THE COMMITTEE OF EUROPEAN SECURITIES
REGULATORS

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

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EXECUTIVE SUMMARY

Background

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

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

3. Following receipt of the mandate from the Commission, CESR began its work on 28 July 2004 by launching a call for evidence for interested parties to submit comments by 27 August 2004. CESR received 30 submissions.

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

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

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

7. As part of the process of producing its advice CESR published a consultation paper (Ref: CESR/04-612b) on November 2004, giving all market participants until 1 February 2005 to submit their views. In addition, a public hearing was held in Paris, at CESR premises, on 14 January 2005.

8. CESR received around 34 responses to the consultation paper and these can be viewed on CESR's website (www.cesr-eu.org).

9. Together with this advice CESR is publishing a Feedback Statement (Ref: CESR/05-140).

Areas covered

10. This paper deals in section II with most of the issues included in the Commission's mandate. Aspects referring to conflicts of interest, fair presentation of credit ratings, relationships with issuers and credit rating agencies and the use of ratings in private contracts and in European legislation, are analysed in detail.

11. Section III includes a number of possible strategic policy options that could be followed to address the aspects discussed in the previous section. An analysis of the pros and cons of each of the proposed options is also provided.

12. Finally, the last section of the paper provides CESR's conclusions on the question raised by the Commission's mandate in relation to the need of registration of credit rating agencies in the EU. In this context, a discussion in relation to the competitive dimension of the credit rating market and the barriers of entry is also included in this chapter.

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CESR

I. INTRODUCTION

Objectives of CESR's advice

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

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

15. Accordingly, the consultation paper was drafted in an open way, putting forward the different options for the issues included in the call for advice and asking market participants to express their views on the alternatives proposed.

16. In line with the abovementioned objective, CESR is proposing two possible ways of handling the final question asked by the Commission's mandate: *does CESR consider it appropriate that credit rating agencies should be registered in the EU?* CESR has reached the conclusions described in Section IV after careful analysis of the responses to the consultation. The feedback from market participants helped CESR to narrow down the range of options to those set out in Section III. After the subsequent debate among its members, CESR has opted for the two options described in paragraphs 265 and 266 of this document.

Global approach

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

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

advice. Contact with CEBS is also encouraged. These views have also been a common theme of the responses to the consultation paper.

19. CESR acknowledges that any initiative on rating agencies must follow this global perspective and, to this effect, the task force has worked in close co-operation with the following bodies:

- **CEBS** has participated as an observer to the task force meetings and its contributions have been very helpful for the task force. One of the objectives of this co-operation has been to avoid any gaps or duplications between CESR work and that of CEBS under the CRD. Also, CEBS's expertise has been extremely valuable for the drafting of the sections that describe the main features of the Capital Requirements Directive and the interaction between this initiative and the one CEBS is undertaking under the CRD.

- The US Securities and Exchange Commission (**SEC**) has showed its willingness to collaborate with CESR and has informed regularly the task force of the developments in the US.

- **IOSCO's** recent work on this area (the Report on the activities of CRAs including the Statement of principles and the Code of conduct fundamentals) has been one of the main inputs for this paper. This is reflected in the assessment of the IOSCO Code that it is made in paragraphs 253-255 of this advice.

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

20. The focus on ratings has increased in the wake of bankruptcy filings by large publicly held companies with rated securities. In some of these cases, CRAs have been criticized for failing to notice evidence of financial problems at several major issuers until just prior to the entity's collapse.

21. The consequent increased importance of ratings to the efficient functioning of markets inevitably increases the need for confidence in the reliability and quality of those ratings.

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

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

1. **European Parliament**

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

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

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

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

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

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

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

2.2 **IOSCO's Code of Conduct Fundamentals for Credit Rating Agencies**

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

Therefore, IOSCO decided to develop a Code of Conduct for credit rating agencies, irrespective of legal and regulatory structures that was published on IOSCO's website on December 2004. The Code is attached as Annex B to this paper.

As stated in its introduction, the CRA Code of Conduct Fundamentals are designed to be a set of measures that should be included in some form or fashion in the codes of conduct of individual CRAs. As currently drafted, these measures are not intended to be rigid or formulistic: when incorporating these measures into their own codes of conduct, CRAs will be able to maintain a degree of flexibility to deal with the different legal and market circumstances in which they operate.

According to the introduction of the Code, CRAs should explain if and how their own codes of conduct deviate from the Code Fundamentals and how such deviations nonetheless achieve the objectives laid out in the Code Fundamentals and the IOSCO CRA Principles. This will permit market participants and regulators to draw their own conclusions about whether the CRA has implemented the Code Fundamentals to their satisfaction, and to react accordingly. In developing their own codes of conduct, CRAs

should keep in mind that the laws and regulations of the jurisdictions in which they operate vary and take precedence over the Code Fundamentals. These laws and regulations may include direct regulation of CRAs and may incorporate elements of the Code Fundamentals itself.

3. United States Securities and Exchange Commission (SEC)

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

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

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

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

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

Following the Enron collapse, the SEC submitted to Congress in January 2003 its report on the role and function of credit rating agencies in the operation of securities

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

markets in response to the Congressional directive contained in Section 702 of the Sarbanes-Oxley Act of 2002.

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

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

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

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

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

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

Most of the 46 commenters responding to the SEC's 2003 concept release supported retention of the NRSRO concept; only four recommended that it be eliminated. Generally, commenters requested that the SEC clarify the current NRSRO recognition criteria and application process and also enhance the SEC staff's ability to ensure that a credit rating agency continues to meet the minimum standards that led to the

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

NRSRO designation. The SEC staff have considered a number of approaches on how best to achieve the objectives recommended by commenters, and anticipate moving forward with an acceptable proposal in the near future.

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

4.1 Rating Agencies Survey by US AFP (November 2002)

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

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

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

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

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

5. The Capital Requirements Directive

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

5.1 Methodology

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

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

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

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

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

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

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

5.2 Individual Credit Assessments

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

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

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

5.3 CEBS work to promote convergence on recognition standards in 5.1 and 5.2

CEBS is working to promote convergence in the supervisory recognition processes of ECAIs across Europe by defining a common understanding on the criteria necessary to implement the recognition requirements laid down in the CRD. CEBS' focus is on the specific issue of the use by credit institutions and investment firms of external credit assessments for the purpose of determining the risk weighting of an exposure which is needed to calculate the amount of capital to set aside to cover the credit risk. According to the CRD, credit institutions and investment firms may use the external credit assessments of an ECAI to determine risk weightings only if the ECAI has been recognised as 'eligible' by the competent authorities. This recognition can only be granted if the ECAI is judged to meet the requirements laid down in the CRD.

In seeking to achieve supervisory convergence in this area, the focus of CEBS' work will include:

- the recognition requirements set out in the CRD;
- the ECAI recognition process and ongoing assessment; and
- the mapping of credit assessments to risk weightings.

<u>Definitions</u>

Credit rating agencies

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

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

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

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

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

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

31. Also, CESR has considered the different stages of both initiatives: the CRD proposal and the Commission's call for advice to CESR. Even though the CRD proposal is based on the new Basel accord, and therefore it seems unlikely that its key features would be modified during the legislative process, it is also clear that the way it is implemented will be very important in assessing its real impact on the way CRAs operate, if they wish to qualify as eligible ECAIs. Without prejudice at this stage to the final outcome of both initiatives, CESR believes that the subjection to two sets of duplicative requirements of a CRA who is also an eligible ECAI should be avoided. Respondents to the consultation fully supported this approach and also stressed the different scope of both concepts (ECAIs and CRAs).

32. For the reasons above and given the comments made by the respondents on the need to ensure a worldwide harmonised approach when dealing with CRAs and the international nature of the activities of this entities, CESR has decided to align its definition with the one included in IOSCO's final code.

33. Therefore, the term **credit rating agency** will have the following meaning when used in this paper: **those entities whose business is the issuance of credit ratings for the purposes of evaluating the credit risk of issuers or debt and debt-like securities**. The

term "debt and debt-like securities" is used to refer to debt securities, preferred shares, and other financial obligations of this sort that CRAs rate.

Credit rating

34. Following the approach stated in the consultation paper and the vast support showed by market participants to the IOSCO definition, CESR has decide to follow the definition on credit ratings as included in IOSCO's final Code.

35. Therefore the term **credit rating** will have the following meaning when used in this paper: **an opinion regarding the creditworthiness of an entity, a credit commitment, a debt or debt-like security or an issuer of such obligations, expressed using an established and defined ranking system. Credit ratings are not recommendations to purchase or sell any security.**

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

37. CESR thinks that the fundamental attributes of structured finance ratings are the same as those of corporate ratings. Notwithstanding, there are some differences between both rating procedures. What distinguishes the rating of structured finance transactions from the rating of traditional instruments is that the sponsor has greater flexibility to adapt the features of the transaction in order to achieve the desirable outcome. This is why the CRA involved plays a more active role than in the case of a corporate rating, ie advising the sponsor about the proposed structure of the transaction according to the rating level desired for each of the tranches of the structure. CESR is of the opinion that the main issue regarding structure finance ratings is the transparency and consistent application of CRA's methodologies. A CRA should however not have to take additional measures other than those with regard to conflicts of interest in general.

Unsolicited Rating

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

39. CESR initially proposed in the consultation paper a definition based on the fact of who takes the initiative. However, after further analysis and taking into consideration the difficulties expressed by market participants to come up with a definition of unsolicited ratings that can encompass all the relevant aspects that need to be consider in the relationship between issuers and CRAs, **CESR has decided not to provide a definition of unsolicited rating**. Instead, CESR has decided to explain what is meant by this term in the different sections that analyse this topic.

SME

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

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

II. RULES OF CONDUCT DIMENSION AND OTHER ISSUES RAISED BY THE EUROPEAN COMMISSION

2.1 INTERESTS AND CONFLICTS OF INTEREST

Interests and conflicts of interest in general

Extract from the mandate

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

Explanatory Text

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

43. Conflicts of interest between the rating agency and issuers may pose risks to ratings being independent, objective and high quality. These risks may be caused by multiple relationships between the credit rating agency and the issuer whose creditworthiness the credit rating agency rates or rating evaluating services. It should be stressed that both real and perceived independence, objectivity and quality of credit ratings is important, as the mere perception of lack of independence, objectivity and quality of credit ratings can undermine confidence in them. This means that any degree of uncertainty about credit ratings, whether actual or potential, is to be reduced as far as possible. It should be emphasized that the mere existence of diverging interests or conflicts of interests between the relevant parties does not automatically imply a market failure. It is only when these conflicts of interests impair the production of independent, objective and high quality credit ratings that a problem arises with regard to investor confidence, upon which the good functioning of securities markets depend.

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

45. To the extent that payment for credit ratings by the issuer being rated creates a risk to independence, objectivity, accuracy, timeliness or assessment of all relevant pieces of information of and about the issuer, the credit rating agency should ensure that all circumstances that impair or are perceived to impair the credit rating process are assessed and addressed in a structural way. It is primarily the credit agency's responsibility to ensure through policies and measures that the credit ratings to be issued are up to the highest possible professional standard and able to withstand any divergence or conflict with other detrimental interest.

46. At the same time, it is crucial that the credit rating agencies disclose in a proper way, within their rating reports, any specific situation of conflicts of interest, which can impair the credit rating. CESR takes the view that this would be an appropriate way of implementing measure 2.7 of the IOSCO Code.

47. CESR also wishes to emphasize its advice on implementing measures with regard to articles 13 section 3 and 18 of the Markets in financial instruments Directive (Box 7) concerning conflicts of interests of investment firms. This advice sets out the way in which interests and conflicts of interest should be treated. Taking into account the differences between investment firms and credit rating agencies, CESR takes the view that the said implementing measures provide a comprehensive framework to address the issues of interests and conflicts of interest.

48. CESR notes that recital 10 of the Investment Recommendations Directive 2003/125/EC under the market abuse regime states that the opinions issued by credit rating agencies do not constitute a recommendation within the meaning of said Directive. However, according to this recital, credit rating agencies should consider adopting internal policies and procedures designed to ensure that credit ratings published by them are fairly presented and that they appropriately disclose any significant interests or conflicts of interest concerning the financial instruments or the issuers to which their credit ratings relate. According to CESR, rating agencies, by implementing the aforementioned policies and measures, can promote transparency and thereby help advance investor confidence.

ADVICE

49. In order to adequately address the risk of interests and conflicts of interests in general, both aspects of management and disclosure are important.

50. Credit rating agencies should have in place effective policies and measures to identify, eliminate where possible, manage and disclose all its interests and conflicts of interest, as meant in measure 2.6 of the IOSCO Code.

51. Credit rating agencies should aim for transparency as the best way forward to enable investors and issuers to understand the quality and objectivity of the credit rating. Credit rating agencies should therefore implement measure 2.7 of the IOSCO Code.

Ancillary services

Extract from the mandate

> *(1) Technical advice related to the issue of provision of advisory/ancillary services by credit rating agencies*
>
> *The technical advice should at least take into account:*
> - *the risk that the provision of advisory services by rating agencies to issuers they rate might influence the rating of these issuers;*
> - *the possible consequent need to disclose, manage or prohibit such advisory services;*
> - *the provisions of Article 6 paragraph 5 of European Parliament and Council Directive 2003/6/EC (the Market Abuse Directive) and of Commission Directive 2003/125/EC implementing the Market Abuse Directive as regards disclosure of interests and conflicts of interest for investment recommendations while recognising the differences between credit ratings and investment recommendations;*
> - *the provisions of Article 13 paragraph 3 and Article 18 of European Parliament and Council Directive 2004/39/EC on markets in financial instruments, as well as CESR's current work on technical advice for possible implementing measures in respect of those Articles. CESR shall ensure that its advice in respect of rating agencies is consistent with the treatment of conflicts of interest foreseen for investment firms.*

Explanatory Text

52. Interests or conflicts of interest that can or could be perceived to be the result of ancillary services are best addressed by transparency, and certainly not by prohibition. In a market oriented solution, the least intrusive option is to merely ensure that investors and issuers are able to appreciate the position the credit rating agency might be in, in terms of interests or conflicts of interest.

53. A credit rating agency may wish to provide ancillary services to issuers. These services may consist, among others, of risk management services, consulting services including for structured finance, data and analysis provision services, hypothetical ratings, also called rating advisory services. With ancillary services, the credit rating agency may be primarily interested in increasing earnings by providing more services to an issuer than just credit rating assessments. A credit rating organisation may consider these services as a traditional and integral part of the rating process as these services may help to ensure both the transparency of the rating and of the rating process itself.

54. On the other hand, the issuer might be perceived to influence the credit rating agency to the extent that his influence on the credit rating agency might increase by accepting ancillary services in addition to credit rating assessments. With multiple relationships

between a credit rating agency and an issuer there are more possibilities for mutual influence, dependency or pressure.

55. The provision of other services should not in any way allow the credit rating agency to pressure an issuer into using these services for fear that the credit rating might otherwise be less favourable or that by taking on these services, the rating might be more favourable to the extent that the issuer has only limited alternative credit rating agencies to mandate.

56. A credit rating agency should take all reasonable steps to identify conflicts of interest between themselves, including their managers, employees and tied agents, or any persons directly or indirectly linked to them by control and issuers they rate that arise in the course of providing any ancillary services. A credit rating agency should take reasonable care to disclose their interests or indicate conflicts of interests concerning ancillary businesses that they carry out.

57. In order to enhance investor confidence in credit ratings notwithstanding that the credit rating agency supplies additional services to an issuer who's creditworthiness is being rated, the credit rating agency should ensure that the credit assessment process is completely unaffected by the existence of or potential for the said services. Measures 2.4 and 2.5 of the IOSCO Code deal with the actual or potential conflicts of interest that may result from other business relationships between a credit rating agency and an issuer than the mere provision of credit rating services. They state in general terms that ratings should be unaffected by such relations and that ancillary businesses should be separated – operationally and legally – from the rating process.

58. In addition, investors should be able to learn (i) whether the credit rating agency has provided additional services to a particular issuer, (ii) the proportion such additional fees constitute against the fees earned by credit assessment services with regard and (iii) whether a credit rating agency has to have in place strict firewalls or other mechanisms aimed at safeguarding against any potential conflicts of interest and abuses (creation of Chinese walls, creation of parent companies where ancillary businesses are located, separation of staff exercising different functions, implementation of code of conduct providing procedures and measures to avoid any conflicts).

59. Investors and issuers should be able to assess themselves whether they want to attach any meaning to the fact that a credit rating provides more services than the mere provision of credit ratings to an issuer, by the rating assessment services/rating evaluation services or other. In this respect CESR fully recommends the application of measure 2.5 of the IOSCO Code.

60. A market-oriented solution to address the risk that the provision of ancillary services might influence the credit ratings process would not be to prohibit these services all together. The credit rating agencies however should be transparent about their policies and measures that address the actual or potential threat to market confidence in credit ratings due to ancillary services.

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61. General policies and measures to counter conflicts or interest as a result of ancillary services should suffice, as pointed out in measures 2.5 and 2.6 of the IOSCO Code . Credit rating agencies would do well by disclosing the application of the relevant policies and measures by publishing a prominently placed internet link to the relevant information in each credit rating, as stated in article 5 section 3 of the Investment Recommendations Directive 2003/125/EC.

62. Credit rating agencies should take measures along the lines of its advice on implementing measures with regard to articles 13 section 3 and 18 of the Markets in financial instruments Directive (Box 7) concerning conflicts of interests of investment firms, especially those mentioned under nos. 7 and 8 in Box 7 with regard to the content of the conflicts' policy.

ADVICE

63. In order to adequately address the risk of ancillary services interfering with the quality and objectivity of credit ratings credit ratings agencies should introduce and implement policies and measures to separate the rating services from all other services. Credit ratings agencies should take separational measures, as stated in measures 2.5 of the IOSCO Code and disclose the said policies and measures, as stated in measures 2.6 and 2.7 of the IOSCO Code.

Payments by issuers

Extract from the mandate

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

The technical advice should at least take into account:
- *the risk that payments for credit ratings to the rating agencies by subscribing issuers might influence the rating of these issuers;*
- *the possible consequent need to disclose the existence (but not the amount) of, or manage, such payments;*
- *the issue of unsolicited ratings turned into solicited;*
- *the possible consequent need to disclose, or manage, unsolicited ratings;*
- *the provisions of Article 6 paragraph 5 of European Parliament and Council Directive 2003/6/EC (the Market Abuse Directive) and of Commission Directive 2003/125/EC implementing the Market Abuse Directive as regards disclosure of interests and conflicts of interest for investment recommendations while recognising the differences between credit ratings and investment recommendations;*

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

Explanatory Text

64. A credit rating agency's primary interest is to make a profit by providing credit rating services. In order to make profits a credit rating agency needs to be able to produce independent, objective and high quality credit ratings that meet the needs of investors and issuers who pay for the ratings. An issuer's primary interest should be to retain long-term investor confidence. In these general terms the interests of the credit rating agency and the issuer might diverge. Both issuer and credit rating agency need each other's information, although their interests may diverge.

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

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

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

68. The option of having a credit rating agency disclose a fee scheme could decrease the bargaining power of issuers to negotiate discounts from a disclosed fee scheme. Any proposed measure that could in effect weaken the negotiating position of the issuer vis-à-vis the credit rating agency is not advisable. In addition, a disclosed fee scheme would not prevent an issuer from trying to influence the rating. This constitutes a second reason for not having an credit rating agency disclose a detailed fee scheme.

69. A credit rating agency should manage the risk or the perception of risk that come with an issuer-based fee scheme by introducing policies and measures, as well as monitoring and enforcing their application. Most important, a credit rating agency should adopt and should be seen to apply a fee scheme that reduces issuer influence and enhances independence, objectivity, accuracy, timeliness and genuine assessment

of all relevant information from or about the issuer throughout the entire credit ratings process. A credit rating agency should implement and should be seen to have implemented measures 2.1 – 2.10 of the IOSCO Code in particular aiming at policies and measures as well as at disclosure, for managing conflicts of interest in relation to payments by issuers.

ADVICE

70. In order to effectively address the risk of an issuer paying for the rating and wanting to influence the outcome of that rating, it is best that the credit rating agency implement policies and measures which generally counter actual or potential undue issuer influence as well as ensure the independence and objectivity of the rating process, as stated in measures 2.1 – 2.3 and 2.12 of the IOSCO Code. These measures are concerned with the independence and objectivity of the rating process and with the separation between staff involved in analysis and commercial negotiations with issuers.

71. A credit rating agency should have sound policies and procedures in place to address actual or potential undue influence by an issuer who pays for and is the subject of the rating as part of a conflicts' policy in general, as meant in measures 2.6 and 2.8 of the IOSCO Code specifically.

<u>**Unsolicited credit ratings**</u>

Explanatory Text

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

73. With an unsolicited credit rating, the issuer does not normally pay the credit rating agency. This can very well mean that the credit rating has been issued without any undue influence by the issuer that is being rated. On the other hand, there is a risk that unsolicited ratings are set lower than what is motivated by the actual issuer

creditworthiness, as this could be used as a pressure from the rating agency to get co-operation and payment by the issuer.

74. Uncertainty about whether a credit rating has been issued on an unsolicited basis and thus about the amount of information and issuer co-operation that the rating is based on, may undermine user confidence in these kind of credit ratings. Measure 3.9 of the IOSCO Code provides for disclosure of whether the issuer has requested a credit rating and whether the issuer has participated in the rating process.

75. Investors should keep in mind that the issue of unsolicited ratings is important in two areas. First of all, a credit rating may be tempted to use an initially unsolicited rating based upon publicly available information with a view to unduly pressure the issuer into co-operating and/or paying for the rating.

76. Secondly, a credit rating based on publicly available information without the genuine and wholehearted involvement of the issuer could or should lead investors to differently appreciate the quality of the unsolicited rating. In a market orientated solution to address both said aspects of unsolicited ratings transparency about the nature of the credit rating best serves the interests of those wanting to be able to assess the quality of the rating. Importantly, by not prohibiting unsolicited ratings potential for new credit rating agencies or new credit rating business remains available.

77. The responses received pursuant to the consultation stated that the scope of the consultation paper regarding unsolicited ratings was too narrow and that in any case several aspects should be taken into account to assess whether a credit rating is unsolicited or not.

78. The following factors were proposed to be relevant in determining whether a credit rating is unsolicited or not:

    a. who takes the initiative to contact the other party, the credit rating agency or the issuer;
    b. degree of co-operation between the credit rating agency and the issuer;
    c. whether or not the credit rating agency has access to management of the issuer;
    d. whether or not the credit rating agency has access to non-public confidential information;
    e. extent of provision of information by the issuer;
    f. whether or not the issuer mandates or contracts the credit rating agency;
    g. whether or not the issuer pays for the credit rating.

79. CESR takes the view that the mere element of 'initiative' is too narrow to determine whether a rating is unsolicited or not. All seven aspects as mentioned above are relevant in this respect. CESR emphasizes that the issue of unsolicited ratings is first and foremost relevant to investor wanting to be able to appreciate the quality of ratings, the issuers being the very subject matter.

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80. The extent of provision by the issuer / degree of access to non-public confidential information is crucial in enabling investors and other interested parties to determine whether a credit rating is unsolicited or not. The term "participated" in measure 3.9 of the IOSCO Code should be interpreted as including the provision of and/or access to non-public confidential information.

81. Whether an issuer mandated, contracted, paid, initiated or requested the rating, as stated in measure 3.9 of the IOSCO Code, is also important to investors.

ADVICE

82. In order to address the issue of unsolicited ratings turning into solicited ratings the credit rating agency should disclose within each rating (i) whether the credit rating was initiated by the issuer or by the credit rating agency itself and (ii) whether the issuer participated in the rating assessment process, meaning whether the credit rating agency was provided with or had access to non-public confidential information, as meant in measure 3.9 of the IOSCO Code.

Capital or other interest links

Extract from the mandate

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

The technical advice should at least take into account:
• the risk that capital links (such as shareholdings or loans) or any other interest links between rated issuers and credit rating agencies might influence the rating of these issuers;
• the possible consequent need to disclose the existence of such links along with the rating;
• the provisions of Article 6 paragraph 5 of European Parliament and Council Directive 2003/6/EC (the Market Abuse Directive) and of Commission Directive 2003/125/EC implementing the Market Abuse Directive as regards disclosure of interests and conflicts of interest for investment recommendations while recognising the differences between credit ratings and investment recommendations;
• the provisions of Article 13 paragraph 3 and Article 18 of European Parliament and Council Directive 2004/39/EC on markets in financial instruments, as well as CESR's current work on technical advice for possible implementing measures in respect of those Articles. CESR shall ensure that its advice in respect of rating agencies is consistent with the treatment of conflicts of interest foreseen for investment firms.

Explanatory Text

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

84. Credit rating agencies thus need to ensure that any kind of interest links with issuers do not influence the independence, objectivity and integrity of their credit ratings. A credit rating agency should implement and be seen to implement measures 2.4 – 2.6 of the IOSCO Code. Credit rating agencies should promote confidence in credit ratings by introducing policies and measures managing and disclosing financial links or other interests between a credit rating agency and issuers, its affiliates or investments in general and the issuer or its affiliates or investments being rated in particular.

85. Many respondents agree that it is not necessary to disclose the policies and procedures regarding capital and other interest links with each rating. CESR takes the view that such procedure would be excessive, but recommends, as suggested during the consultation, that each rating opinion should contain an Internet hyperlink, displayed prominently, to such policies and procedures in question that users can access.

ADVICE

86. CESR considers that the implementation of measures 2.4, 2.6 and 2.7 of the IOSCO Code, by credit rating agencies, would adequately address the issues and concerns referred to throughout this section.

2.2 FAIR PRESENTATION

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

Levels of skills of agencies' staff

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Extract from the mandate

> <u>*Levels of skills of agencies' staff*</u>
> *(1) Technical advice related to the level of skills of agencies' staff*
>
> *The technical advice should at least take into account:*
> *• the risk that lack of sufficient or inappropriate skills might lead to poor quality credit rating assessments;*
> *• the possible consequent need to disclose or regulate such skills, taking into account an analysis of the relative risks of different regulatory and non-regulatory options;*
> *• the provisions of Article 6 paragraph 5 of European Parliament and Council Directive 2003/6/EC (the Market Abuse Directive) and of Commission Directive 2003/125/EC implementing the Market Abuse Directive as regards the fair presentation of investment recommendations while recognising the differences between credit ratings and investment recommendations;*
> *• the provisions contained in the Commission's proposed review of capital requirements for banks and investment firms; the provisions of Article 13 of European Parliament and Council Directive 2004/39/EC on markets in financial instruments, as well as CESR's current work on technical advice for possible implementing measures in respect of this Article. CESR shall ensure that its advice in respect of rating agencies is consistent with the treatment of organisational aspects, compliance and audit functions foreseen for investment firms.*

Explanatory Text

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

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

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

90. In this respect, measure 1.4 of the IOSCO Code states that a credit rating agency should use people who, individually or collectively have appropriate knowledge and experience in developing a rating opinion for the type of credit being applied. Moreover, measure 1.7 states that a credit rating agency should ensure that it has and devotes sufficient personnel with sufficient skill sets to make a proper rating assessment and that its personnel likely will have access to sufficient information needed in order make such an assessment. Finally, measure 1.8 provides that the credit rating agency should structure its rating teams to promote continuity and avoid bias in the rating process.

91. CESR believe that there is no need to directly regulate any required level of skills of staff involved in the rating process, as a credit rating agency has an inherent self-interest in ensuring high quality analytical staff. It should be sufficient for investors and issuers to be able to assess policies and procedures regarding levels of skills of staff in general rather than with regard to each rating in particular, as meant in the measures 1.4 and 1.7 of the IOSCO Code.

92. A credit rating is processed not by an individual analyst but crucially involves a rating committee. Accordingly, it is the responsibility of the credit rating agency not only to organize adequate levels of skills of all staff involved in issuing the rating, but also to make transparent how it goes along producing a rating. As levels of skills of analytical staff are a crucial factor contributing to the quality of the credit ratings investors and issuers should be able to assess the efforts that the credit rating agency puts into ensuring well skilled staff.

93. The relevant policies and measures should take account of (i) qualifications, (ii) experience, (iii) workload and (iv) evaluation of performance. In other words, the quality of staff would not merely be the result of training, expertise and experience as stated in the consultation paper. All four aspects should be evaluated by a credit rating agency while assessing whether it has sufficient resources in place to make a proper rating assessment.

94. CESR recommends that information on the process of producing a rating is provided by credit rating agencies among the "sufficient information" that measure 3.5 of the IOSCO Code states. The credit rating agencies should publish sufficient information about its procedures, methodologies and assumptions, so that outside parties can understand how a rating was arrived at by the credit rating agency.

ADVICE

95. CESR recommends that credit rating agencies implement measures 1.4 and 1.7 of the IOSCO Code.

Methodologies used for building credit ratings

Extract from the mandate

Methodologies used for building credit ratings *(2) Technical advice related to methodologies used for building credit ratings* *The technical advice should at least take into account:* *• the risk that inappropriate, undisclosed or weak methodologies might lead to biased credit ratings or to biased interpretation of credit ratings;* *• the possible consequent need to disclose or regulate such methodologies, taking into account an analysis of the relative risks of different regulatory and non-regulatory options;* *• the provisions of Article 6 paragraph 5 of European Parliament and Council Directive 2003/6/EC ('Market Abuse Directive') and of Commission Directive 2003/125/EC implementing the Market Abuse Directive as regards fair presentation of investment recommendations while recognising the differences between credit ratings and investment recommendations;* *• the provisions contained in the Commission's proposed review of capital requirements for banks and investment firms;* *• the comparability of ratings within and across Member States for various categories of economic entities, with particular attention to Small and Medium Enterprises.*

Explanatory Text

96. Methodologies used in the rating process are fundamental in guaranteeing that a credit rating is of good quality and that it is perceived as of good quality by all market participants. To reach these purposes, methodologies used by credit rating agencies have to fulfil some characteristics: they should be appropriate, strong and clear for users.

97. This does not necessarily imply that methodologies should be subjected to some kind of standards, neither that only one or few kinds of methodologies are appropriate, but rather that it is possible to assess (by the market, regulators, etc.), by using information available on the rating process, that these methodologies were appropriate to come to a reliable credit rating. To reach this purpose, two other elements are necessary.

98. The first one is that methodologies are rigorous, systematic and put in a formal way (e.g. in written form), also with the purpose of communicating them to all rating users. The second one is that methodologies are adequately disclosed, so that rating users could be effectively informed about all their characteristics and any updating of them.

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99. In terms of policy issues concerning credit rating agencies methodologies, regulation could concern the content of methodologies and procedures and/or could establish conditions for an adequate disclosure to the public of these aspects. Moreover, the same issues could be addressed by self-regulation.

100. Rules currently in force or proposed concerning Fair presentation are provided in the Commission Directive 2003/125/EC, implementing the Market Abuse Directive as regards fair presentation of investment recommendations, in the proposed Capital Requirements Directive (CRD) and in the "IOSCO Statement of Principles" and "IOSCO Code of Conduct Fundamentals".

101. The Directive 2003/125/EC provides rules as regards the indication of the reliability and the sources of information on which recommendations are based, a clear separation between facts and interpretations and a clear indication of forecasts or assumptions.

102. These issues have to be considered, by taking into account elements of similarities and differences between investment recommendations and credit ratings: in fact, they have a similar information function towards financial markets and operators, but are quite different as regards the contents and the potential risk of conflicts of interest, since credit ratings are not recommendations to buy, sell or hold any security and credit rating agencies are normally not part of conglomerates operating in areas such as investment banking, differently from intermediaries which produce investment recommendations.

103. The proposed Capital Requirement Directive prescribes recognition requirements also in respect of an eligible ECAI's methodology. This makes the competent authorities of Member States responsible for assessing whether or not an ECAI's methodology meets the CRD requirements of objectivity, independence, on-going review and transparency and disclosure.

104. Finally, the IOSCO Principles and the IOSCO Code establish principles and rules on credit rating methodologies, in the Sections "Quality and Integrity of the Rating Process" and "Transparency and Timeliness of the Ratings Disclosure".

105. More particularly, measure 1.1 of the IOSCO Code states that credit rating agencies should adopt, implement and enforce written procedures and methodologies to ensure that the opinions they disseminate are based on a fair and thorough analysis of all relevant information available. Measure 1.4 states that ratings should reflect all public and non-public information known, and believed to be relevant, to the credit rating agency, consistent with its published methodology, and measure 1.6 establishes that the credit rating agency and its analysts should take steps to avoid issuing any credit analyses or reports that contain misrepresentations or are otherwise misleading.

106. Measure 1.9 of the IOSCO Code deals with the issue of monitoring and updating ratings, by providing that the credit rating agency should regularly review the issuer's creditworthiness, initiate a review of the status of the rating upon

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becoming aware of any information which reasonably can influence the rating and update the rating on a timely basis, based on the results of such review.

107. Measure 3.2 of the IOSCO Code establishes that the credit rating agency should publicly disclose its policies for distributing ratings and reports. Measure 3.5 provides that the credit rating agency should publish sufficient information about its procedure, methodologies and assumptions so that outside parties can understand how a rating was arrived at by the credit rating agency; moreover, measure 3.6 states that credit rating agencies, when issuing or revising a rating, should explain in their press releases and reports the key elements and assumptions underlying the rating opinion. According to measure 3.10, the credit rating agencies should fully and publicly disclose any material modification of these methodologies, practices, procedures and processes and, where feasible and appropriate, disclosure of such modifications should be made prior to their going into effect.

108. Finally, measure 3.9 provide that the credit rating agency should disclose whether the issuer participated in the rating process or whether a rating is not initiated at the request of the issuer, so as its policies and procedures regarding unsolicited ratings.

109. CESR believes that there is no need or opportunity of explicitly regulating the content of methodologies used by credit rating agencies in elaborating credit rating, since this kind of regulation would seriously risk to erode individual quality and independence of the credit rating agencies analysis, and consequently to harm the quality of information flow in securities market, like it is suggested also by almost an unanimity of responses in this sense by market operators to the CESR's consultation.

110. Moreover, a strict regulation on methodologies could determine an excessive "standardisation" of rating procedures and methodologies, by reducing the informative content which can derive from the application of different kind of methodologies (by different credit rating agencies) and potentially slowing down the process of innovation of rating's methodologies and analyses. Finally, the definition and monitoring of methodologies from regulatory authorities could transmit to the market the wrong impression that regulators are able in some ways to guarantee a "minimum" level of quality of rating.

111. Therefore, the position of CESR on this issue is that general principles and rules provided by the IOSCO Code are sufficient, if genuinely implemented, to establish a satisfactory regulatory framework to define the content and the quality of ratings.

112. At the same time, CESR highlights the importance of having a satisfactory level of disclosure on methodologies and other elements on which the rating is based, as strongly supported by a vast majority of market operators. In particular, all users of ratings should have sufficient elements to understand and assess methodologies and other criteria used to determine a rating, as well as the key elements and assumptions underlying a credit rating.

113. Rules contained in the IOSCO Code on this issue, as described before, are quite exhaustive and comprehensive. Particularly, measures contained in the Section 3.A. of the IOSCO Code deal with all important aspects concerning disclosure of different elements which relate the elaboration and the diffusion of credit rating.

114. However, CESR wants to stress the importance that provisions of the IOSCO Code are implemented in a way which allows investors to understand very clearly how the credit rating agency arrived at a rating (like the IOSCO Code states in measure 3.5). In particular, CESR advocates the implementation of measures 3.5 and 3.6 of the IOSCO Code in such a way that the key elements and assumptions underlying a credit rating should be listed and explained in detail and facts should be clearly separated by assumptions and interpretations.

115. In fact, CESR believes that it is not sufficient, for a clear and exhaustive understanding for investors, that these key elements and assumptions are described in general terms (e.g. by referring generically to the financial and economic situation of the issuer).

116. Moreover, as regards disclosure of methodologies and criteria used to elaborate a rating, CESR believes that the interests of investors and issuers in being able to appreciate the credit ratings are best served by the credit rating agency having to give prior notice of changes in methodologies or criteria. Concerning this issue, CESR supports the measure 3.10 of the IOSCO Code and believes that the rule should be applied generally, and that the expression "Where feasible and appropriate" should refer only to real exceptions, the reasons of which should, in any case, be carefully explained by the credit rating agency.

117. The importance of disclosure on these elements could also imply, as an alternative to self-regulation only, the need to introduce some specific rules on fair presentation which would establish a minimum level of disclosure on those elements and assumptions which make clear for market operators and investors to understand how a specific rating was determined by a credit rating agency.

118. This choice, which was also supported by various respondents to the CESR's public consultation, would be helpful particularly in case the implementation of the IOSCO Code on these aspects would not be satisfactory.

ADVICE

119. CESR recommends measures 1.1-1.10 of the IOSCO Code, concerning the substance of methodologies and criteria used by credit rating agencies.

120. CESR recommends, in order to enhance transparency of the rating process in general and of methodologies, criteria and information used in the process in

particular, measures 3.1-3.10 of the IOSCO Code. Therefore, CESR recommends that credit rating agencies implement these measures.

2.3 RELATIONSHIP BETWEEN ISSUERS AND RATING AGENCIES

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

Access to inside information by credit rating agencies

Extract from the mandate

The technical advice should at least take into account:

- *the existing lack of clarity and harmonisation of legislation relating to access to inside information from issuers by rating agencies;*

- *the need to investigate appropriate measures to ensure that inside information is not inadvertently disseminated, selectively disclosed or misused in other way;*

- *the need to ensure a level playing field between credit rating agencies;*

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

The existing lack of clarity and harmonisation of legislation relating to access to inside information from issuers by rating agencies

Explanatory text

122. CRAs perform a service to issuers as well as to investors by reducing information asymmetries, thereby lowering the cost of capital for issuers. CRAs collect and analyse information from a variety of sources and frequently the information

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used by a CRA in assigning a rating will be a combination of information that is publicly available and that which is not public and has been obtained directly from the relevant issuer[3]. Most of the publicly available information concerning an issuer will be derived from the information released by the issuer in its disclosure statements, so the ongoing disclosure obligations that apply to issuers become vitally important to the rating process.

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

124. CESR points out, though MAD does not explicitly mention it, that while an issuer can give non public information to a CRA, it should be under no obligation to do it. CESR takes the view, which is supported by the market, that this issue is part of the issuer’s judgement at any point in time.

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

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

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

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

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

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

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

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

131. Clarity and legal harmonisation is desirable with respect to access to inside information from issuers to CRAs to improve comparability.

ADVICE

132. MAD will adequately address issues concerning access to inside information.

The need to investigate appropriate measures to ensure that inside information is not inadvertently disseminated, selectively disclosed or misused in other way.

Explanatory text

133. The various requirements concerning the dissemination of inside information have already been discussed from the perspective of the issuer. One of the greatest risks associated with the circulation of inside information is that those who possess it might trade in financial instruments to which it relates. This is a general risk which

exists regardless of the status of the individual or legal entity concerned, but it is a risk that is addressed by the Market Abuse Directive which prohibits insider dealing by both natural and legal persons. This includes CRAs, so to the extent that insider dealing by CRAs or their staff is perceived to be a risk because of the possibility that they may have access to inside information, it is already addressed.

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

135. One reason why rating actions are themselves likely to influence the prices of related financial instruments is because of the additional information that CRAs usually have access to compared to the market as a whole. For ratings that are compiled purely on the basis of publicly available information, it seems very unlikely that the rating will itself have an impact on prices, though it may be a possibility if the CRA is regarded as being particularly influential or its analyses as being particularly accurate and significant. This suggests that those ratings based only on public information are far less likely to amount to inside information.

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

137. It is CESR's understanding that CRAs often, but not always, give issuers an opportunity to check that any factual statements that are due to be made by the CRA when announcing the rating are correct and to ensure that no confidential information is inadvertently disclosed by the CRA. The requirements of the Market Abuse Directive outlined above require an issuer to disclose inside information as soon as possible which could be interpreted as requiring the issuer in these circumstances to itself announce the rating change before the CRA does. It might be the case that a CRA would be far less willing to share such information with the issuer in advance of publishing the information if the result was going to be that the issuer themselves

would disclose the rating. An analogy could be drawn here to the situation regarding the publication of investment research recommendations, even though it is recognised that these differ from rating opinions. An investment firm which is about to publish research may also contact the issuer in advance of publication to ensure that no factual inaccuracies are contained in the report. Some investment research recommendations could also amount to inside information for reasons similar to those outlined above in respect of ratings, particularly where the publisher of the research is highly regarded. It is possible that in these circumstances, the issuer themselves might consider that they need to publish the information themselves before the 'owner' of the research can.

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

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

140. Those within a CRA who know about rating decisions before they are published, or who have access to any inside information obtained from an issuer could themselves trade on the basis of this information, or could themselves pass it on to others. Some critics of CRAs have expressed concern regarding special access to information that subscribers to a CRA's services may receive. These concerns are that subscribers to a CRA's services may receive valuable analytical insights that may not be publicly disseminated and that this might include inside information which has been obtained as part of the rating process. This might occur due to the detailed reports that might be received by subscribers which explain the basis for a rating or because some CRAs permit subscribers to contact their analysts directly to ask questions about the reasoning behind a rating decision. There is also a risk that a CRA's rating decision itself could be communicated to subscribers ahead of being made available to the market as a whole.

141. As discussed above, the provisions of the Market Abuse Directive covering the use of inside information and the disclosure of it to others will also apply to CRAs and

any inside information they possess. The framework established under the Market Abuse Directive permitting issuers to disclose inside information to others who owe a duty of confidentiality only applies to issuers and does not permit the widespread circulation of inside information from one entity or individual to another. Hence a CRA or a member of their staff who has access to inside information of any sort is prohibited from passing on this inside information to anyone else except in the normal course of their employment, profession or duties. Any disclosure of inside information by a CRA or its staff therefore would appear to constitute an offence under the Market Abuse Directive, other than in the situation outlined above where an imminent rating decision is communicated to an issuer on a confidential basis for the purpose of checking the accuracy of the information it is based on etc. Any recipient of information in these contexts, including issuers themselves, will also be committing an offence under the Market Abuse Directive if they deal on the basis of inside information they are given.

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

143. In summary, the provisions of the Market Abuse Directive in this context prohibit:

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

ADVICE

144. MAD adequately addresses issues concerning access to /handling of/ disclosure of inside information. There is no need for additional regulatory measures.

145. Further regulation is not advisable for the IOSCO Code contains a suitable approach in governing the way CRAs handle confidential information from issuers.

CESR

The need to ensure a level playing field between credit rating agencies

Explanatory text

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

147. There could still be occasions however where a level playing field with respect to the availability of information does not exist between CRAs. This is most likely to occur in the context of "unsolicited ratings" particularly if the relevant issuer decides not to co-operate with the CRA in question. As such, the rating process behind an unsolicited rating may lack the type of issuer input and, depending on the circumstances, access to non-public information that a solicited rating may incorporate. This may impair the quality of the rating and some might argue that a level playing field (in terms of the information available to them) for all CRAs would be desirable. This issue is addressed below in the section dealing with the relationship between issuers and CRAs under "the need for all rating agencies to have access to the same information from companies (rating agency data room)".

148. CESR doubts, which is supported by some market participants, whether a “level playing field” is desirable between CRAs in this context. The information disclosed to a CRA is very much part of a dialogue between issuer and analyst which can vary significantly between analysts. The ability of analysts to manage this dialogue usefully is a key competency of a CRA. Additional restrictive regulation which limits this potential differentiation between CRAs is not advisable.

ADVICE

149. Establishing a “level playing field” between CRAs concerning access to inside information beyond the general requirements of the MAD is not advisable.

The provisions of Articles 1,2,3 and 6 of European Parliament and Council Directive 2003/6/EC (the Market Abuse Directive) and of Commission Directive 2003/124/EC implementing the Market Abuse Directive as regards the definition and public disclosure of inside information while recognising the differences between credit ratings and investment recommendations

Explanatory text

CESR

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

ADVICE

151. MAD adequately addresses issues concerning access to /handling of/ disclosure of inside information. There is no need for additional regulatory measures

152. Further regulation is not advisable for the IOSCO Code contains a suitable approach in governing the way CRAs handle confidential information from issuers.

<u>Other issues concerning the relationship between issuers and rating agencies</u>

Extract from the mandate

The technical advice should at least take into account:

- *the need to ensure that issuers periodically have the opportunity to discuss with rating agencies the assumptions and fundamental determinants of their ratings;*
- *the need to ensure that information published by rating agencies (alongside rating opinions) is accurate and the role issuers are to play in such a process;*
- *the need for issuers to understand how rating agencies restate the figures they give them;*
- *the importance of rating agencies archiving all information related to a rating so that a rating decision can be explained to issuers at a later stage;*
- *the need for all rating agencies to have access to the same information from companies (rating agency data room).*

Introduction

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

The need to ensure that issuers periodically have the opportunity to discuss with rating agencies the assumptions and fundamental determinants of their ratings

The need for issuers to understand how rating agencies restate the figures they give them

Explanatory text

154. Most of the perceived problems in this area arise from issuers not understanding how a CRA has arrived at a particular conclusion when providing a rating, meaning that some rating actions may be viewed by issuers as unfair, inappropriate or even unjustified. CESR is aware of the tension between the need for ratings to be fair and for CRAs to be independent from the issuers they rate on the one hand, and the need for issuers (and the market) to clearly understand what forms the basis of any particular rating decision. Taken to an extreme, if an issuer fully understood precisely how a CRA came to a particular decision, it might attempt to influence future ratings by only providing information it believed would result in a favourable rating. This could result in less information being provided, or worse, it might result in the provision of inaccurate or misleading information in the hope that this would result in a more favourable rating. Two specific provisions of the current IOSCO Code addresses these risks in paragraphs 1.14 and 2.1 respectively:

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

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

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

156. Paragraph 3.5 of the current IOSCO Code requires a CRA to publish sufficient information about its procedures, methodologies and assumptions so that outside parties can understand how a rating was arrived at by the CRA. In terms of specific rating decisions, the Code requires the following in paragraph 3.7 and CESR considers

that the information provided to the issuer by the CRA prior to issuing or revising a rating should be specific and detailed in relation to the facts underlying the rating:

> "Where feasible and appropriate, prior to issuing or revising a rating, the CRA should inform the issuer of the critical information and principal considerations upon which a rating will be based and afford the issuer an opportunity to clarify any likely factual misperceptions or other matters that the CRA would wish to be made aware of in order to produce an accurate rating. The CRA will duly evaluate the response. Where in particular circumstances the CRA has not informed the issuer prior to issuing or revising a rating, the CRA should inform the issuer as soon as practical thereafter and, generally, should explain the reason for the delay."

157. CESR is of the opinion, that a "right of appeal" is an opportunity given to the issuers to correct factual errors and misrepresentations. Such an approach should be part of the regular relationship between issuer and CRA. But CESR as well as the market emphasise that such process should carefully balance issuers´ rights and CRAs independence and that on no account should ratings be the result of negotiations.

ADVICE

158. No additional provisions are recommended. CRAs should specify this issue in their own codes of conduct in pursuance to IOSCO Code to make sure that relevant information is provided to the issuer to give an opportunity to correct obvious objective errors and misjudgements.

The need to ensure that information published by rating agencies (alongside rating opinions) is accurate and the role issuers are to play in such a process

Explanatory text

159. As stated above, the IOSCO Code currently requires a CRA to give an issuer an opportunity to comment on the basis of a rating to help ensure that the CRA's rating is accurate. In addition, there are broader measures that apply to the conduct of a CRA in this regard, designed to prevent the publication of inaccurate or misleading information. Firstly, the IOSCO Code contains a number of provisions in paragraphs 1.1 to 1.8 relating to the quality of the rating process, including specifically at paragraph 1.6

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

Second, the Market Abuse Directive makes it an offence for anyone to disseminate false or misleading information where they know or ought to know that it is false or misleading where this is likely to create a false or misleading impression in relation to a financial instrument admitted to trading on a regulated market.

160. CESR takes the view, which is also supported by the market, that it is not in the commercial interest of a CRA to publish information which in not accurate due to the risk of damaging its own reputation.

161. Additionally, information published as part of the supporting press release of a rating will according to opinion of CESR either be publicly available information or information provided by issuers and the responsibility for the accuracy of that information generally will lie with the issuer.

ADVICE

162. There is no further need to ensure that information published by rating agencies is accurate, as together the IOSCO Code and the MAD provide a mechanism, which to the greatest extent possible will incentivise CRAs to be accurate.

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

Explanatory text

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

164. This issue is addressed in the current version of the IOSCO Code for Credit Rating Agencies, albeit in general terms. Paragraph 1.5 requires that:

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

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

ADVICE

166. It is not essential to prescribe additional requirements. CRAs should specify this issue in their own codes of conduct in pursuance to IOSCO Code Provision 1.5 requirements.

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

Introduction

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

Explanatory text

168. If all CRAs had access to the same information, any differences in ratings could be as a result of a different methodology used to analyse the information. Since these methodologies will be public given the requirements of the IOSCO Code, there will be some transparency in this area. Issuers who are seeking a rating are, however, then likely to approach whichever CRA they consider is likely to give them the most

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attractive rating for a given price. This might be regarded by some as a positive development likely to reduce costs, but there are also very real risks that it might lead to a reduction in the quality of ratings as they become "commoditised" and competition becomes focused on the desired outcome of the rating process.

169. Each CRA employs different methodologies in arriving at its ratings and therefore needs access to different types of information. The market sees a risk that a data room could put pressure on CRAs to adopt similar or even identical methodologies, resulting in a possible reduction in diversity of approaches which could heighten risk of CRAs, as a group, failing to recognise a problem until it is too late.

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

171. The relationship between an issuer and a CRA is likely to vary considerably depending on the circumstances of the issuer and the reasons why a rating is being sought. For ratings sought by CRAs themselves and not by issuers, a level playing field in terms of the information available would be of benefit, particularly to smaller CRAs trying to increase their coverage, but there is a question as to whether it is appropriate to mandate that an issuer must provide the same information to a CRA it does not want to engage with that it has made available to a CRA that it has willingly co-operated with. We note that no similar requirement exists in the context of issuers' contacts with research analysts where similar demands to meet with senior management are often made.

ADVICE

172. It is not necessary to have measures requiring the establishment of a rating agency data room for all rating agencies to have access to the same information from companies.

2.4 USE OF RATINGS IN PRIVATE CONTRACTS IN EUROPE

Extract from the mandate

> ***3.5. TECHNICAL ADVICE RELATED TO THE USE OF RATINGS IN EUROPEAN LEGISLATION AND IN PRIVATE CONTRACTS***
> *(…..)*
> *Are there issues relating to the use of ratings in private contracts?*

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

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

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

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

- CRA ratings are frequently used in private contracts for a variety of purposes, the most recurrent use being the inclusion of "rating triggers" in financial contracts. Rating triggers are contractual provisions that give counterparties and lenders the right to terminate the credit availability, accelerate credit obligations, or have the borrower post collateral, in the event of specified rating actions, such as if the rating of the borrower's fixed-income securities falls below a certain level. These provisions are sometimes required by counterparties in order to help them secure collateral and recover prospective losses in cases where a borrower faces a serious likelihood of bankruptcy or default.
- Not all rating triggers are alike. Some are relatively harmless, such as those that incrementally increase the interest paid on loans and bonds in line with rating downgrades. However, some might have significant

potential negative impact on the issuer. In this case, contractual rating triggers can seriously escalate liquidity problems at firms faced with a deteriorating financial outlook. For instance, when investors are entitled to sell their bonds back to an issuer immediately following a downgrade, which results in a funding crisis just when a firm is least able to deal with it.

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

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

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

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

- Information concerning the issuer's capital resources (both short and long term);
- Information on the borrowing requirements and funding structure of the issuer;
- Information regarding any restrictions on the use of capital resources that have materially affected, or could materially affect, directly or indirectly, the issuer's operations.

180. This provision could be understood as requiring the disclosure of material rating triggers. In that respect, CESR's recommendations for the consistent implementation of the European Commission's Regulation on Prospectuses n° 809/2004 (Ref: CESR/05-054b) recommends the application of the abovementioned provision of the Commission's Regulation in the following way: "Where the issuer has entered into covenants with lenders which could have material effect of restricting the

use of credit facilities, and relevant negotiations with the lenders on the operation of these covenants are taking place, this fact should be discussed. Where a breach of covenant has occurred or is expected to occur, the prospectus should give information on how the issuer intends to remedy the situation".

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

ADVICE

182. Taking into account all these aspects and the comments submitted by market participants, CESR is of the view that there is no need of specific requirements in the context of the operation of credit rating agencies regarding the use of ratings in private contracts, since the current EU framework provides the necessary tools to ensure that the market is properly informed of the possible effects that rating triggers might have in the market.

2.5 USE OF RATINGS IN EUROPEAN LEGISLATION

Extract from the mandate

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

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

(…)

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

184. As part of the analysis undertaken in relation to this issue, CESR included in its questionnaire a specific question relating to the use of ratings by financial regulatory authorities. The questionnaire responses indicated that financial regulators in many

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

185. CESR already explained in the consultation paper that, in its view, this question can only be answered on a case-by-case basis. This view was shared by most of the responses to the consultation.

ADVICE

186. CESR considers that the use of ratings in European legislation should not simply be encouraged in a general way without a case-by-case analysis of the different proposals. In any event, it would be necessary to identify all the alternatives capable of achieving the regulatory objectives sought by the use of ratings in the legislation. A detailed study of the strengths and weaknesses of each alternative, including the use of ratings, should be prepared prior to any conclusion.

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

Extract from the mandate

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

Explanatory text

187. The appropriateness of requiring registration of credit rating agencies in the EU is clearly a factor of the impact that the registration regime would have upon the market. It is therefore necessary to analyse the likely effect of different degrees and types of intervention in order to determine the optimal approach.

188. Detailed analysis suggests that there are essentially four core options, although there is considerable flexibility in the precise scope and degree of intensity of these options.

189. The four options are:

- Monitoring market developments;
- Third party certification or enforcement of the IOSCO Code;
- A registration/regulation regime (with the potential intensity of this regime ranging from "strong" to "light" and the potential scope of this regime ranging from covering the entire set of issues addressed by the IOSCO Code to just covering specific aspects of CRA activity); and
- Including the IOSCO Code within the CRD's recognition procedure.

190. An analysis of the pros and cons of each of these four options is set out below.

OPTION A: MONITORING MARKET DEVELOPMENTS

191. This option reflects the idea that pre-existing regulatory initiatives and market forces are currently quite sufficient to deal with all the issues arising in the market for the provision of credit ratings. Therefore it could be an option to merely monitor for the time being developments related to CRAs, investors and issuers, particularly by considering the impact of the adoption of the IOSCO Code and of the new rules

provided by the CRD on the behaviour of the CRAs and then making a judgment about whether these measures are effective enough. Maybe after a certain period of time further measures (as described in the following options) could be reconsidered.

Pros

192. CRAs already face significant incentives to maintain the highest possible standards, particularly as they rely heavily on their good reputation with issuers and users of ratings. The perception that a CRA was not fully compliant with the fundamentals of the IOSCO Code could lead to market sanctions that would severely impair its business. The current threat of regulatory action should the rating industry not be seen to be fully compliant significantly enhances these incentives.

193. No clear market failures have so far been identified in the market for the provision of credit ratings.

194. Regulatory intervention is likely to increase barriers to entry, innovation and competition, especially where this is not targeted effectively.

195. Several important initiatives have already been taken to ensure that the market functions effectively in the future.

196. The primary advantage of this option therefore is that it would allow regulators the opportunity to properly assess the combined impact of market forces, the IOSCO Code, the Market Abuse Directive, the Capital Requirements Directive and the anticipated SEC initiative. This would allow a highly informed decision to be made about:

- whether there is in fact any need for regulation or rather that the existing initiatives, together with the threat of further regulatory action, have prompted the market to ensure that high standards are maintained in all areas; and

- if regulatory intervention is required, where the market failures are occurring and for what reason. This could allow regulators to make their response more efficient and avoid unduly increasing barriers to entry or competition.

197. A second advantage is that market participants are concerned that regulatory intervention could:

- give investors the impression of an absolute guarantee of quality of ratings;

- threaten the independence and quality of ratings (or the perception of this).

198. An absence of further regulatory intervention would avoid this problem.

199. A third advantage is, quite simply, that this option is supported by the vast majority of market participants, including CRAs, issuers and users of ratings.

Therefore, selecting this option would help to continue the constructive dialogue and co-operation between the regulatory community and the market.

Cons

200. There have been few specific allegations that CRAs face conflicts of interest similar to those of sell-side securities analysts. It has been alleged that CRAs have failed to perform adequate research into the companies they rate, failed to question the quality of an issuer´s public auditor and failed to adequately account for risk associated with an issuer´s operations in jurisdictions with weak accounting standards or lax regulatory oversight. [4]

201. Choosing the self-regulatory option would mean giving up on addressing these issues via European regulation for the time being.

202. Without enforcement of the IOSCO Code, there is a risk that CRAs will choose not to implement it effectively, thereby undermining its value. Moreover, the degree of disclosure of the implementation of the Code would be left to the will of CRAs, with the possible consequence that the market would not be properly informed on how – and in which measure – the CRAs are implementing the IOSCO Code.

203. If CRAs did not implement the IOSCO Code effectively this could lead to a power shift away from issuers and investors towards the CRAs, which are already, because of their role, in a position of strength towards issues and investors.

204. If some kind of problems exist in the market for the provision of ratings, selecting this option will allow these problems to exist for a longer period of time.

OPTION B: THIRD PARTY CERTIFICATION OR ENFORCEMENT OF THE IOSCO CODE

205. This option provides that a third party certifies or enforces the compliance of single CRAs' codes of conduct – which should be disclosed by the CRAs – with IOSCO Code. This third party could be private (for example the external auditor) or public (or semi-public): in the first case, it would "certify" the extent of compliance with the IOSCO Code, whereas in the second case it would be an outside arbitration body to which market operators, and potentially investors, could apply, to obtain the enforcement of the IOSCO Code.

Pros

206. The third party would, at the very least, verify and certify publicly the extent of compliance with the IOSCO Code and potentially (depending upon the precise nature of its role and powers) be able to take action to ensure compliance.

[4] Report of the IOSCO Technical Committee Chairmen's Task Force to Strengthen Capital Markets against Financial Fraud.

207. Issuers, and potentially investors, would have transparent information provided by a third party about the extent of compliance by the credit rating agency with the IOSCO Code, thereby enhancing investor confidence in the credit ratings. If an arbitration body was to be established, issuers, and potentially investors, would have somewhere to turn to (in addition to utilising the media and trade associations) when they wish to air a grievance in relation to the actions of a CRA. This could provide resolution in particular cases and would also act as a strong a priori disincentive to CRAs to act in a way that might lead to a grievance, a potentially public censure or an action.

208. This option would leave the responsibility of establishing ways of implementing the IOSCO Code within the credit rating agencies, while at the same time would introduce some kind of third party monitoring of the extent of compliance with the IOSCO Code.

Cons

209. There is no obvious body or institution already in existence that could be guaranteed to perform the role of certification/enforcement body in a truly independent manner.

210. It is not clear how the third party could be given power to act in such a capacity, nor what its powers could involve. Without legally binding sanctions, this would be a weaker form of enforcement.

211. CRAs themselves are better placed to certify compliance or explain areas of non-compliance than a third party who may not understand their policies and procedures as perfectly.

212. The proposed certification/enforcement body may not be necessary given the development by CRAs of internal processes for ensuring compliance with published policies and procedures.

213. The existence of an arbitration body which considers individual ratings could cause the rating process to degenerate into a bargaining process, potentially impairing the subjective component of ratings and putting a brake on the process of amending or updating ratings.

OPTION C: REGISTRATION/RECOGNITION REGIMES "STRONG" AND "LIGHT"

214. "This option could involve:

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- a recognition that a CRA complies with a pre-determined set of criteria established and published by EU authorities, without actually implying an authorisation to operate. Compliance with said criteria could be assessed by the party in charge of the recognition or implemented by a rather declarative procedure by CRAs. In this context recognition would not be a legal requirement for CRAs operating in the EU market for the provision of ratings. Rather, applying for recognition would be voluntary. CRAs might choose to be recognised because of the enhancement this would give to their reputation. In choosing to be recognised, CRAs would be agreeing to comply, on a continuous basis, with any information or oversight requirements EU authorities attached to this recognition. Any failure to comply with these requirements could lead to de-recognition, with the associated negative impact this could have upon the CRA's reputation; or
- a form of authorisation to operate in the EU market for the provision of ratings. Under this approach no CRA would be able to operate in the EU market for the provision of credit ratings without being authorised. Failure to comply with any information or oversight requirements EU authorities attached to this authorisation could lead to sanctions including de-authorisation which would mean that the CRA would no longer be able to operate in the EU.

215. The criteria for determining this recognition/authorisation could involve:

- the IOSCO Code itself, i.e. a relatively high level set of provisions;
- detailed, more prescriptive, rules implementing the IOSCO Code ; or
- either of the above approaches but only in relation to a narrower sub-set of issues than that covered by the IOSCO Code.

216. Following recognition/authorisation CRAs could:

- publicly explain whether or not they comply with the IOSCO Code and any deviations they make from the IOSCO Code;
- provide information to securities supervisors on a regular basis, or upon request, to allow a light monitoring of CRA's compliance with the recognition/authorisation criteria. This information could potentially include an independent analysis by the CRA's auditors of the compliance with each of the relevant criteria; or
- be subject to ongoing supervision of their compliance with the recognition/authorisation criteria.

217. The approaches outlined above could be implemented by a variety of different parties, either;

- the national regulator of each Member State in which the CRA operates;
- a committee of relevant regulators;

- a lead regulator (which could be the national regulator which first receives an application from a CRA or the regulator in the jurisdiction where the CRA's activities are most significant) or
- a European body.

218. Any recognitions/authorisations could be placed upon a common public list.

219. The precise method chosen, and the parties involved, for implementing this option could have a significant impact upon the degree to which it affects the market for the provision of credit ratings.

Pros

220. The main advantage of this option would be to provide additional assurance to the market and public authorities that a rating has been developed in an environment where adequate policies and procedures exist to ensure that, for example, published methodologies have been followed, conflicts of interest have been managed and ratings are presented in a fair manner.

221. Furthermore, recognition/authorisation, and the implementation of this, would incentivise CRAs to be diligent and work to avoid future failings in the rating process.

222. It is also possible that recognition/authorisation could increase the perceived status of smaller/newer CRAs and in doing so encourage new entrants or expansion of the activities of incumbents.

223. Some EU jurisdictions have given formal status to CRAs under their national legislation (for a variety of purposes) without necessarily having an oversight regime linked to this formal status. An EU regime could avoid the need for multiple national initiatives, whilst at the same time taking into account the international nature of the activities of at least the largest CRAs.

224. The United States SEC currently operates a form of recognition system. This option could therefore help to align the regimes applied to CRAs in two of the world's major markets.

225. Although the largest rating agencies active in the EU are subject to an SEC regime, some CRAs active in the EU may choose not to operate in the US and therefore may avoid SEC review. An EU authorisation regime would ensure that all participants in the EU market were subject to some form of appraisal by regulators.

226. Non-EU regimes applied to CRAs may not focus on precisely the same issues that are of interest to EU regulators.

227. Moreover, taking concrete action in the EU could influence initiatives in other jurisdictions thereby promoting high standards globally.

Cons

228. This option has the potential to create barriers to competition and innovation, especially where:

- the scope of the regime is broader;
- the degree of prescription is higher;
- the intensity of ongoing oversight is stronger; and
- the number of parties involved in implementation is larger.

229. Increasing the cost base (due to increased compliance costs) of CRAs in this way could lead to an increase in the cost of ratings thereby potentially discouraging the access of smaller issuers to rating and therefore the European Capital market.

230. An authorisation regime could risk inadvertently giving a quality seal to ratings and might threaten the perception of their independence/credibility.

231. It is not a valid purpose of registration to provide a badge of respectability to new or small rating agencies.

232. This option poses a danger, if it is different from regulatory initiatives taken in other systems, that ratings from EU CRAs would be viewed differently from those produced by non-EU CRAs, thereby creating an un-level playing field.

233. It could be difficult to design a regime that did not give rise to a number of extraterritorial concerns.

234. The majority of industry participants expressed reservations about having any regulatory mechanism.

OPTION D: INCLUDING THE IOSCO CODE WITHIN THE CRD'S RECOGNITION PROCEDURE

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

Pros

236. Any form of enforcement of the IOSCO Code reduces the potential for CRAs to not implement the Code effectively.

237. Regulatory intervention generally increases barriers to entry and competition. Eliminating some of the duplication that would result from simultaneously implementing the CRD and the IOSCO Code in regulation could reduce the potential detriment to competition.

238. Minimising the regulatory burden imposed upon CRAs could help to avoid increasing the cost of producing ratings (and therefore the cost of acquiring a rating, which is of particular importance to firms such as SMEs).

239. This approach avoids the inefficiencies that would be associated with having two distinct EU regulatory regimes applied to a CRA that is also an ECAI.

240. Furthermore, a combined approach would reduce the risk of contradictory requirements being applied for securities market and ECAI recognition purposes.

Cons

241. The primary disadvantage with this approach is that the objectives, target populations and risk assessment criteria of the CRD and securities regulators are not the same

- Regarding the objectives, the CRD provisions in relation to ratings focus solely on whether the ratings are likely to be of sufficient quality for banking supervisors to be confident in their use for the purpose of determining the risk weighting of an exposure and therefore how much regulatory capital needs to be set against that risk position. In contrast, securities regulators are focused not only upon the quality of ratings but also upon their market impact, and therefore a wider range of issues, such as fair presentation or effective disclosure, are of importance.

- In relation to the target populations, many CRAs may choose not to become ECAIs under the CRD and therefore utilising the CRD to enforce the IOSCO Code is unlikely to cover the entire population of CRAs that are active in European securities markets. Some CRAs could therefore continue to operate in the EU without complying with the IOSCO Code, thereby creating an uneven playing field and competitive distortions.

- In terms of the assesment criteria, the IOSCO Code covers issues e.g. those related to market abuse that are outside the scope of the CRD. Banking supervisors might take the view that some aspects of the Code are not directly relevant to the objectives of the CRD.

242. A second disadvantage of this approach is the fact that, after lengthy negotiations, the CRD provisions in relation to credit ratings have already been agreed.

243. A third disadvantage of this approach is the increased complexity of the regime which banking supervisors would have to implement and ECAIs would have to comply with. The aims and the objectives of various provisions might become unclear and lead to conflicting views on the optimal methods of compliance.

244. A fourth disadvantage is that enforcement of the IOSCO Code by banking supervisors could place greater reliance on the use of de-recognition of an eligible ECAI as an enforcement mechanism. Any failure to comply could lead to de-recognition as an eligible ECAI, with the associated impact that its ratings could not be used for capital purposes.

245. A final disadvantage is the additional complexity this would add to co-ordination and responsibility sharing arrangements in those EU jurisdictions that have made the valid choice of not structuring their banking and securities regulation within a single regulatory body.

IV. CONCLUSIVE CONSIDERATIONS BY CESR

4.1 COMPETITIVE DIMENSION: REGISTRATION AND BARRIERS TO ENTRY

Extract from the mandate

Technical advice related to availability of credit ratings and to the existence of possible entry barriers to the market for the provision of credit ratings
The technical advice should at least take into account:

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

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

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

Explanatory text

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

247. CESR notes that the market is deemed to be a natural oligopoly, with three major CRAs and a variable number of small niche CRAs, equity research companies and Credit Registers. Barriers to entry do exist in relation to the market for credit ratings, but do not appear to be insurmountable, rather they are generally characterised as natural.

248. New CRAs face a number of natural barriers to entry and existing CRAs face a number of natural barriers to expansion. The very nature of the CRA market might make it difficult for new CRAs to succeed. Issuers usually only desire ratings from those CRAs that are respected by investors. However, investors might tend to respect only those CRAs with a history of accurate and timely credit ratings. Investors could be reluctant to accord the ratings of a new entrant the same regard as those of

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established CRAs because new entrants lack historical default rates by which investors can compare performance to that of other CRAs. As a result, issuers may be reluctant to engage a new entrant for a rating. Without investor or issuer interest, it may take considerable time for a CRA's rating business to become self-sustaining.

249. A new entrant may have fewer resources (staff, analytical tools and other resources) and coverage than more established CRAs. Without these resources and coverage, a new entrant may be at a disadvantage vis-à-vis more established CRAs, who may be able to hire more staff (and more experienced staff) to analyze large issuers involved in numerous complicated transactions. There might be high start-up costs that new entrants could face, therefore new CRAs may be perceived to be vulnerable to financial pressures that larger CRAs may be insulated against. To a new entrant, a single fee-paying issuers may comprise a large portion of the CRA's overall revenue, creating a potential barrier to entry as rating users might fear this significant revenue steam would influence rating decisions. Likewise, the large amount of capital and time necessary to establish a new entrant may necessitate an affiliation with a larger firm. In addition, as already discussed in the previous paragraph, issuers do not have any incentives to engage new entrants for a rating, consequently lack of cooperation from issuers could mean that new entrants might have to base their ratings solely on public information. The problems set out above could discourage the use of ratings issued by new CRAS.

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

251. Also, a significant number of respondents expressed the desire for regulators to carefully avoid increasing barriers to entry, stating that any statutory/unduly prescriptive regulation could increase barriers. The small CRAs had an opposite view, as they think that a regulatory mechanism with a clear set of criteria that CRAs would follow could have a positive effect on competition.

ADVICE

252. CESR is of the opinion that the impact of regulatory requirements on competition is not clear and therefore it cannot conclude that any regulatory

requirements would either increase or decrease the entry barriers to the rating industry. Thus CESR does not recommend the use of regulatory requirements as a measure to reduce or remove entry barriers to the market for credit ratings.

4.2 IOSCO CODE

253. In Section II CESR has discussed the different aspects included in the European Commission's mandate. CESR believes that the scope of any provisions that could be considered for CRAs should be based on the IOSCO Code. Even though there are some areas where it could be argued that the IOSCO Code will not sufficiently deal with issues brought up, the IOSCO Code strikes a balance between the different interests in the rating process; those of the agencies themselves, those of the issuers and those of investors.

254. In some areas, the IOSCO Code contains very high level provisions, which means that the judgement on whether the IOSCO Code is sufficient or not, can hardly be thoroughly analysed until the CRAs have been starting to use them. It might well be the case that detailed, more prescriptive provisions would be necessary to implement the Code. Some of theses possible additional provisions have been identified throughout this document. As the IOSCO standards are global, any initiative of this kind should be properly co-ordinated with other supervisors outside the EU.

ADVICE

255. Without prejudice to the previous paragraph, CESR is of the opinion that, overall, the substance of the IOSCO Code is the right answer to the issues raised by the Commission's mandate as discussed in section II of this document as it will improve the quality and integrity of the rating process and enhance the transparency of CRAs' operations.

4.3 NEED FOR REGULATION?

Extract from the mandate

3.6. REGISTRATION
Taking account of 3.1-3.5 and on the basis of analysis on the financial markets – including any possible market failures – does CESR consider it appropriate that credit rating agencies should

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be registered in the EU? If so, how and under what type of regime, bearing in mind the need to avoid giving investors the impression of an absolute guarantee of quality of ratings?

Explanatory text

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

257. According to CESR's view the main question for the EU is thus to what extent the IOSCO Code should be enforced by any regulatory mechanism[5] or whether to wait whether the CRAs by themselves will take sufficient steps to comply with the Code.

258. Together with the main concern of investor confidence, another consideration that has to be taken into account is the effect that any regulatory mechanism would have on market dynamics. The rating industry has strong features of being a natural oligopoly. The reasons why this is the case have been developed previously in this chapter. In brief, this has to do with the fact that rating agencies build on credibility that has been developed during a number of years. Investors rely on CRAs that have a long, well-documented history on providing credible ratings to debt issues.

259. Any form of regulatory mechanism could imply that the already high barriers to entry increase even further, since compliance with the regulatory requirements would further increase the costs of entering the market. To what extent this would happen depends on the level of intensity of the regulatory mechanism chosen. On the other hand, it can be argued that even though regulation normally increases barriers to entry in markets, this does not necessarily have to be the case when it comes to CRAs. The argument would be that it is so difficult for new entrants to gain reputation in the rating market, that becoming recognised by the EU could actually help the new entrants to gain credibility. The regulatory mechanism in itself could be of assistance to reassure issuers and investors that a new CRA meets certain standards. In the reactions to the Consultation Paper, the majority of respondents thought that regulatory activities would increase barriers to entry, even though there were also respondents that thought that the effect could be the opposite. This last point was especially brought up by smaller CRAs who think that regulation might be the only way to achieve market acceptance alongside the big CRAs. In their point of view, special treatment should be given to rating agencies pioneering into new markets such as the market for ratings on small and medium sized companies. But some

[5] In the following paragraphs, the term regulatory mechanism has the meaning given in the option C of the previous chapter.

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respondents also expressed that it is not a valid purpose of regulation to provide a badge of respectability to new or small rating agencies as a way of helping with their marketing. The effects of any regulatory mechanisms on market dynamics are thus opaque, and CESR will not argue that market dynamics would be a strong reason for either having a regulatory mechanism nor not having it. This would also be somewhat awkward, since financial regulation is rarely used for dealing with competitive issues.

260. The reason for having a regulatory mechanism should rather be that there exists some market failure that has to be dealt with. In essence all the issues discussed in the previous chapter arise because the existence of conflicts of interests between the CRAs and the issuers and/or the users of ratings (the investors). These types of conflicts of interests between professional players on the financial markets are natural and exist in numerous areas of the markets. They become especially apparent in the rating market because of the lack of balance of power between the different players. Issuers are relatively weak compared to the CRAs because of their dependence on the ratings they get. Investors have not historically invested large resources in improving rating agencies behaviour, perhaps because there was insufficient transparency on the way CRAs operated to facilitate this. This meant that CRAs historically have a very strong position. What the IOSCO Code is trying to do is to rebalance the interests between the different players.

261. It is important to stress that this is what the Code does – it adjusts the balance of power between different interests in the rating market, in particular it does this by substantially increasing the transparency of the rating process and prescribing thoroughness in the methodology. It will not change the CRAs in a way that they necessarily give more accurate ratings. The focus on ratings has increased in the wake of bankruptcy filings by large publicly held companies with rated securities. In some of these cases, CRAs have been criticised for failing to notice evidence of financial problems at several major issuers until just prior to the entity's collapse. The alleged failures could very well be the same, even if the Code would had been applied at those times. The CRAs repeatedly argue that a rating is an opinion, not a fact itself and that the facts on which they rely to make their rating decisions are provided by the issuers themselves and their agents and advisors. CRAs do not audit or verify this information and assume it to be accurate. The Code might not prevent issuers from misleading CRAs in the future, but it will certainly promote investor protection by safeguarding the integrity of the rating process. In this respect, the Code may make it easier for market players to evaluate the quality of CRAs and thereby market mechanisms may induce better ratings in a longer term. If, in addition to the provisions of the IOSCO Code, a regulatory mechanism were set up, this would further incentivise CRAs to be diligent and work to avoid future failings in the rating process.

262. According to CESR, the question on whether the IOSCO Code should be enforced or not is a matter of efficiency. On the one hand, the Code is new and we have not yet been able to see how well the CRAs adopt it, and what the effects of it are. If the compliance of the Code is taken on genuinely, the introduction of

recognition procedure might not improve much. Since this would come at some cost, it may not be beneficial from an overall point of view. The costs are the normal ones that exists with regulation; costs for administering the system, that it may hamper the dynamics of market practices etc.

263. A particular cost could be that any recognition system that is set up is mainly dealing with problems that relates to the dominant CRAs. If this system is set up, a number of other CRAs will probably seek recognition. Depending on how strong the supervision is, the recognising of a large number of CRAs may become quite a lengthy procedure. If the requirements are modest, this may not become a big problem, but on the other hand, there is a risk that CRAs of lower quality are becoming recognised and thereby get a quality stamp by the EU. Consequently, any recognition system to work well should be able to reach a good balance between too high and too low levels or regulatory requirements.

264. On the other hand, rules without enforcement mechanisms risk becoming weak. If the CRAs do not comply with the Code or do note disclose information on the extent of compliance, there are no formal supervisory powers to react against them. It may also be the case that the CRAs make another interpretation of the Code than the authorities, and that they view themselves as compliant. In these cases, the market pressure for them to adjust is probably not very strong. Without a formal mechanism to intervene, it may also be difficult to get enough information from the CRAs for both the authorities and other interested parties, to actually evaluate compliance with and disclosure on the extent of compliance with the Code.

265. When it comes to the enforcement issue, a clear majority of CESR members is of the view that there is an argument for the wait and see approach, where no recognition system is set up at present, and the effects of the Code are let to work. The introduction of the IOSCO Code states that the IOSCO Technical Committee may revisit the Code in the future should experience dictate that modifications are necessary. Overall, this is the preferred option by the respondents to the consultation.

266. An alternative, supported by a distinct minority of CESR members, would be a recognition system set up for the EU; a system where CRAs voluntarily register and thereby subscribe to that they will follow the IOSCO Code. This would be assessed by the party in charge of the recognition or implemented by a rather declarative procedure by CRAs. The system should be supported by subsequent reporting mechanisms, on a regular basis or when required, but should not use a more stringent regulatory system with periodic on-site and off-site examinations. It is important that such a recognition system is as efficient as possible at a European level and avoids to the extent possible duplicatory oversight and therefore unnecessary costs for CRAs. This would exclude the involvement of the national regulator of each Member State in which the CRA operates.

267. The issue of the CRD and recognition of ECAIs have not been touch upon in the previous discussion. The reason is that CESR thinks that this process must be seen

separately from the issue of conduct rules for CRAs. The CRD has its own objectives and the ECAI recognition system must be set up according to those objectives. At the same time, these objectives and the effects of the ECAI recognition system cannot be seen separately from the aims and the results of the IOSCO Code. This means that it is necessary that there is a close cooperation between CESR and CEBS and the banking regulators. However, this cooperation is necessary regardless of whether a recognition system is set up for the IOSCO Code or not. If the EU choose not to set up a recognition system for CRAs, it is important to have insight into the ECAI recognition procedure, so that effects on securities markets can be well understood. If a recognition system is set up, it is important that exchange of information takes place, so that ECAI recognition and CRA recognition is taking place in a consistent manner. This need of co-operation between regulators should be extended also to CEIOPS and insurance supervisors.

268. As already stated in the introductory section of this document, CESR stresses the need for a common worldwide approach on the treatment of CRAs. CESR acknowledges that the US SEC is currently assessing a possible review of the NRSRO system. Before any decision is taken on any side of the Atlantic, either by the European Commission or by the SEC, CESR encourages a close co-ordination between the different regulators and hopes to continue to be an active party in this process.

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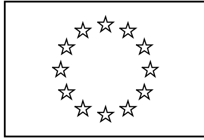
ANNEXES TO THE ADVICE

ANNEX A



EUROPEAN COMMISSION
Internal Market DG

Brussels,

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

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

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

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

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

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

1. BACKGROUND

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

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

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

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

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

(i) potential conflicts of interests within rating agencies;

(ii) transparency of rating agencies' methodologies;

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

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

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

The aim of the call is for CESR to provide the Commission with technical analysis and advice relating to the identified questions[11] in order for the Commission to assess the need, or not, for introducing European legislation or other solutions in this field.
In view of the commitment made by the Commission at the Oviedo Informal ECOFIN Council, the July 2005 deadline mentioned in European Parliament's resolution and the numerous public contributions already made on the topic, the Commission requests CESR's advice by [1 April 2005].

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

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

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

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

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

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

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

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

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

3.1. Technical advice related to the issue of interests and conflicts of interest for credit rating agencies

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

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

The technical advice should at least take into account:

- the risk that the provision of advisory services by rating agencies to issuers they rate might influence the rating of these issuers;

- the possible consequent need to disclose, manage or prohibit such advisory services;

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

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

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

The technical advice should at least take into account:

- the risk that payments for credit ratings to the rating agencies by subscribing issuers might influence the rating of these issuers;

- the possible consequent need to disclose the existence (but not the amount) of, or manage, such payments;

- the issue of unsolicited ratings turned into solicited;

- the possible consequent need to disclose, or manage, unsolicited ratings;

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

- the provisions of Article 13 paragraph 3 and Article 18 of European Parliament and Council Directive 2004/39/EC on markets in financial

instruments, as well as CESR's current work on technical advice for possible implementing measures in respect of those Articles. CESR shall ensure that its advice in respect of rating agencies is consistent with the treatment of conflicts of interest foreseen for investment firms.

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

The technical advice should at least take into account:

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

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

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

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

The technical advice should at least take into account:

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

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

The technical advice should at least take into account:

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

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

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

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

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

The technical advice should at least take into account:

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

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

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

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

The technical advice should at least take into account:

- the need to ensure that issuers periodically have the opportunity to discuss with rating agencies the assumptions and fundamental determinants of their ratings;

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- the need to ensure that information published by rating agencies (alongside rating opinions) is accurate and the role issuers are to play in such a process;
- the need for issuers to understand how rating agencies restate the figures they give them;
- the importance of rating agencies archiving all information related to a rating so that a rating decision can be explained to issuers at a later stage;
- the need for all rating agencies to have access to the same information from companies (rating agency data room).

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

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

Technical advice related to availability of credit ratings and to the existence of possible entry barriers to the market for the provision of credit ratings
The technical advice should at least take into account:

- whether there are any entry barriers to the market for credit ratings arising from regulatory requirements or otherwise and, if so, whether measures could/should be taken to reduce or remove any such barriers;
- the new framework for capital requirements for banks and investment firms;
- the coverage and availability of credit ratings in different Member States for various categories of economic entities, with particular attention to SMEs.

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

European legislation makes use of ratings as a regulatory instrument. The proposed framework for capital requirements for banks and investment firms would extend the use of ratings in European legislation. From a technical point of view, does CESR

consider that further use of ratings in European legislation should be encouraged beyond these measures?

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

3.6. REGISTRATION

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

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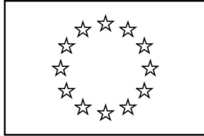

EUROPEAN COMMISSION
Internal Market DG

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

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

1. EUROPEAN PARLIAMENT

1.1 European Parliament Resolution on role and methods of rating agencies

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

Main features of the European Parliament resolution:

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

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

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

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

- Regards specialisation of some rating agencies (in specific economic sectors or

specific attributes of rated issuers) should not constitute any obstacle to their being treated on a level playing field with other rating agencies by regulatory authorities;

- Asks the Commission, CESR and the European Banking Committee to take into account the conclusions of the Financial Stability Forum, the IOSCO report on credit rating agencies and any reform of rating agency approval by the US SEC;
- Considers that rating agencies have public good objectives and should, therefore, report on their yearly activities and in particular on the financing of their rating activities;
- Favours inviting agencies to discuss setting up a voluntary industry body that would determine best practice, encourage training and provide a disputes and arbitration procedure for issuers or investors that felt aggrieved by the process leading up to an agency's decision;
- Wishes to oblige rating agencies to make public all their unsolicited ratings and to explain upon request any substantial difference between any unsolicited and subsequently solicited rating on the same debt or rated entity;
- Rejects the idea of regulating of content and opinions expressed by the agencies, stressing the need of agencies' independence from political or business influence, but does not reject regulation of process (whilst recognising the difficulty of drawing such a distinction);
- Wants issuers and debtors (that choose to be rated) to provide all relevant information on a permanent basis to rating agencies;
- Wants agencies to be transparent with regard to their methods, models and fees;
- Wants ratings users to disclose any rating triggers included in loan agreements in order to preserve the stability of markets;
- Asks the EU's competition authorities to consider any evidence of oligopoly;
- Calls on the Commission to submit, by 31 July 2005, its assessment of the need for appropriate legislative proposals to deal with the issues in the Parliament's Resolution and to ensure that any provisions adopted are consistent with the review of capital requirements for banks and investment firms (Basel II).

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

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

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

2. INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS (IOSCO)

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

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

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

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

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

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

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

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Main features of the Statement of Principles:

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

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

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

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

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

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

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

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

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

3. UNITED STATES SECURITIES AND EXCHANGE COMMISSION (SEC)

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

"nationally recognised statistical rating organisations" (NRSROs) by the SEC through the no-action letter process. There are currently four NRSROs: Moody's Investors Service, Inc; Fitch, Inc; Standard and Poor's, a division of The McGraw-Hill Companies, Inc; and Dominion Bond Rating Service Limited (DBRS).

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

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

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

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

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

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

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

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

Areas of questions presented by the SEC for public discussion:

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

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

4. G8 DECLARATION ON 'FOSTERING GROWTH AND PROMOTING A RESPONSIBLE MARKET ECONOMY' (JUNE 2003)

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

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

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

5. ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT (OECD)

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

The initial Principles of Corporate Governance were adopted by OECD governments in 1999. It was decided that they should be revised in 2002, following a request from

OECD governments for reinforcement of the Principles in response to then recent corporate scandals. A draft of the revised version was submitted to the public in January 2004.

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

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

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

6.1 Rating Agencies Survey by US AFP (November 2002)

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

Main result of the AFP survey:

- 65% of corporate practitioners and 60% of financial industry service providers believe the SEC should clarify the procedures it uses for recognising rating agencies;
- 73% of corporate practitioners and 71% of financial industry service providers believe the SEC should periodically review the rating agencies it recognises;
- 56% of corporate practitioners and 63% of financial industry service providers believe that the recognition of additional rating agencies would improve ratings quality;
- 58% of corporate practitioners and 76% of financial industry service providers believe that the recognition of additional rating agencies would improve timeliness.

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

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

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

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

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

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

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➢ **Regulatory recommendations**:

- Credibility and reliability of ratings: no prescription of rating agencies methodology by regulators, but requirement that every rating agency documents and adheres to its chosen, published methodology; requirement to disclose the date of the last formal review and of the last ratings update;

- Transparency in the rating agency recognition process and removal of barriers to competition: transparent, simple, stringent but attainable criteria for recognition or approval of rating agencies;

- Improvement of on-going regulatory oversight of approved rating agencies: regular review of each recognised agency;

- Inside information flows: regulators should require rating agencies to document and implement policies and procedures to prevent the selective disclosure of inside information (in particular where rating agencies are part of a wider organisation that might benefit from inside information) and prohibit former rating agencies analysts from taking positions in securities markets or working as journalists;

➢ **Recommendations for a rating agency Code of Standard Practices**:

- Improvement of the transparency of the rating process: public disclosure of methodology and of changes in methodology; public disclosure of the definition and historical default rates of each rating symbol used; public disclosure of the qualification and sector coverage of the analyst concerned;

- Protection against conflicts of interest: ownership structure unlikely to create conflicts of interest; strong Chinese walls between rating analysts and agency staff responsible for raising revenue from solicited ratings; strong Chinese walls between rating analysts and staff involved in providing rating advisory services;

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

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

- Improvement of communication with issuers and other market participants: review by issuers of accuracy of reported information prior to public release; disclosure by the rating agency to the issuer of the key assumptions and fundamental analysis underlying the rating decision; right of appeal by the

issuer, including to the rating committee or through an outlook from a new group of analysts; recording of information related to the issuer for a sufficient period;

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

- Minimum list of information to provide to rating agencies: business strategy, legal and management structure and processes, business environment, risk management and financing, any material change in the financial situation;
- Full review between rating agency and issuer at least once a year;
- Information of rating agency by issuer ahead of launching any corporate actions;
- Fast answer to rating agency requests;
- No pre-emptive action to challenge or counter the release, during the period where rating agencies submit communications to the issuer prior to their public release;
- Not taking advantage of a delay in the release of a rating by making any debt issuance other than the refinancing of maturing short-term debt.

ANNEX B

CODE OF CONDUCT FUNDAMENTALS FOR CREDIT RATING AGENCIES

THE TECHNICAL COMMITTEE OF THE INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS

CODE OF CONDUCT FUNDAMENTALS FOR CREDIT RATING AGENCIES

INTRODUCTION

Credit rating agencies (CRAs) can play an important role in modern capital markets. CRAs typically opine on the credit risk of issuers of securities and their financial obligations. Given the vast amount of information available to investors today – some of it valuable, some of it not – CRAs can play a useful role in helping investors and others sift through this information, and analyze the credit risks they face when lending to a particular borrower or when purchasing an issuer's debt and debt-like securities.[6]

In September 2003, IOSCO's Technical Committee published a Statement of Principles Regarding the Activities of Credit Rating Agencies.[7] The Principles were designed to be a useful tool for securities regulators, rating agencies and others wishing to articulate the terms and conditions under which CRAs operate and the manner in which opinions of CRAs should be used by market participants. Because CRAs are regulated and operate differently in different jurisdictions, the Principles laid out high-level objectives that rating agencies, regulators, issuers and other market participants should strive toward in order to improve investor protection and the fairness, efficiency and transparency of securities markets and reduce systemic risk. The Principles were designed to apply to all types of CRAs operating in various jurisdictions. However, to take into account the different market, legal and regulatory circumstances in which CRAs operate, and the varying size and business models of CRAs, the manner in which the Principles were to be implemented was left open. The Principles contemplated that a variety of mechanisms could be used, including both market mechanisms and regulation.

Along with the Principles, IOSCO's Technical Committee also published a Report on the Activities of Credit Rating Agencies that outlined the activities of CRAs, the types of regulatory issues that arise relating to these activities, and how the Principles address these issues.[8] The CRA Report highlighted the growing and sometimes controversial importance placed on CRA assessments and opinions, and found that, in some cases, CRAs activities are not always well understood by investors and issuers alike. Given this lack of understanding, and because CRAs typically are subject to little formal regulation or oversight in most jurisdictions,

[6] CRAs typically provide credit ratings for different types of debts and financial obligations — including, for example, private loans, publicly and privately traded debt securities, preferred shares and other securities that offer a fixed or variable rate of return. For simplicity's sake, the term "debt and debt-like securities" is used herein to refer to debt securities, preferred shares, and other financial obligations of this sort that CRAs rate.
[7] This document can be downloaded from IOSCO's On-Line Library at www.iosco.org (IOSCOPD151).
[8] This document can be downloaded from IOSCO's On-Line Library at www.iosco.org (IOSCOPD153).

concerns have been raised regarding the manner in which CRAs protect the integrity of the rating process, ensure that investors and issuers are treated fairly, and safeguard confidential material information provided them by issuers.

Following publication of the CRA Principles, some commenters, including a number of CRAs, suggested that it would be useful if IOSCO were to develop a more specific and detailed code of conduct giving guidance on how the Principles could be implemented in practice. The following Code of Conduct Fundamentals for Credit Rating Agencies is the fruition of this exercise. As with the Principles, with which it should be used, the Code Fundamentals were developed out of discussions among IOSCO members, CRAs, representatives of the Basel Committee on Banking Supervision, the International Association of Insurance Supervisors, issuers, and the public at large.[9]

The Code Fundamentals offer a set of robust, practical measures that serve as a guide to and a framework for implementing the Principles' objectives. These measures are the fundamentals which should be included in individual CRA codes of conduct, and the elements contained in the Code Fundamentals should receive the full support of CRA management and be backed by thorough compliance and enforcement mechanisms. However, the measures set forth in the Code Fundamentals are not intended to be all-inclusive: CRAs and regulators should consider whether or not additional measures may be necessary to properly implement the Principles in a specific jurisdiction, and the Technical Committee may revisit the Code Fundamentals in the future should experience dictate that modifications are necessary. Further, the Code Fundamentals are not designed to be rigid or formulistic. They are designed to offer CRAs a degree of flexibility in how these measures are incorporated into the individual codes of conduct of the CRAs themselves, according to each CRA's specific legal and market circumstances.

IOSCO Technical Committee members expect CRAs to give full effect to the Code Fundamentals. In order to promote transparency and improve the ability of market participants and regulators to judge whether a CRA has satisfactorily implemented the Code Fundamentals, CRAs should disclose how each provision of the Code Fundamentals is addressed in the CRA's own code of conduct. CRAs should explain if and how their own codes of conduct deviate from the Code Fundamentals and how such deviations nonetheless achieve the objectives laid out in the Code Fundamentals and the IOSCO CRA Principles. This will permit market participants and regulators to draw their own conclusions about whether the CRA has implemented the Code Fundamentals to their satisfaction, and to react accordingly. In developing their own codes of conduct, CRAs should keep in mind that the laws

[9] A consultation draft of the Code Fundamentals was published for public comment in October 2004. This document (IOSCOPD173) and a list of public comments IOSCO received on the consultation draft (IOSCOPD177) can be downloaded from IOSCO's On-Line Library at www.iosco.org. The online version of the list of public comments includes hyperlinks to the comment letters themselves.

and regulations of the jurisdictions in which they operate vary and take precedence over the Code Fundamentals. These laws and regulations may include direct regulation of CRAs and may incorporate elements of the Code Fundamentals itself.

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

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

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

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

TERMS

The Code Fundamentals are designed to apply to any CRA and any person employed by a CRA in either a full-time or part-time capacity. A CRA employee

who is primarily employed as a credit analyst is referred to as an "analyst." For the purposes of the Code Fundamentals, the terms "CRA" and "credit rating agency" refer to those entities whose business is the issuance of credit ratings for the purposes of evaluating the credit risk of issuers of debt and debt-like securities.

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

THE IOSCO CODE OF CONDUCT FUNDAMENTALS FOR CREDIT RATING AGENCIES

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

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

1. QUALITY AND INTEGRITY OF THE RATING PROCESS

A. Quality of the Rating Process

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

known to the CRA that is relevant to its analysis according to the CRA's published rating methodology.

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

1.3 *In assessing an issuer's creditworthiness, analysts involved in the preparation or review of any rating action should use methodologies established by the CRA. Analysts should apply a given methodology in a consistent manner, as determined by the CRA.*

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

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

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

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

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

B. Monitoring and Updating

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

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

b. *initiating a review of the status of the rating upon becoming aware of any information that might reasonably be expected to result in a rating action*

(including termination of a rating), consistent with the applicable rating methodology; and,

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

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

C. Integrity of the Rating Process

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

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

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

1.14 *The CRA and its employees should not, either implicitly or explicitly, give any assurance or guarantee of a particular rating prior to a rating assessment. This does not preclude a CRA from developing prospective assessments used in structured finance and similar transactions.*

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

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

other CRA staff or by the CRA itself against any employees who, in good faith, make such reports.

2. CRA INDEPENDENCE AND AVOIDANCE OF CONFLICTS OF INTEREST

A. General

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

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

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

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

2.5 *The CRA should separate, operationally and legally, its credit rating business and CRA analysts from any other businesses of the CRA, including consulting businesses, that may present a conflict of interest. The CRA should ensure that ancillary business operations which do not necessarily present conflicts of interest with the CRA's rating business have in place procedures and mechanisms designed to minimize the likelihood that conflicts of interest will arise.*

B. CRA Procedures and Policies

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

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

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

2.9 The CRA and its employees should not engage in any securities or derivatives trading presenting conflicts of interest with the CRA's rating activities.

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

C. CRA Analyst and Employee Independence

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

2.12 The CRA should not have employees who are directly involved in the rating process initiate, or participate in, discussions regarding fees or payments with any entity they rate.

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

a. Owns securities or derivatives of the rated entity, other than holdings in diversified collective investment schemes;

b. Owns securities or derivatives of any entity related to a rated entity, the ownership of which may cause or may be perceived as causing a conflict of interest, other than holdings in diversified collective investment schemes;

c. Has had a recent employment or other significant business relationship with the rated entity that may cause or may be perceived as causing a conflict of interest;

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

e. *Has, or had, any other relationship with the rated entity or any related entity thereof that may cause or may be perceived as causing a conflict of interest.*

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

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

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

3. CRA RESPONSIBILITIES TO THE INVESTING PUBLIC AND ISSUERS

A. Transparency and Timeliness of Ratings Disclosure

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

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

3.3 *The CRA should indicate with each of its ratings when the rating was last updated.*

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

3.5 *The CRA should publish sufficient information about its procedures, methodologies and assumptions (including financial statement adjustments that deviate materially from those contained in the issuer's published financial statements) so that outside parties can understand how a rating was arrived at by the CRA. This*

information will include (but not be limited to) the meaning of each rating category and the definition of default or recovery, and the time horizon the CRA used when making a rating decision.

3.6 *When issuing or revising a rating, the CRA should explain in its press releases and reports the key elements underlying the rating opinion.*

3.7 *Where feasible and appropriate, prior to issuing or revising a rating, the CRA should inform the issuer of the critical information and principal considerations upon which a rating will be based and afford the issuer an opportunity to clarify any likely factual misperceptions or other matters that the CRA would wish to be made aware of in order to produce an accurate rating. The CRA will duly evaluate the response. Where in particular circumstances the CRA has not informed the issuer prior to issuing or revising a rating, the CRA should inform the issuer as soon as practical thereafter and, generally, should explain the reason for the delay.*

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

3.9 *For each rating, the CRA should disclose whether the issuer participated in the rating process. Each rating not initiated at the request of the issuer should be identified as such. The CRA should also disclose its policies and procedures regarding unsolicited ratings.*

3.10 *Because users of credit ratings rely on an existing awareness of CRA methodologies, practices, procedures and processes, the CRA should fully and publicly disclose any material modification to its methodologies and significant practices, procedures, and processes. Where feasible and appropriate, disclosure of such material modifications should be made prior to their going into effect. The CRA should carefully consider the various uses of credit ratings before modifying its methodologies, practices, procedures and processes.*

B. The Treatment of Confidential Information

3.11 *The CRA should adopt procedures and mechanisms to protect the confidential nature of information shared with them by issuers under the terms of a confidentiality agreement or otherwise under a mutual understanding that the*

information is shared confidentially. Unless otherwise permitted by the confidentiality agreement and consistent with applicable laws or regulations, the CRA and its employees should not disclose confidential information in press releases, through research conferences, to future employers, or in conversations with investors, other issuers, other persons, or otherwise.

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

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

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

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

3.16 *CRA employees should not selectively disclose any non-public information about rating opinions or possible future rating actions of the CRA, except to the issuer or its designated agents.*

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

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

4. DISCLOSURE OF THE CODE OF CONDUCT AND COMMUNICATION WITH MARKET PARTICIPANTS

4.1 *The CRA should disclose to the public its code of conduct and describe how the provisions of its code of conduct fully implement the provisions of the IOSCO Principles Regarding the Activities of Credit Rating Agencies and the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies. If a CRA's code of conduct deviates from the IOSCO provisions, the CRA should explain where and why these deviations exist, and how any deviations nonetheless achieve the objectives contained in the IOSCO provisions. The CRA should also describe generally how it intends to enforce its code of conduct and should disclose on a*

timely basis any changes to its code of conduct or how it is implemented and enforced.

4.2 *The CRA should establish a function within its organization charged with communicating with market participants and the public about any questions, concerns or complaints that the CRA may receive. The objective of this function should be to help ensure that the CRA's officers and management are informed of those issues that the CRA's officers and management would want to be made aware of when setting the organization's policies.*

ANNEX C

Summary of responses to CESR's questionnaire on CRAs addressed to its members

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

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

As the CESR questionnaire only focused on the abovementioned issues/jurisdictions not covered by the IOSCO one, the conclusions drawn from the latter are fully valid for CESR work unless otherwise stated in this summary. Said conclusions are summarized in section III of the IOSCO Report on the Activities of Credit Rating Agencies[10].

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

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

1. General: CRAs' operations in the EU

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

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

2. Market failures

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

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

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

4. Oversight

The majority of CESR members indicated that no particular government agency in their jurisdiction exercises oversight authority over CRAs as such. Notwithstanding, in certain countries credit ratings are used in particular areas of securities regulation, such as public offers of securities or securitizations. In these cases, the

securities regulators exercise supervision over CRAs' activities regarding only the issues where credit ratings are mandatory according to the relevant legislation.
In addition, some CESR members indicated that CRAs operating in their jurisdictions are subject to a variety of securities and financial regulations, particularly those governing disclosure and use of information.

5. Registration

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

6. Users of CRA ratings

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

Issuers

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

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

Regulators

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

7. Regulatory Recognition Criteria

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

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

8. Barriers to Market Entry

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

9. Availability of Credit Ratings

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

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

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

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

11. Conflicts of interest

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

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

ANNEX D
USE OF RATINGS IN PRIVATE CONTRACTS

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

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

2. UNITED STATES SECURITIES AND EXCHANGE COMMISSION (SEC)

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

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

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

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

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

3. European Central Bank: Occasional paper series (N°. 16/June 2004): "Market dynamics associated with credit ratings. A literature review"

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

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

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

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

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

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

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

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

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

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

Table

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

Source: Moody's Investors Service (2001).

As can be seen in this table, contingency clauses are diverse in nature, and hence their consequences, if activated, may be wideranging:

• Collateral, L/Cs and bonding provisions are clauses that are usually written into bank loan agreements. When the clause is triggered, the mechanism does not result in a change in the initial financing conditions but
requires the borrower to pledge assets to guarantee its financing over time. Hence, the impact of the triggered clause should mainly be on the opportunity cost of capital.

• Pricing grids or adjustments in interest rates or coupons are features found both in bonds and in bank loans where the initial interest rate or coupon is revised in the event of a change in the borrower's rating (or in some of its financial ratios). The impact of the exercised trigger is a mechanical increase in the cost of capital.

• Acceleration clauses may have more severe, or sometimes even critical, effects. For example, for a loan or bond initially issued for a long period, the triggering of the clause may result in an acceleration of repayments
or even early termination of credit. As mentioned above, these types of clause are used both in bond contracts and in bank loan agreements as well as in back-up credit lines. Not only does the triggering of a clause result in an increase in the cost of capital, but also in an immediate need for new capital.

Two major problems associated with rating triggers are worth highlighting:

• Rating triggers can contribute to "credit cliff" situations. "Credit cliff" is market jargon for a situation in which dire consequences, i.e. compounding credit deterioration, possibly leading to default, may be expected should certain risk scenarios materialise. In this regard, S&P has stated that "in these cases, if there is a rating change, it will necessarily be a very substantial change (due to) the entity's greater sensitivity to credit quality or a particular occurrence." This can put material pressure on the company's liquidity or its business. For example, when downgraded, the position of a company that is performing poorly will worsen as its cost of capital rises. Rating triggers and other covenants, particularly when combined, can contribute to the development of such credit cliffs and may speed up the pace at which the cost of capital increases due to credit deterioration. This is especially the case in situations where multiple triggers are set off simultaneously, or when the triggering of one clause leads to an accumulation of negative consequences. It is not clear how CRAs take

these situations into account. Bonds rated at the lowest investment-grade notch (where traditionally a large proportion of these rating triggers have been found) tend to suffer large price falls when they are downgraded. Owing to the above mentioned risks of self-fulfilling effects, the presence of rating triggers may reinforce the finding that rating agencies are only willing to decide on a rating action when it is unlikely to be reversed shortly afterwards.

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

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

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

Furthermore, the present context of incomplete transparency and disclosure of rating triggers may be seen as impacting on the price discovery mechanism of fixed income products (and, by extension, equities) as it results in an additional risk premium associated with this "rating trigger" uncertainty. This in turn may lead to a higher cost of capital and higher yields than would have been the case under a more transparent framework. Thus, the "benefits" of these clauses are not fully exploited. However, if rating triggers were systematically disclosed from their inception, this information would be priced in from the start in bond issues (and stocks) and the number of triggers used in debt issues of any single borrower would probably be more limited. Moreover, it could also be argued that the expected benefits (for issuers) from these devices would prove illusory, as the relative prices of the various debt instruments of an issuer/borrower and its equity price would adjust to

reflect the existence of rating triggers in some debt instruments, and that the benefits (in terms of favourable financing conditions) stemming from trigger-carrying instruments would be offset by deteriorating financing conditions (and increased volatility) for "unprotected" instruments. It is, of course, unlikely that all rating triggers could be disclosed, since there are private placements and bank loan agreements with embedded options. Still, greater transparency should have both direct and indirect positive effects on credit markets."

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

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

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

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

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

- Rating triggers are increasingly being incorporated into loan agreements, indentures, and financial contracts. This is often done to the detriment of the creditors who intend to be protected by these triggers, as well as the borrowers who provided them. Investors who think they might be protected by a rating trigger contained in their respective contract may find - as in recent cases - that there is no protection because the trigger can potentially cause a default or bankruptcy adversely affecting all creditors.
- The presence of rating triggers may result in downward rating pressure depending on the severity of the triggers, the underlying facts and circumstances surrounding the credit, and the rating level of the issuer.
- Rating triggers can result in a precipitous decline in confidence and liquidity. Rating triggers intended to set-off default, acceleration, or "puts" in back-up credit lines, bond indentures, and counterparty agreements are particularly risky. For example, a back-up revolving credit that goes away or a large bond that is puttable in the event of a downgrade below a certain level, are potentially very negative in a difficult scenario. The loss of liquidity when a downgrade occurs may be stressful for the borrower, precisely at the time when the company is least able to deal with

an associated loss of investor confidence. Such triggers can be highly destabilizing because all parties may not behave in a rational fashion.

• Moody's intends to identify, where possible, the existence of rating triggers in each issuer's financial structure, to examine whether those issuers whose agreements contain particularly risky rating triggers have the wherewithal to survive a downgrade to the specified trigger level and the consequences of the trigger.

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

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

The main findings are summarized below:

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

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

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

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

issuer's refusal to provide information about its rating triggers to Moody's will be considered a negative factor in the ratings process.

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

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

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

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

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

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

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

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

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

e) FITCH survey (2002).

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