personnel from Commercial Information and Activities MIS Policy Prohibiting Sales and Marketing by Credit Rating Personnel.
Reporting of fees and pricing policy ➢ To support above	As above.
SF Indicator ➢ Investor Transparency (awareness of SF complexities)	IOSCO Code of Conduct Fundamentals for CRAs: Paragraph 3.7 Hong Kong: Paragraph 53 of the SFC Code of Conduct for CRAs South Africa: Provision 18(5) of the Credit Rating Services Act of 2012 Mexico: Annex 1, Section II, Subsection (A), Item 9 of the Mexico National Banking and Securities Commission's General Rules Applicable to Securities Rating Institution
Reporting errors in methodologies	IOSCO Code of Conduct Fundamentals for CRAs: Paragraphs 1.1, 1.13, 1.15, and 3.3 United States: SEC Rule §240.17g-8(a)

[67] Not intended to be an exhaustive list. These provisions are intended to serve as examples of measures currently in place in third-country jurisdictions that are responsive to the CRAR and regulatory use objectives.

EU Rule and Objectives	Existing International, Third-Country[67] and MIS Measures
➢ Support objectives of related CRAR provision for the review of methodologies ➢ Ratings quality ➢ Investor protection	Canada: NI 25-101 (Designated Rating Organizations): Paragraphs 2.2, 2.9, 2.11, 2.12, 2.25, and 4.15 Hong Kong: SFC Code of Conduct for CRAs: Paragraphs 5, 12, 13, 16, and 59 MIS Code of Professional Conduct 1.2, 1.7, 1.9, and 3.13
Shareholding ➢ Conflicts of interest	IOSCO Code of Conduct Fundamentals for CRAs: Paragraphs 2.1, 2.2, 2.3, 2.4, and 2.6(e) Hong Kong: SFC Code of Conduct for CRAs: Paragraphs 26, 27, 28, 29, 32, and 33 Canada: NI 25-101 (Designated Rating Organizations): Paragraphs 3.1, 3.2, 3.3, 3.4, 3.7, and 3.8 Singapore: MAS Code of Conduct for CRAs: Paragraphs 5.1, 5.2, 5.3, 5.4, 6.1 and 6.2 MIS Code of Professional Conduct 2.6(e) MIS Policy on Shareholding MIS Procedure on Shareholding MIS Policy Prohibiting MIS from Rating MCO