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ESMA Consultation Paper - 19 December 2024– Guidelines on Internal Controls for Benchmark Administrators, Credit Rating Agencies and Market Transparency Infrastructures
Reference # ESMA80-1286971524-661
Response Scope Ratings GmbH

Dear Sir or Madam,

Scope Ratings appreciates the opportunity to respond to the European Securities and Markets Authority (ESMA) consultation paper on Guidelines on Internal Controls for Benchmark Administrators, Credit Rating Agencies and Market Transparency Infrastructures, dated 19 December 2024.

This document provides detailed responses to the questions posed by ESMA. Our responses aim to contribute to the ongoing dialogue and ensure that the CRA regulatory reporting framework remains robust and effective.

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Executive Summary

Scope Ratings seeks clarification on ESMA's Consultation Paper regarding internal controls and risk management on the following key points:

- **Risk appetite:** Scope Ratings would appreciate further clarification on how risk appetite and tolerance levels should be set and assessed.
- **Methodology development & implementation:** Scope Ratings recommends allowing methodology developers to participate in implementation while ensuring conflict management through governance structures.
- **Proportionality in risk management & internal controls:** Further guidance on intra-group outsourcing, internal audit expectations, and proportionality criteria (e.g., portfolio size, revenue, staff size) would be welcomed.
- **Internal Audit:** Scope Ratings proposes safeguards for independence, clearer third-party risk assessment expectations, minimum audit cycles, and formalized follow-up procedures.
- **Internal Control expectations:** Clarification would be appreciated on demonstrating IC existence and effectiveness, including required documentation, testing, and timelines.
- **Additional considerations:** Scope Ratings would like to underline that strong coordination among IC functions, use of data analytics in audits, and recognition of Internal Audit's advisory role is beneficiary to the whole CRA organisation.

Part 1: Internal Control Framework

Component 1.1 Control Environment

A supervised entity's Management Body and executive senior management both contribute to establishing the tone at the top regarding the importance of internal control. The executive senior management is responsible for the development and performance of internal control and assessing the adequacy and effectiveness of the control environment. The Management Body should exercise oversight of executive senior management in these areas.

Characteristics

1.1.1 The supervised entity's executive senior management should establish a strong culture of ethics and compliance within the supervised entity through the implementation of policies and procedures that govern the conduct of the supervised entity's staff

1.1.2 The supervised entity's executive senior management should ensure that the supervised entity's policies and procedures:

- i. Specify that the supervised entity's business should be conducted in compliance with the relevant Regulations and with the supervised entity's corporate values;

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ii. Clarify that in addition to the compliance with legal and regulatory requirements and internal policies, staff are expected to conduct themselves with honesty and integrity and perform their duties with due skill, care and diligence; and

iii. Ensure that staff are aware of the potential internal and external disciplinary actions, legal actions and sanctions that may follow misconduct.

1.1.3 The supervised entity's executive senior management should establish, maintain and regularly update adequate written internal control policies, mechanisms and procedures.

1.1.4 The supervised entity's executive senior management should retain responsibility for activities outsourced to external service providers or delegated to business partners.

Component 1.2 Risk Management

Effective risk management framework should involve a dynamic and continuously evolving process for identifying, assessing and managing risks to the achievement of the supervised entity's main objectives. For example, this includes risks resulting from the supervised entity's use of new technologies and changes to its external risk landscape.

Characteristics

1.2.1 The supervised entity should conduct its internal risk assessments in accordance with a defined and comprehensive risk assessment methodology. This methodology should define and identify in advance the criteria and objectives against which the supervised entity's risks are going to be assessed.

1.2.2 The supervised entity should set its risk appetite and identify risk tolerance levels as part of the risk assessment process.

1.2.3 The supervised entity's risk assessment methodology should encompass all business lines and IC Functions of the supervised entity.

1.2.4 The supervised entity's risk assessment process should identify and assess changes that could significantly impact the system of internal control. This includes changes to its environment, organisation, activities and operations

1.2.5 The supervised entity's risk assessment methodology should be subject to continuous evolution and improvement

Component 1.3 Control Activities

These control activities should be preventative, detective, corrective or deterrent in nature.

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1.3.1 Segregation of Duties – The supervised entity should ensure appropriate segregation of duties to manage risks of conflicts of interest, fraud and human error. The segregation of duties should ensure that:

- i. Staff members responsible for carrying out a task are not responsible for approving the outcome of its exercise;
- ii. Staff members responsible for the development, implementation or approval of a task/work item are not responsible for validating, assessing and reviewing it ⁽¹⁾

Where this cannot be avoided, this should be mitigated by staff members not being exclusively responsible for the activity ⁽²⁾

Footnotes:

(1) For CRAs, (i) persons conducting the analysis of a credit rating should not be solely responsible for the approval of the credit rating, (ii) persons responsible for the development of credit rating methodologies should not be involved in their implementation; (iii) persons responsible for the validation, assessment or review of a credit rating methodology should not be involved in their development, implementation or approval.

(2) For instance, through a four-eyes check.

1.3.2 Documentation – The supervised entity should document its policies and procedures covering all areas of their business activities subject to the provisions of the relevant Regulations.

1.3.3 Documented Controls and Control testing – The supervised entity should document the key controls in place to ensure adherence to its policies and procedures relevant to the Regulations. The documentation of these controls should set out:

- i. A description of the control
- ii. The associated risk(s)
- iii. The role(s) or functions(s) responsible for performing the control
- iv. The role(s) or functions(s) responsible for reviewing the control
- v. The evidence that the control has been executed
- vi. The frequency of execution of the control
- vii. A description of the testing procedure

1.3.4 Designation of Responsibilities – The supervised entity should designate in a clear and defined manner the roles or functions responsible for carrying out controls relating to the obligations under the Regulations and specify their respective roles and responsibilities. In doing

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so, the supervised entity should distinguish between day-to-day controls at the business level and those carried out by specific control functions.

1.3.5 Authorisations and Approvals – The supervised entity should have authorisation processes to ensure that only authorised individuals have access to information and tools on a need to know and least privilege basis. The supervised entity should also have processes in all business activities to ensure that activities are approved and executed only by staff members acting within the scope of their authority.

Footnotes:

For instance, for CRAs, only the persons with appropriate authorisation should carry out the credit rating process, the validation of methodologies and the review of the results of validation.

1.3.6 Verifications, validations, reconciliations and reviews – The supervised entity should take measures to detect and act upon inappropriate, non-authorised, erroneous or fraudulent activities in a timely manner.

Footnotes:

This includes data validation and input controls, reviews of lists for authorised access to confidential information. For CRAs, such controls apply to, inter alia, credit rating activities and the processes underlying these activities such as credit methodology/model validation.

1.3.7 Information and Communication Technology (ICT) General Controls (only for supervised entities not subject to DORA) – The supervised entity should implement strategies, policies and procedures that ensure the digital operational resilience of the ICT systems of the supervised entity in supporting the supervised entity's business processes. The supervised entity should design its ICT controls and solutions proportionately. Therefore, ICT controls will vary among organisations depending on the nature, scale and complexity of the underlying business processes and of the relevant functions supported by those systems. Supervised entities should ensure that they have sufficient controls to ensure data quality, in terms of availability, confidentiality and integrity of data, including data validation, processing controls and data file control procedures. The supervised entity should establish relevant information security management system and related control activities. As part of this, a supervised entity should determine the necessary controls to ensure the authenticity, confidentiality, integrity and availability of information as it is processed from source to ultimate user. The supervised entity should establish and document all relevant ICT acquisition, development and maintenance processes control activities.

Component 1.4 Information and Communication

Supervised entities should establish procedures for the downward sharing of accurate, complete and good quality information to staff and external stakeholders. Supervised entities should also establish procedures for the regular reporting of information on the internal control system and

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activities to the Management Body and executive senior management including information relating to behaviour and adherence to internal controls.

Characteristics

1.4.1 The supervised entity should ensure appropriate internal and external communication, sharing accurate, complete and of good quality information in a timely manner to the market, clients, users of its services and regulators.

1.4.2 The supervised entity should establish upward communication channels, including a whistleblowing procedure, to enable the escalation of internal control issues to the Management Body and executive senior management. The Management Body and executive senior management should also receive regular updates about the internal control system and activities, including on information security. The supervised entity should have escalation procedures in case of disagreement between IC Functions and operating units.

1.4.3 The supervised entity should establish downward communication channels from the Management Body, executive senior management and control functions to the staff. This should encompass regular updates on the objectives and responsibilities for internal control, communication of identified compliance or information security issues and presentations and training on policies and procedures.

Component 1.5 Monitoring

Supervised entities should ensure that they undertake monitoring activities that will help ascertain whether the components of a supervised entity's internal control system are present and functioning effectively.

Characteristics

1.5.1 The supervised entity should ensure evaluations of the internal control system are carried out at different business levels of the supervised entity such as business lines, control functions and internal audit or independent assessment functions.

1.5.2 Monitoring activities should be designed and carried out in a way that enables the supervised entity to check whether the supervised entity is meeting its legal and regulatory requirements as well as adhering to its internal codes of conduct, policies and procedures. This includes the supervised entity's information security policies and procedures.

1.5.3 The evaluations of the internal control systems should be carried out on a regular or thematic basis or through a mix of both.

1.5.4 The supervised entities should build ongoing evaluations into the business processes and adjust them to changing conditions.

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1.5.5 The supervised entities should ensure that deficiencies identified from monitoring evaluations and the required remediation actions are reported to the Management Body and executive senior management who should then monitor the timely implementation of corrective action(s).

1.5.6 In the case of outsourcing, the supervised entity should allocate the task for monitoring outsourced business processes to a member of staff. Supervised entities should ensure that sufficient information concerning objectives and delivery expectations is provided to the service provider, and that due diligence is conducted prior to the appointment of the provider.

Questions for Respondents

Q1. Do you have any comments on the proposed Guidelines under the section on IC Framework? In providing your comments, please refer to the general principle, component and/or characteristic that you are commenting on.

Section 1.2.2

We would appreciate if ESMA could clarify their understanding of "setting the risk appetite and identifying risk tolerance levels as part of the risk assessment process". We understand that the Risk Appetite and respective tolerance/threshold levels are set and approved as part of the Risk Appetite Framework and subsequently used within the risk assessment process to compare the results of the assessment to respective Risk Appetite tolerance/threshold levels.

Section 1.3.1 footnote 1) (ii)

Scope Ratings recommends removing the sentence in (ii) and add "and vice-versa" in (iii) in this footnote 1).

In our view, and based on the principle of proportionality, "persons responsible" for development can also be involved in the implementation. It is even advisable that this happens to ensure adequate knowledge to achieve high quality ratings. Scope Ratings understands ESMA's concerns of having persons responsible for both the development and implementation of a methodology. Scope Ratings believes that these concerns are addressed with robust processes governing segregation of tasks to manage risk of conflicts of interest, fraud and human error, including, among other things, a first line only committee quorum for the approval of the methodology development and separate ones for the implementation of the methodology (rating committees). Second line is also solely and independently responsible to provide an approval for the first line to be able to use a new or updated methodology.

Q2. Are there any other comments you wish to raise on this section?

Further guidance on any objective measures to assess the proposed characteristics of the Risk Management function as per Section 1, and in line with the proportionality approach, would be appreciated.

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Point 1.3.1: At CRAs, staff members in charge of carrying out the analytical work of a credit rating should not be responsible for the approval of that credit rating. In addition, staff members responsible for the development of credit rating methodologies should not be involved in their implementation. Finally, staff members responsible for the development or implementation of credit rating methodologies should not be responsible for their review or validation.

We would suggest ESMA to clarify whether the intend to a) forbid Lead Analysts to be part of the voting quorum and, more importantly, b) forbid employees developing methodologies to be involved in their implementation. We understand for the consultation paper that Lead Analysts cannot be solely responsible for the approval of a credit rating and employees responsible for the development cannot be solely responsible for their implementation.

This would in our opinion reduce our efficiency and rating quality, especially the second item.

Part 2: Internal Control Functions

Component 2.1 Compliance Function

The compliance function of a supervised entity is responsible for monitoring and reporting on compliance of the supervised entity and its employees with its obligations under the relevant Regulation. The compliance function is responsible for following changes in the law and regulation applicable to its activities. The compliance function is also responsible for advising the Management Body on laws, rules, regulations and standards that the supervised entity needs to comply with and to assess, in conjunction with other relevant functions, the possible impact of any changes in the legal or regulatory environment on the supervised entity's activities.

Characteristics

2.1.1 The compliance function should perform its functions independently of the business lines and should provide regular reports to the supervised entity's Management Body, and where relevant, Independent Non-Executive Directors (INEDs).

2.1.2 The compliance function should advise and assist staff members to comply with the obligations under the relevant Regulation. The compliance function should be proactive in identifying risks and possible non-compliance through the timely monitoring and assessment of activities, as well as follow-up on remediation.

2.1.3 The compliance function should ensure that compliance monitoring is carried out through a structured and welldefined compliance monitoring programme. The scope of compliance activities needs to cover all the business and IT processes and systems that could affect the supervised entity's compliance with the relevant Regulation.

2.1.4 The compliance function should assess, and where appropriate in conjunction with other relevant functions, the possible impact of any changes in the legal or regulatory environment on

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the supervised entity's activities and communicate, as appropriate, with the risk management function on the supervised entity's compliance risk in a timely manner.

2.1.5 The compliance function should ensure that compliance policies are followed and should report to the Management Body and executive senior management on the supervised entity's compliance risk.

2.1.6 The compliance function should cooperate with the risk management function to exchange information necessary for their respective tasks.

2.1.7 The findings of the compliance function should be taken into account by the Management Body and executive senior management as well as by the risk management function within their risk assessment processes.

Component 2.2 Risk Management Function

Footnotes:

Where the supervised entity is part of a wider group, the group should ensure that its risk management function includes the activities of the EU-based supervised entities.

The risk management function of a supervised entity is responsible for the development and implementation of the risk management framework. It should ensure that risks relevant to its obligations under the Regulations are identified, assessed, measured, monitored, managed and properly reported by the relevant departments/functions within the supervised entity.

Characteristics

2.2.1 The risk management function should perform its functions independently of the business lines and units whose risks it oversees but should not be prevented from interacting with them.

2.2.2 The risk management function should ensure that all risks that could materially impact a supervised entity's ability to perform its obligations under the Regulation, or its continued operation, are identified, assessed, measured, monitored, managed, mitigated and properly reported by and to the relevant units within the supervised entity in a timely manner.

2.2.3 The risk management function should monitor the risk profile of the supervised entity against the supervised entity's risk appetite to enable decision-making.

2.2.4 The risk management function should provide advice on proposals and risk decisions made by business lines and inform the Management Body as to whether those decisions are consistent with the supervised entity's risk appetite and objectives.

2.2.5 The risk management function should recommend improvements to the risk management framework or/and amendments to risk policies and procedures where necessary. The risk

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management function should revisit risk thresholds in accordance with any changes in the organisation’s risk appetite.

Component 2.3 Information Security Management Function

The information security management function of a supervised entity is responsible for the development and implementation of information security within the supervised entity. A supervised entity should establish an information security function that promotes an information security culture within the supervised entity.

Characteristics

2.3.1 The information security management function should be responsible for reviewing and monitoring the supervised entity’s compliance with the supervised entity’s information security policies and procedures.

2.3.2 The information security management function should manage the supervised entity’s information security activities.

2.3.3 The information security management function should develop and deploy an information security awareness program for personnel to enhance the security culture and develop a broad understanding of the supervised entity’s information security requirements.

2.3.4 The information security management function should report to and advise the Management Body and executive senior management on the status of the information security management system and risks (e.g., information about information security projects, information security incidents and the results of information security reviews).

Component 2.4 Internal Audit Function

An internal audit function of a supervised entity is responsible for providing an independent, objective assurance and advisory activity designed to improve the organisation’s operations. It helps the organisation to accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of the internal control system.

Characteristics

2.4.1 The internal audit function should perform its functions independently of the business lines and other IC Functions. It should be governed by an internal audit charter that defines its role and responsibilities and is subject to oversight by the Management Body.

2.4.2 The internal audit function should follow a risk-based approach and adhere to international internal audit standards and leading practices.

2.4.3 The internal audit function should independently review and provide objective assurance that the supervised entity’s activities, including outsourced activities, are in compliance with the

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supervised entity's policies and procedures as well as with applicable legal and regulatory requirements.

2.4.4 The internal audit function should establish at least once a year, based on the annual internal audit control objectives, an audit plan and a detailed audit programme, which is subject to oversight by the Management Body.

2.4.5 The internal audit function should provide regular reports to the independent members of the Management Body or to the Audit Committee, if in place.

2.4.6 The internal audit function should communicate its audit recommendations in a clear and consistent way that allows the Management Body and executive senior management to understand the materiality of recommendations and prioritise accordingly.

2.4.7 Internal audit recommendations should be subject to a formal follow-up procedure by the appropriate levels of management to report on and ensure their effective and timely implementation.

Component 2.5 Review Function

The review function of a CRA is responsible for reviewing credit rating methodologies on at least an annual basis. The CRA's review function is also responsible for validating new methodologies and any changes to existing methodologies.

Characteristics

2.5.1 The review function should perform its functions independently of the business lines that are responsible for credit rating activities and should provide regular reports to the CRA's INEDs.

2.5.2 The CRA's shareholders or staff involved in business development should not perform the tasks of the review function.

2.5.3 Analytical staff should not participate in the approval of new, or validation and review of existing, methodologies which they have developed.

2.5.4 Review function staff should either be solely responsible or have the majority of the voting rights in the committees that are responsible for approving methodologies.

2.5.5 The Review function staff responsible for the validation and/or review of a methodology, who is also involved in its development phase, should not be solely responsible or have the majority of voting right in the approval committees.

2.5.6 In case of outsourcing of the Review Function, the supervised entity should take into account Characteristics 1.5.6 of Component 1.5 Monitoring Activities. This includes that the CRA should have suitable internal control mechanisms to ensure that the outsourced review function

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consistently adheres to regulatory requirements and maintains appropriate analytical quality standards.

Component 2.6 Oversight Function – *Not relevant*

The oversight function covers the main aspects of the provision of their benchmarks. This includes, but is not limited to, the review of the benchmark's definition and methodology, the management of third parties involved in the provision of the benchmarks, assessing internal and external audits or reviews of the administrator's control framework and reporting to the relevant competent authorities any relevant misconduct.

Characteristics

2.6.1 The BA Oversight Function is independent from any Management Body or function of the BA and any external party of the BA. Independence assumes there are no conflicts of interest between the other activities of the members of the Oversight Function and their duties required by the membership within the Oversight Function. The BA should implement an internal control operating framework to prevent and mitigate any potential conflict of interests.

2.6.2 The BA should have clear policies and procedures regarding the set-up and responsibilities of the Oversight Function and its members, including policies and procedures for benchmarks methodology updates and data integrity reviews.

2.6.3 The BA Oversight Function should regularly perform a self-assessment to evaluate its effectiveness and the fitness of its members for the purpose of the function and to identify potential conflicts of interests and propose areas of improvement, if necessary.

2.6.4 The BA Oversight Function should maintain a defined and regular communication channel with the Management Body, executive senior management and other key functions. The BA Oversight Function should be also able to access and challenge Management Information and receive updates regarding the status of remedial actions following internal and external audits, risk, and compliance reports.

2.6.5 The BA Oversight Function should maintain a defined and regular communication channel with the relevant competent authorities, including but not limited to reporting any misconduct or violation by administrators or contributors.

Questions for respondents

Q3. Do you have any comments on the proposed Guidelines under this section on IC Functions? In providing your comments, please refer to the general principle, component and/or characteristic that you are commenting on.

Section 2.2 (Footnotes)

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We would appreciate if ESMA would detail their understanding of “activities of the EU-based supervised entities”. We understand that, as Scope Ratings GmbH and Scope Ratings UK Ltd. are part of a wider Scope Group, (as per the proportionality approach) their Risk Management function includes activities of other entities of the Scope Group, but only the ones that directly impact on the operations and business activities of either Scope Ratings GmbH or Scope Ratings

Further guidance on the scope of the Risk Management function’s assessment in relation to intra-group outsourcing arrangements would be highly appreciated.

2.4.1 Independence: The emphasis on independence is essential to ensure Internal Audit remains free from conflicts of interest. In practice, reinforcing this requirement through explicit safeguards (reporting and compensation) could further enhance effectiveness.

2.4.3 Outsourced activities: the guidelines highlight Internal Audit’s role in reviewing outsourced activities. To strengthen the oversight, ESMA could consider specifying expectations on how IA function should assess third-party risk and compliance. Additionally, further guidance on Internal Audit’s role in intra-group outsourcing arrangements would provide clearer guidance on its responsibilities in performing outsourcing audits.

2.4.4 & 2.4.5 Audit planning and Reporting: the requirement for annual audit plans and reporting to the Management Body ensure transparency. However, it may be useful to clarify expectations around ad-hoc audits in response to emerging risks. Moreover, ESMA could specify a minimum audit cycle (e.g., three years).

2.4.6 & 2.4.7 Follow-up on recommendations: establishing a formal follow-up procedure is critical to ensure audit recommendations are effectively implemented. Introducing KPIs on implementation status could further enhance accountability.

2.5.4 ESMA should leave CRA free to decide how to produce and validate their methodologies according to regulation hence referring to “voting rights in a committee” is prescriptive and inappropriate in our view.

Q4. Do you have any comments on ESMA’s approach to proportionality for Internal Control Functions?

Additionally to the proportionality approach considered in Q3 above, Scope Ratings wants to mention that the proportionality principle is essential in ensuring the regulatory expectations are tailored to the size, complexity, and risk profile of the supervised entities. While the guidelines acknowledge proportionality, further clarification on its practical application would be valuable. In particular:

- Applicability to smaller entities: the guidelines could outline specific scenarios where simplified Internal Audit requirements may apply to smaller CRAs without compromising the integrity of the internal control framework.
- Resourcing consideration: proportionality should consider resource constraints, particularly for CRAs with limited internal audit capacity. Guidance on alternative assurance mechanisms (e.g., periodic external audits, or shared internal audit functions) would be useful.

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We take note of the clarity already proposed by ESMA regarding the proposed approach to proportionality. The proposed measure and information remain however too vague to be safely implemented by different CRAs of different size. This lack of clarity is particularly challenging to assess situation related to building appropriate quorum and degree of separation of tasks expected by ESMA. In particular, We would appreciate if ESMA could define the objective quantitative criteria used to apply proportionality (i.e portfolio of ratings, revenues level, overall staff size, business model to cover one or several asset segment of credit).

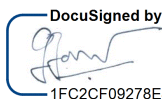
Q5. Are there any other comments you wish to raise on this section?

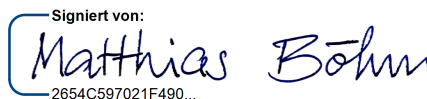
While the proposed guidelines are comprehensive, additional consideration could enhance clarity and effectiveness.

- Coordination with other internal control functions: greater emphasis on the interaction between IA, Risk and Compliance could strengthen the three lines of defence model.
- Technology and data analytics in Internal Audit: given the increasing reliance on technology, ESMA could encourage the use of data analytics and continuous auditing techniques to enhance audit effectiveness.
- Finally, while the guidelines focus on IA's assurance function, ESMA could also acknowledge IA advisory role. IA can provide insights on IC, risk management and governance without compromising its independence.

Scope Ratings remains committed to maintaining a constructive dialogue with ESMA to enhance Supervisory expectations for the management body.

Kind regards,

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Signiert von:

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