THE COMMITTEE OF EUROPEAN SECURITIES REGULATORS

Ref: CESR/05-140

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

FEEDBACK STATEMENT

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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.

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.

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. This feedback statement will discuss the main points which were made by respondents in the consultation process and explain the policy options which CESR decided upon. These

policy options have been followed in the advice that CESR is submitting to the European Commission along this feedback statement (CESR/05-139).

I. Introduction

Definition of credit rating agencies

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

10. Although some commentators agreed with the definition as proposed by CESR and did not provide any additional comments on it, most respondents analysed the proposal in detail and made some suggestions.

11. A first concern was expressed on the need to clarify what would be the use of the proposed definition. Some respondents highlighted the fact that the definition of CRAs is a key issue as it would determine the type of entities that would be subject to any future requirement. In their opinion, this is a specially sensitive issue in the context of further regulation of CRAs, as there is a risk that an inappropriate definition would produce unintended consequences by either being over-inclusive or being too narrow.

12. In addition, some commentators pointed out the need to follow a harmonised approach with IOSCO and, therefore, suggested to align the definition of credit rating agencies with the one provided in IOSCO's final Code of conduct for fundamentals for credit ratings (IOSCO Code), by deleting the word "primary". On the other hand, some commentators expressed their concerns with adopting the broader definition included in the final IOSCO Code as it could be over-inclusive. In their view, this definition, which applies to any entity whose business is to issue credit ratings, regardless of whether this is the entity's primary business, would raise the concern that investment firms or banks' research departments may be considered as CRAs.

13. Finally, there was one commentator that suggested to change CESR's proposed definition to cover those agencies that provide ratings to entities that are not issuers, since they have no history of issuances, but are future issuers starting to build up their credit rating history before they go to issue for the first time. It's proposed definition would be "CRA is the entity whose primary business is the issuance of credit ratings for the purposes of evaluating the credit risk of entities, issuers or debt-like securities".

14. Given the comments made by the consultees 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.

Definition of credit ratings

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

15. Concerning the question on the definition of credit rating, there was a general support of the proposal included in the consultation paper and of CESR's decision to follow the IOSCO definition. However, some respondents rightly pointed out that the definition included in the final version of the IOSCO Code had been slightly amended and proposed CESR to align it's definition with the last version, that does not include the term "forecast" any more. These respondents supported IOSCO's decision to change the word "forecasting" by "regarding" as they consider that it clarifies the fact that credit ratings are not "forecasts", but simply an opinion as to creditworthiness.

16. One respondent, however, considered that CESR's definition was too vague and should be improved. In its opinion, the proposed definition could be understood as covering activities such as the assignment of improved scorings based on economic and financial indicators (quantitative indicators) or the assignment of ratings by export credit agencies. In order to avoid the inclusion of such activities in the definition of credit rating, this respondent proposed a definition that would include some aspects which are characteristic and exclusive of the rating activity. Among these the consultee considered the fact that a credit rating is a deep and far-reaching analysis, that it is based on a vast and detailed range of information, that it implies a close contact with the issuer (except in certain cases of unsolicited ratings) and that it represents an analysis substantiated in a detailed and comprehensive report.

17. CESR acknowledges the concerns expressed by this respondent and is aware of the risk implicit in the use of any definition of being over inclusive or too narrow. CESR has analysed the proposed definition and, although it considers that it has some valid points, it deems that keeping consistency with the IOSCO definition is of utmost importance. Therefore, taking into account 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 Code.

Definition of unsolicited ratings

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

18. Most respondents agree with the definition proposed by CESR only partially. In their view the fact that the definition is only based on one element is consider inappropriate as they believe that the relationship between CRAs and issuers is often more complex. They agree that the question of 'who takes the initiative' is highly relevant but they point out other important factors that need to be taken into account, such as the degree of cooperation by the issuer or whether or not the issuer pays for the rating. Each of these factors is a relevant element that has to be analysed in the different cases.

19. 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 of having a definition that applies to all the sections of its advice, CESR has decided to explain what is meant by this term in the

different sections that analyse this topic. Feedback on the comments provided by respondents on unsolicited ratings is provided in paragraphs 69 to 72.

Use of ratings in private contracts

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

20. There seems to be some consensus around the idea that the use of rating triggers in contracts is in principle a matter of private contract and, therefore, most respondents believe that disclosure of the existence and nature of such clauses should not be mandatory in all cases. These respondents argue that disclosure of rating triggers to the market is not necessary unless there is a serious likelihood that the triggering events will occur and that such contractual arrangements will give rise to problems concerning the future solvency of issuers which would affect third parties. In their opinion, as in these cases the provisions on the Prospectus, Transparency and/or Market Abuse Directives would apply, there is no need of specific requirements in the context of credit rating agencies.

21. Nevertheless, some other responses support the need to require disclosure by issuers on this point as they argued that these triggers may have a material effect on an issuer's ability to service its public debt. In their opinion, there is a considerable need for improvement with respect to the timeliness, as well as the content of the information delivered by issuers to investors, including the disclosure of rating triggers.

22. In addition, the need to disclose the existence of credit ratings to the rating agencies in the process of a rating process, so that the credit rating agency can consider the possible impact in the financial position of the issuer, has been outlined by several rating agencies. The request of this information seems to be a common practice among these agencies.

23. CESR has taken into consideration the fact that most market participants have correctly pointed out that the provisions on the Prospectus, Transparency and/or Market Abuse Directives already deal in a quite complete way with the possible effects that rating triggers might have in the market. Therefore, CESR has decided to state in it advice that current EU framework provides the necessary tools to ensure that the market is properly informed when necessary and that there is no need of specific requirements in the context of credit rating agencies.

Use of ratings in European legislation

Question 5: Do you think that the use of ratings in European legislation should be encouraged beyond the proposed framework for capital requirements for banks and investment firms? If yes, please provide examples.

24. There seems to be an almost unanimous agreement among respondents on the fact that the use of ratings in European legislation should not be encouraged.

25. Some respondents point out the danger of regulation of major spheres of economic activity being transferred from public authorities to private institutions, which might not be

subject to sufficient control. Moreover, they consider that this would only increase the strong influence that CRAs already have on markets and companies.

26. Other respondents agree with CESR that this would require a case by case approach and compelling cost/benefit analysis.

27. The only responses supporting the option of increasing the use of ratings in European legislation are the ones coming from two small credit rating agencies. In so far the opinion translated by ratings is valuable for investors because it permits to seize economies of scale and to surpass asymmetries of information between issuers and investors, they consider credit ratings as an overall transparency element. As possible examples for the use of ratings in European legislation they mention, among others, the requirement of compulsory rating for all issues that are to be listed in an organised market or the use of ratings as a basis for the definition of the investment portfolios of collective investment schemes.

28. Having considered that most of the responses agree with CESR's consideration that the use of ratings in European legislation should not be encouraged in a general way without a case-by-case analysis of any possible proposal, CESR has decided to retain this view in the final advice.

II. Competitive Dimension: Registration and Barriers to Entry

29. Many respondents expressed agreement with CESR's assessment of the current barriers to competition in the market for credit ratings.

Key issues

30. It was generally felt that the credit rating market is not perfectly competitive but rather that it is oligopolistic in nature, although this was not generally felt to be a consequence of anti competitive practice by rating agencies.

31. Moreover, some respondents pointed out that the oligopolistic nature of the rating market does not seem to have produced a reduction in the quality of ratings.

32. Respondents agreed that a number of significant natural barriers to competition exist in the market for credit ratings. The most frequently cited barrier to competition was the need to develop credibility based upon a proven track record for credit assessment, the acquisition of which was felt to be time consuming and capital intensive.

33. The majority of respondents were concerned that regulatory intervention would increase barriers to entry and competition, rather than reduce or remove them.

34. It was not generally felt that SMEs were being denied access to the market for ratings, but rather that few SMEs require a rating given their limited participation in international

public debt markets and their traditional reliance upon relationship with banks for their financing needs.

Other Comments

35. A number of respondents mentioned the significant impact of the US regulatory regime on market structure, reminding CESR of the cross-border nature of many ratings services and the international character of many large CRAs. These respondents tended to urge co-operation and co-ordination at a global level, but in particular with the SEC. One respondent suggested that mutual recognition be considered between the EU and US regimes.

Questions

Question 1: Do you think there is a sufficiently level playing field between CRAs or do you think that any natural barriers exist in the market for credit ratings that need to be addressed?

36. The market was deemed to be a natural oligopoly, with three major CRAs and a variable number of small niche CRAs, equity research companies and Credit Registers.

37. Respondents generally felt that barriers to entry do exist in relation to the market for credit ratings, but that these barriers are not insurmountable. These barriers were generally characterised as natural.

38. Two respondents called for careful consideration of contractual terms. One of these expressed concern regarding contractual clauses committing issuers to approaching the same CRA for a large number of issuances, which could not create adequate conditions for competition between agencies; the other expressed concern about absence of clarity in relation to references to ratings in private contracts.

39. 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. A few of these respondents explicitly mentioned avoiding undue limits on the provision of unsolicited ratings as these were considered to be important for a CRA trying to obtain or increase market share.

40. One respondent expressed the view that the risk of reputational damage was a sufficiently strong incentive to ensure that CRAs act with integrity.

41. One respondent stated that self regulation could be a tool for decreasing barriers to entry by facilitating the differentiation between stronger and weaker CRAs.

42. One respondent expressed the view that establishing a formal regulatory regime would increase the potential to recognise new CRAs.

43. A handful of respondents expressed concern over the possibility that a regulatory regime would make it appear as if regulators were endorsing the quality of ratings produced by regulated CRAs, even though these ratings were necessarily subjective in nature.

44. A small number of respondents cautioned CESR not to lower any thresholds too far in the interests of promoting competition as this could damage the quality and reliability of ratings.

Question 2: Do you believe that coverage of certain market segments or certain categories of economic entity (such as SMEs) may be sub optimal/ Are there measures that regulators could use to effect this scenario? Which are they, and would it be appropriate to use them?

45. It was generally agreed that relatively few SMEs are currently rated although there is evidence to suggest that it is possible for them to obtain a rating. A number of SMEs have successfully achieved a rating, either for the company as a whole or for a securitization of their assets.

46. A significant majority of respondents felt that any absence of coverage of SMEs was a consequence of limited historical demand on their part given their traditional reliance upon bank intermediated, as opposed to capital market, finance. One respondent suggested that where SMEs do try to raise market finance this is typically based on brand recognition in a local market rather than credit quality.

47. A few respondents raised the question as to whether the impact of the Capital Requirements Directive and the increasing use of special financial techniques (such as securitization) might change the status quo. One respondent felt that amendments to the UCITS Directive allowing collective investment in SMEs might stimulate additional demand for ratings.

48. A number of respondents reminded CESR that SMEs may be covered by Credit Registers and should carefully consider the scope of its work accordingly.

49. The vast majority of respondents felt that regulatory intervention in relation to the coverage of SMEs was not required or would not be helpful. Only one respondent argued for ‘special treatment’ for CRAs pioneering into new markets such as that for SMEs.

50. Taking into account all the comments to the consultation on the previous two questions, specially those in relation to the impact of regulation on competition, CESR has decided that, as this impact is not clear, it cannot conclude that regulation would either increase or decrease entry barriers to the rating industry. Consequently, CESR has decided not to recommend the use of regulation as a mean to reduce or remove entry barriers to this market.

III. Rules of Conduct Dimension

Interests and conflicts of interest

51. Generally speaking respondents agreed with the option to make transparent any interests and conflicts of interest between the credit rating agency and its stakeholders.

Key elements

52. Many comments stated that it would promote confidence in the rating agencies if they were to publish information about policies and measures introduced to manage and disclose all actual or potential conflicts of interests.

53. Some commentators stipulated that full transparency on the issue of interests and conflicts of interest should be accompanied by internal measures to manage interests and conflicts of interest, as meant in measure 2.5 of the IOSCO Code. It is then up to the credit rating agency to introduce for example Chinese Walls between the department where all analytical staff work and other departments, with appropriate internal control mechanisms.

Other comments

54. The other main issue raised, questioned the need and effectiveness of a credit rating agency having to disclose the application of the policies and procedures regarding interests and conflicts of interest in each rating issued. It was felt that apart from having to introduce policies and measures managing and disclosing interests and conflicts of interest, it would simply add to a list of disclaimers and other formal information if the aforementioned application would have to be disclosed in each and every rating.

55. Several respondents put forward the suggestion to add to general disclosure of policies and measures concerning interests and conflicts of interest a disclosure merely in case those policies and measures would not have been applied by the credit rating agency to a particular rating, a so-called exception disclosure.

Questions

Question 1: To what extent do you agree that in order to adequately address the risk that any conflicts of interest might adversely affect the credit rating it is sufficient to have the credit rating agency (i) introduce and disclose policies and procedures for management and disclosure of conflicts of interests, and(ii) disclose whether the said policies and procedures have been applied in each credit rating?

56. As explained above, comprehensive information about the policies and procedures for management and disclosure of conflicts of interests as mentioned in part was considered sufficient by the respondents and therefore they did not support part (ii). However, some of them suggested that the credit rating agency could disclose instead if it haven't applied the said policies and measures to a particular rating.

Ancillary services

57. It was generally felt that interests or conflicts of interest that could or could be perceived to be the result of ancillary services should be addressed by transparency, and certainly not by prohibition.

Key elements

58. Many respondents stressed that the so-called rating assessment services or rating evaluation services should not be categorized as ancillary as they belong to the core business of assessing the credit risk of an issuer or of debt or debt-like securities.

59. The other main point raised was the need for credit ratings agencies to introduce and implement policies and measures to separate the rating services from all other services.

Other comments

60. As discussed in the previous section, the other main issue raised questioned the need and effectiveness of a credit rating agency having to disclose the application of the policies and procedures regarding ancillary services in each rating issued. It was felt that apart from having to introduce policies and measures managing and disclosing ancillary services, it would simply add to a list of disclaimers and other formal information if the aforementioned application were to be disclosed in each and every rating.

61. Several respondents put forward the suggestion to add to general disclosure of policies and measures concerning ancillary services a disclosure merely in case those policies and measures would not have been applied by the credit rating agency to a particular rating, a so-called exception disclosure.

Question 2: Do you consider that to adequately address the risk that the provision of ancillary services might influence the credit ratings process it is necessary to prohibit a credit rating agency from carrying out those services? If your answer is yes, how would you address the entry barriers that could be created by imposing such a ban?

62. The responses did not consider it to be a market-orientated solution to address the risk that the provision of ancillary services might influence the credit ratings process by prohibiting these services all together. They suggested instead that credit rating agencies 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.

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

63. The vast majority of respondents did not feel it necessary to single out rating services with regard to structured finance products and thought that 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.

Question 4: To what extent do you agree that in order to adequately address the risk that the provision of ancillary services might influence the credit ratings process it is sufficient *to have the credit rating agency (i) introduce and disclose policies and measures managing and disclosing multiple business relationships with issuers in general and the issuer being rated in particular, and (ii) disclose whether the said policies and procedures have been applied in each credit rating?*

64. Respondents recommended that credit rating agencies take into account only part (i), as part (ii) is considered to add to formal information only.

Payments by issuers

65. In general respondents stated that the issue of payments by issuers, the issuer being the subject of the credit rating, did not per se create a significant conflict of interest or a risk of issuer's influence on the credit rating process. A credit rating agency should have in place effective policies and measures dealing with interests and conflicts of interest in general, including actual or potential undue influence from the issuer paying for the credit rating.

Key elements

66. However, it was strongly felt amongst issuers that the option of having a credit rating agency disclose a fee scheme would decrease the bargaining power of issuers to negotiate discounts from a disclosed fee scheme. In addition, it was felt that a disclosed fee scheme would not prevent an issuer from trying to influence the rating.

Other comments

67. The other main issue raised questioned the need and effectiveness of a credit rating agency having to disclose the application of the policies and procedures regarding interests and conflicts of interest in each rating issued. It was felt that apart from having to introduce policies and measures managing and disclosing interests and conflicts of interest it would simply add to a list of disclaimers and other formal information if the aforementioned application would have to be disclosed in each and every rating.

Question 5: To what extent do you agree that in order to adequately address the risk that an issuer paying for a credit rating might influence his rating it is sufficient to have the credit rating agency (i) introduce policies and procedures, including but not limited to the introduction of a fee scheme, (ii) disclose his fee scheme and (iii) disclose whether the fee scheme has been applied in each credit rating?

68. As stated above, in general respondents advocated that credit rating agencies 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 part (i). It was also argued that a credit rating agency should only disclose if and when its policies and measures have not been applied to a particular rating.

Unsolicited ratings

Question 6: In order to deal with issues related to unsolicited ratings, to what extent do you agree that it is sufficient to have the credit rating agency (i) introduce and disclose policies *and measures with regard to issuing unsolicited credit ratings and (ii) disclose whether the said policies and measures have been applied in each unsolicited credit?*

69. Nearly all respondents reflected on the definition and implications of unsolicited ratings. It was generally felt that transparency rather than prohibition or other kinds of regulation would best achieve the aim of enhancing confidence in unsolicited ratings.

Key elements

70. The responses received stated that the scope of the consultation paper regarding unsolicited ratings was to narrow and that in any case several aspects together indicate whether a credit rating is unsolicited or not. There was a broad sense of need for transparency rather than regulation to enhance investor's and issuer's confidence in unsolicited ratings.

71. The following aspects 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 rater or the issuer;
b. degree of co-operation between the credit rater or the issuer;
c. whether or not the credit rater has access to management of the issuer;
d. whether or not the credit rater 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.

Other comments

72. Many respondents saw the need to have transparency not only about the policies and procedures with regard to the issuance of unsolicited rating but also about their application.

Capital or other interest links

73. Generally speaking respondents agreed with the option to make transparent any financial or other link between the credit rating agency and an issuer.

Key elements

74. Many comments stated that it would promote confidence in the rating agencies if they were to introduce 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. They also said that this kind of information should be disclosed.

75. Nevertheless, many consultees agreed that it is not necessary to disclose whether the policies and procedures regarding capital and other interest links should be made along with each credit rating.

Other elements

76. One respondent considered that it is not in the interest of credit rating agencies to allow ratings to be influenced by their relationships with issuers because this influence would impact on their reputation in the markets. Nevertheless, where such a relationship exists that it would be appropriate to disclose its nature.

77. Another respondent argued that no direct or indirect capital link should exist between issuers and rating agencies, i.e. it should be either prohibited or at least disclosed to market participants.

Question 7: To what extent do you agree that in order to adequately address the risk that any financial or other link between a credit rating agency and an issuer might influence the credit ratings process it is sufficient to have the credit rating agency (i) introduce policies and measures managing and disclosing financial links or other interests between a credit rating agency and issuers or its affiliates or investments in general and the issuer or its affiliates or investments being rated in particular, (ii) disclose the said policies and procedures and (iii) disclose whether the said policies and procedures have been applied in each credit rating?

78. As explained above, in general respondents did not see the need for option (iii).

79. CESR has analysed the views of the respondents in the section referring to conflicts of interest in general and more specifically in all of the aspects included in the previous questions, and has come to the conclusion that 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. In addition, 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. As CESR considers that all these aspects are adequately dealt with in the IOSCO Code, CESR has included in its advice the opinion that credit rating agencies should follow the provisions of the Code in relation to these aspects.

Fair Presentation

Levels of skills of agencies' staff

80. Respondents generally commented that there is no need to 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.

Key elements

81. The main issue raised questioned the necessity and effectiveness of a credit rating agency having to disclose the application of policies and procedures regarding levels of skills of

staff in each rating issued. It was felt that apart from having to introduce policies and measures managing and disclosing levels and skills of staff credit rating agencies would simply produce a list of disclaimers and other formal information if the aforementioned application would have to be disclosed in every rating itself. This point was raised by users and issuers on the one hand and credit rating agencies on the other hand.

82. Several respondents put forward the suggestion to add to general disclosure of skills policies and measures a disclosure merely in case those policies and measures would not have been applied by the credit rating agency to a particular rating, a so-called exception disclosure.

Other comments

83. Some responses emphasized that a credit rating is processed not by an individual analyst but crucially involves a rating committee. Accordingly, the levels of skills of staff should not be focussed upon too much.

84. Other respondents commented that the said 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.

Questions

Question 1: To what extent do you agree that in order to adequately address the risk that lack of sufficient or inappropriate skills might lead to poor quality credit ratings it is sufficient to have the credit rating agency (i) introduce policies and measures managing and disclosing levels of skills of staff, (ii) disclose the said policies and measures and (iii) disclose whether the said policies and measures have been applied in each credit rating?

85. All respondents felt that parts (i) and (ii) would be appropriate but part (iii) would add any value.

Question 2: Do you have any alternative approaches to address the actual or potential risk that lack of sufficient or inappropriate skills might lead to poor quality credit rating assessments?

86. Nearly all respondents did not feel that an alternative solution to the one proposed by CESR would add any significant transparency to the proposals put forward under parts (i) and (ii), taking into account that it is also important to have information about workload.

Methodologies used for building credit ratings

87. A vast majority of the responses with regard to 'fair presentation' focussed on the part on 'methodologies', thereby emphasizing the importance of this aspect relative to the aspect of 'levels of skills' of analytical staff.

Key elements

88. First and foremost, nearly all respondents stressed the need not to interfere with the content of the methodologies and criteria that a credit rating agency wishes to use in processing a rating. Imposing regulation on rating methodologies or processes is considered in many comments unhelpful and counter-productive.

89. Many comments opposed regulating the content of the methodologies used for ratings. Their arguments can be summarised as follows:

- Regulation of methodologies would reduce the flexibility of CRAs to adapt them to changes in market conditions;
- a possible reduction in the level of innovation of ratings, because of a stronger "standardisation" of rating procedures and methodologies;
- the risk of "moral hazard", due to the fact that Governments, which issue debt securities, could use the regulation of methodologies to influence credit rating agencies; as a consequence, the independence of credit rating agencies could be jeopardized;
- the risk that regulation of methodologies can be seen, from the market's point of view, as a kind of endorsement of rating methodologies and therefore of the rating assessments by regulators.

90. Also, nearly all comments stated the importance of having a satisfactory level of disclosure on methodologies and other elements on which rating is based. Credit rating agencies also stated that they already adopted procedures and measures aimed at disclosing their methodologies, key elements and assumptions to the public, as also requested by the IOSCO Code. Users especially felt it is necessary to be able to assess the key elements and assumptions underlying a credit rating. Taking into account that a credit rating may involve both objective and subjective evaluation of public and non-public confidential or inside information, investors and issuers should be able to understand as much as possible about methodologies and criteria used to add value, in terms of creditworthiness of an issuer or an issued product, to the information available or received from the issuer.

91. Various respondents furthermore emphasized the need to be able to assess any changes to methodologies or criteria used to process a rating, even before these changes are applied to ratings. Credit rating agencies are in favour of this kind of approach too, provided that, with regard to the concept of prior notice, this is considered a general principle which allows exceptions.

92. Many respondents consider that provisions contained in the IOSCO Code are sufficient to guarantee a satisfactory level of disclosure. Some comments state that they consider acceptable that the level of disclosure of methodologies and other factors on which a rating is based should be established by regulation.

Questions

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

93. Various comments stated that methodologies normally are already disclosed by credit rating agencies, like information and other elements on which the rating is based. Moreover, some respondents concluded that the extent and accuracy of information provided and used in the rating process are more important for the quality of credit ratings than the disclosure of methodologies, whereas the absence of disclosure can affect the interpretation of rating by users.

Question 4: Do you see more advantages or disadvantages in the regulation of credit rating agencies methodologies by securities regulators? Please describe the advantages and disadvantages that you consider and which is the best way of dealing with them. Do you believe that this regulation would contribute in some ways to lead to common global standards for credit rating agencies?

94. Most comments stated that disadvantages of explicitly regulating methodologies largely outweigh any possible advantages (see also Section 11 for the description of some reasons of that). Many respondents felt that the same methodologies and criteria should apply to similar products or issuers, but that this aspect does not need to be fixed by regulation.

Question 5: Do you believe provisions of the IOSCO Code are sufficient, in terms of rules on credit rating agencies' methodologies and the corresponding disclosure? Do you believe that credit rating agencies should disclose to issuers changes in metholdogies before starting to use new methodologies?

95. Most respondents argued that provisions of the IOSCO Code adequately address issues concerning credit rating agencies' methodologies. Some comments mention that the determination of an appropriate level of disclosure should be established by regulation.

96. Respondents generally agreed that changes in methodologies should be disclosed before the new methodology is applied.

Question 6: Do you believe that regulation should concern all aspects of credit rating agencies' methodologies? How appropriate is the choice of explicitly regulating the four proposed issues (disclosure and explanation of the key elements and assumptions of a rating, indication of some forms of risk warning, rules on updating of ratings and the inclusion of some market indicators within a rating opinion)? Would you deal with these issues by self-regulation?

97. Generally respondents concluded that regulation should not concern the content of methodologies and that the market is the best elements to evaluate in the effectiveness and the completeness of methodologies.

98. Following the opinion of most market participant in relation with all the aspects analysed under the heading of fair presentation of credit ratings, CESR advocates in its final advice for an adequate implementation by credit rating agencies of the provisions of the Code referring to these aspects. More specifically, CESR agrees with the message from the consultation against the regulation of methodologies.

Relationship between issuers and rating agencies

Key issues

99. The vast majority of respondents expressed that MAD adequately addresses issues concerning access to/handling of/disclosure of inside information and the IOSCO Code covers other aspects of relationships with issuers. Hence, they believe there is no need for additional regulatory measures in this area, nor for a dedicated regime governing CRAs as expressed by a unanimity of answers to question 6. Respondents generally felt that the MAD and the provisions of the IOSCO Code adequately covered the issues identified in terms of the relationship between issuers and CRAs.

100. With regard to the "right of appeal" issue, respondents emphasized that such process should carefully balance issuers' rights and CRAs independence and that on no account should ratings be the result of negotiations. Many respondents also recognised that most CRAs already provide some form of procedure for a rating to be appealed, if for example an issuer has new information which they feel should be taken into account by the CRA.

Other Comments

101. There were other responses which made some particular comments/suggestions. The calls for more consistency and a level playing field on what is inside information etc relate to MAD implementation generally.

Question 1: Do you consider that the combination of the requirement of the MAD in this area and the requirement of the current version of the IOSCO Code adequately address the issue of access to inside information by CRAs?

102. Most Comments believe that CESR's consultation paper accurately describes the scenarios in which CRA's might be the 'owners' of price sensitive information. The problem seems to be well covered by the combination of the MAD and the IOSCO Code. They do not see a need for any further measures in this area.

103. But it is also expressed that the combination does not meet current UK best practice whereby there are restrictions on trading by persons possessing relevant information not generally available (known as RINGA). It provides more flexibility in that it allows action to be taken in relation to behaviour based on information which would be taken into account by investors but is not sufficiently precise and specific to be inside information as would be the case under MAD.

Question 2: What is your view on requiring an issuer to itself disclose an imminent rating change where it has been advised of this by a CRA and where the rating announcement may itself amount to inside information in relation to the issuer's financial instruments?

104. A very large number of comments consider that issuers should not be obliged to disclose an imminent rating change themselves.

105. Respondents think that it is appropriate to focus not just on access to inside information held by an issuer, but also on inside information generated by a CRA given that a rating action may indeed amount to inside information.

106. But responsibilities for disclosing inside information concerning an (imminent) rating change or other rating decision should, in principle, lie with issuers themselves. Rating changes are made by credit rating agencies. Their disclosure is in principle therefore the job of CRAs as well. While imminent rating changes are inside information for issuers themselves, they only really become hard inside information once the rating process has been completed and the rating report and the wording of the press release have been agreed between the issuer and the CRA. CRAs are then required to disclose the result immediately thereafter. To ensure that the information communicated to the capital market is understandable and not misleading; issuers should therefore not be obliged to disclose an imminent rating change. The Market Abuse Directive already provides a means of implementing such an approach in the opinion of the respondents. To avoid any legal uncertainty, some proposed that this should, be expressly made clear in any regulation of this area.

107. Comments note that if issuers were subject to a regulatory requirement to immediately disclose a rating change, credit rating agencies would have to change their processes so that ratings changes were disclosed immediately. This would be inconsistent with IOSCO recommendations in this regard (and would be inconsistent with giving issuers any time for appeal of a rating decision).

108. Besides, one comment highlights the market's benefits that these announcements be made by the CRA in an even-handed and dispassionate way.

Question 3: Do you consider that the requirements of the MAD in this area sufficiently address the risks that inside information might be disseminated, disclosed, or otherwise misused?

109. The vast majority of market participants mention that during the rating process CRAs receive a lot of confidential information from the issuer; this can be information subject to Article 1 MAD. But it can also go beyond out of this information e.g. other industrial and trade secrets. For this reason it must be on the one hand ensured that CRAs handle all non-public information concerning issuers confidentially until issuers have approved its release and on the other hand CRAs should be required to disclose how they ensure the confidentiality of non-public information.

110. But beyond the answers to question 1 some respondents highlighted that the MAD ignores information provided by issuers which is commercially confidential but not relevant to securities dealing.

111. Some market participants disagree with the suggestion that information provided to subscribers should be regarded as not being public in the sense of the Directive, apparently simply because they pay a subscription fee (any more than information contained in a paid

for newspaper or magazine). They disagree with the suggestion that it is not in the normal course of a credit rating agency's business to provide information to its subscribers. Theses suggestions are overreaching and suggest that CESR wishes to restrict the freedom of publications to communicate information to their subscribers, simply because they express views that are authoritative and influential.

112. Also some comments note that it must be ensured that CRAs handle all non-public information concerning issuers confidentially until issuers have approved its release. CRAs should be required to disclose how they ensure the confidentiality of non-public information.

Question 4: Are there any other issues concerning access to inside information which CESR should consider from the perspective of establishing a level playing field between CRAs?

113. Some comments stress that more clarity and legal harmonisation are desirable with respect to access to inside information from issuers to rating agencies, particularly given the global nature of many issuers who issue bonds in various currencies and in various regulatory regimes. This would improve comparability for investors across a corporations debt issues.

114. Additionally it is noted by most comments that establishing a "level playing" field" between CRAs concerning access to inside information beyond the general requirements of the MAD is neither feasible nor desirable.

115. It was mentioned that, while CESR should in formulating approaches to regulation normally seek to avoid by that regulation aggravating or creating additional distortions affecting the competition within an industry (except where there are sound public policy grounds for accepting such distortions), it is generally the responsibility of competition authorities not of CESR to consider "level playing fields" in competitive markets.

116. Furthermore, some participants doubt whether a "level playing field" is even desirable between CRAs in this context. The information disclosed to a CRA is very much part of a dialogue and while some "hard" information may be provided to all such agencies solicited by an issuer – e.g. certain financial information – other such information and most "soft" information – e.g. the views or hopes or expectations of management on a wide variety of topics will have been given in response to analysts' questions which can vary significantly between analysts. The ability of analysts to manage this dialogue well and usefully – or not – is a key part of the "know how" of an agency. Regulation which restricted this potential differentiation between CRAs would be regretted.

Question 5: Are there any other issues concerning the MAD provisions concerning inside information that you consider to be of relevance to CRAs and their activities which need to be considered?

117. Nearly all comments to this question express that under the MAD, issuers may disclose inside information to third parties in the normal course of their activities assuming the recipient owes a duty of confidentiality. It should be mentioned explicitly that, while an

issuer can give non public information to a CRA, it should be under no obligation to do it. This is part of the issuer's judgment at any point in time. If a CRA whose model uses access to management and confidential non-published information feels that access or information disclosed in insufficient or incomplete or in any way misleading, it should refuse to rate or should withdraw an existing rating.

118. Additionally it is said that during the rating processes according to Article 6 (3) of the MAD CRAs have to keep a list of the persons who work for them and who have access to specific information. This list has to be sent to the competent authority on request. Issuers are therefore required to enter in the list they keep only the CRA but not all the employees of the CRA with access to inside information. Some respondents felt, however, that it is unclear what the procedure is if the CRA is based outside the EU: it should be examined here which measures may be taken to ensure the European regulators can obtain the information they need to enable them to do their job.

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

119. All reactions show that a minimum standard governing the way credit rating agencies handle confidential information from issuers is not necessary. The IOSCO Code contains a suitable approach in this respect.

Question 7: Is this provision sufficient to ensure that issuers have an opportunity to discuss and understand the underlying basis for any rating decision? If not, what other measures do you consider should be introduced?

120. The mass of comments agree that this provision is sufficient enough.

121. But some participants would urge CRAs and issuers soliciting ratings to go beyond the IOSCO Code:

- Some would go beyond article 3.7 of the IOSCO Code and have all draft public releases or analysis being sent to the issuer prior to its public release to allow for correction off actual errors or strong misinterpretation an not only "where feasible and appropriate " as indicated in the IOSCO Code. This can be achieved by adoption of a wider code of practice for all participants in the credit rating process as proposed by international treasury associations.
- While IOSCO implies a contract between CRAs and soliciting issuers, some commentators consider formalisation of relationships through a contract to be essential. This needs to include protection of confidential non-published information released by the issuer to the CRA. It could also refer to the party's practice of following a "code of Conduct" in managing their relationships.
- Some reiterate or comment that CRAs should systematically and publicly disclose in advance not only the methodologies and criteria, but also their material changes to methodology, with any exceptions limited to the most

extreme and urgent situations. We take "material" as meaning a methodology change which will lead directly to variation of some ratings.

Question 8: In addition to being able to discuss the basis for a rating should an issuer has a "right of appeal" where they disagree with the CRA's opinion?

122. Most comments do have different views concerning any so called "right of appeal". No majority could be found on this issue and all answers differ. Some comments see the "right of appeal" only as an opportunity given to the issuers to correct factual errors and misrepresentations, other comments also wish for a review of the rating by a new rating committee or a "fresh analysis". But it is acknowledge that such process should carefully balance issuers' rights and CRAs independence.

123. Some comments see the "right of appeal" as an opportunity to be informed by the CRA about 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 – as it is written down in the IOSCO Code, number 3.7.

124. Hence those comments wish that before disclosure of any rating decision by a CRA, the issuer affected should be advised of the key information and basic considerations underlying the decision. They precised that such a requirement is necessary to ensure that errors are avoided, that important new information can still be included in the rating result and that the rating therefore accurately reflects the current situation. This, however, presupposes that after the rating result has been communicated to the issuer by the CRA, the issuer can appeal against the result within a reasonable period by submitting concrete reasons and demand a review of the result by the CRA before it is published. Respondents stress that such a right of appeal should explicitly cover objective errors and misjudgements but on no account should ratings be the result of negotiations. Views differ significantly on the time available for the appeal, between less than an hour to several days.

125. Some respondents feel that an appeal process should however not be a way to delay a decision that needs to be communicated to the markets as quickly as possible. Therefore the agency should be able, if the appeal resolution cannot be performed immediately, to inform the market of the pending review. It is underscored that the appeal process is not compatible with the mooted obligation on issuers to communicate any rating change immediately.

Question 9: Do you consider the provisions of the current draft IOSCO Code and the MAD to be sufficient to ensure that information published by CRA's is accurate?

126. Most comments think that usually accuracy will be contested not with respect to information but with respect to opinion. Accuracy can never be ensured. But together the IOSCO Code and the MAD provide a mechanism which to the greatest extent possible will incentivise CRAs to be accurate.

127. It is also stressed that it is not in the commercial interest of a CRA to publish information which is not accurate.

128. Additionally ratings are, in themselves, neither accurate nor inaccurate as they represent opinions. The information published as part of the supporting press release will 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.

Question 10: Given the lack of specificity in the current draft IOSCO Code to maintain internal records for any particular time period, do you think more specific measures would be appropriate, requiring for example al the information received by a CRA to be kept, along with records supporting its credit opinions, for a minimum of 5 years?

129. There is no clear picture of comments to this point. Rating Services already typically retains relevant information supporting credit rating decisions for a long time period. The requirements may vary by country and there is no need for CESR to prescribe additional requirements.

130. Some participants believe that this may be best left for the CRAs to specify in their own codes of conduct in pursuance to IOSCO Code Provision 1.5 requirements.

131. Some participants are in favour of specific regulation requiring credit rating agencies to keep a record of their rating processes and the data supporting their credit opinions.

132. The period of five years seems to be appropriate for some respondents, if local legislation doesn't give local entities the obligation to keep information and data for a longer period of time.

Question 11: Do you consider that it would be appropriate to introduce measures requiring the establishment of a rating agency data room to ensure that all CRAs had access to the same information concerning a particular issuer?

133. There was no positive answer to this question. It is stressed by the mass of comments that the proposal is not practical given that each CRA employs different methodologies in arriving at its ratings and therefore needs access to different types of information. If a data room requirement was imposed, it would put pressure on CRAs to adopt similar or even identical methodologies. The reduction in diversity of approach would heighten risk of CRAs, as a group, failing to recognise a problem until too late.

134. In particular, some market participants do not believe that it is necessary or desirable to adopt regulations compelling issuers to give the same information to different rating agencies. Where the issuer is participating in the ratings process with two or more rating agencies, the rating agencies may have different methodologies with differing information requirements which may justify the provision of differing information. If there is any disparity in ratings between agencies, which cannot be explained by differences in methodology or the published analysis, this is likely to lead to an agency making follow up enquiries or users seeking additional information to understand the reason for the differences. Some participants reserve the right to withdraw its ratings if it considers that there has been inadequate disclosure.

CESR

135. After analysing all the issues mentioned under the heading of relationship between issuers and rating agencies, CESR supports the view expressed by market participants that MAD, together with the requirement of the current version of the IOSCO Code, adequately addresses the issues concerning this relationship. More specifically, on the aspects relating to access to /handling of/ disclosure of inside information, CESR considers that further regulation is not advisable as MAD and the IOSCO Code provides a suitable framework to handle this questions.

IV. Regulatory Options Concerning Registration and Rules of Conduct for Credit Rating Agencies

136. The vast majority of respondents expressed an opinion on the regulatory options concerning registration and rules of conduct for CRAs. In general, respondents felt that the range of options set out by CESR was comprehensive, although a number of respondents commented that it would be possible to develop hybrids of these options.

Key issues

137. The enormous mass of comments stress that they support the IOSCO Code all the way, especially their idea that CRAs have got to publish if they comply with the IOSCO Code, and if they do not that they have got to explain the deviation. Users and investors are engaged. They will observe how CRAs implement the Code Fundamentals and will react to the way CRAs "comply or explain". In the view of some commentators there is no substitute for market acceptance of the value and credibility of ratings from a certain CRA. This view seems to be also consistent with the growing acceptance of the policy of regulatory intervention only when there is a demonstrable market failure which market participants are unable or unwilling to correct.

138. Some comments note that the only sensible and pragmatic next step is to allow CRAs the opportunity to implement the Code Fundamentals and demonstrate compliance with it rather than to rush into regulation or arbitration responses which will very likely adversely impact the quality and availability of ratings. Additionally CESR is asked to monitor the compliance of the provisions and decide to a later point in time (various respondents mention 2 years) whether the goals have been achieved.

139. However some comments mention that the Code Fundamentals and their self-regulatory idea are not sufficient. Because of the great influence of CRAs stricter rules could ensure the quality and independence of CRAs and their decisions as well as help to overcome the present situation of oligopoly. This last point is especially brought up by smaller CRAs who think that this might be the only way to achieve market acceptance alongside the three 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. Rating agencies could play concerning to this comments an invaluable, groundbreaking role in opening up new markets.

140. But it is also expressed that it is not a valid purpose of registration to provide a badge of respectability to new or small rating agencies as a way of helping with their marketing.

Nevertheless the choice of any regulatory option should be conditioned by the aim to allow and foster competition in the rating market.

141. Some comments in favour of the option of registration supported the idea that this registration should be based on the implementation of the IOSCO Code, because this form of regulation is less intrusive, more based on internationally-recognized principles and guarantees a stronger enforcement of the Code.

142. Even many respondents which are in favour of the self-regulation option argue that, if there will be any registration/regulation regime, they would favour a registration scheme which simply requires the CRA to attest that it is following at least the Code Fundamentals and disclosing as well as explaining why CRAs are not following those parts of the Code Fundamentals.

143. Should a registration/regulation regime be introduced comments believe that any one legal entity wishing to register in the EU should only have to register once and that registration should be acknowledged by all regulators within the EU. A requirement for more than one registration would not only hamper the activities of larger CRAs, it could be a significant barrier to entry or growth of new smaller CRAs.

144. Some comments mention that the CRA should be able freely to choose with which single national securities regulator to register.

145. In some comments view it would be advisable if some outside arbitration body were in a position to collect information on violations of the Code Fundamentals and to act as an institution of appeal in the case that investors or issuers feel that CRAs have not complied with the Code Fundamentals. The outside arbitration body could decide on cases and publish the decisions so that investors and issuers can be aware of theses incidents. The arbitration body could be an independent public or private sector institution comprising a number of experts familiar with the working of CRAs and the needs of investors and issuers and should co-operate closely with the supervisory authorities. On the other hand it is also mentioned that even the IOSCO working group could not agree on such a arbitration body.

146. Some comments highlight that creating another regulatory system for CRAs in the EU, in addition to the CRD requirements, could lead to duplication of the regulatory burden for CRAs. It is questioned the underlying of this regulatory option. Regulation of ECAIs aims at ensuring safe risk management by banks of their capital reserves through, among other things, holdings of instruments that are rated following a strict and demanding process desined to achieve that purpose and therefore focused more on aspects of CRA market experience, credibility, independence, international access and resources, less so on competition, conduct and issuer/CRA relationships; as such a large number of the criteria for eligibility of ECAIs might not be suited for some CRAs, especially smaller CRAs and new entrants.

147. Some comments mention that including the IOSCO Code within the CRD infrastructure would leave it open to member states to implement the IOSCO Code in different ways and the international consensus that the IOSCO Code has achieved could be lost. Further the CRD will only cover those CRAs that want to be recognized for external ratings and it being not obvious that all CRAs will have an interest in becoming recognized in this respect. Hence one comment mentions that it would be prudent to monitor the initiatives of

CEBS concerning the CRD and ECAIs and to determine whether any additional regulation or some kind of registration system is justified. Additionally CRD contemplates the ability of competent authorities in Member States to recognize an ECAI only in the Member State whereas the IOSCO Code is not meant to be interpreted by every nation but they have an international character. Nevertheless, it should be pointed out that the CRD allows that a member state voluntarily recognises the ECAI recognition granted by another member state.

148. On the contrary, few comments argue that the enforcement of the IOSCO Code should be granted within the procedure of the CRD. The reasons adduced in support of this position are especially based on the goal of avoiding a duplication of rules.

149. Many comments mention additionally that the ongoing procedure should be consistent with the work of CEBS especially concerning the CRD. But linking to the CRD process might add unnecessary complication. Furthermore CEIOPS might be confronted with similar questions in future. A close coordination between all regulators involved (CESR, CEBS and CEIOPS) seems inevitable if rating definitions are to be consistent across all fields of European legislation. Moreover any form of registration should also be a matter of coordinated action between the SEC and the supervisory authorities at the European level or within EU member states.

150. Some comments mention that intrusive regulation may give investors the impression of a sort of guarantee given by regulators of quality of ratings, and investors could be entitled to expect near perfect reliability and quality of ratings to the extent that all aspects of a CRA's business are to be regulated in detail. Market participants seem to accept that they can not expect any CRA or rating systems to act as a perfect evaluator of credit risk or quality of the complexity of evaluating the various objective and subjective factors that affect creditworthiness and reflecting them in a single symbolic rating. All in all a formal registration/regulation regime could also ignore the global nature of the financial service industry and could lead the global CRAs to relocate their EU operations outside the EU.

Other Comments

151. The IOSCO Code was generally considered to cover the full range of issues affecting the use of credit ratings in the securities markets.

Question 1: Could you assess the policy options concerning the need for regulation or other measures, with particular reference to the practical implications for competition in the rating market and for the quality of ratings and of information to the market? In particular:

- *A full registration/regulation regime based upon detailed criteria (option 1);*
- *A lighter registration/regulation regime essentially based upon the IOSCO Code (option 2);*

- *To assess compliance to IOSCO Code in a parallel process to CRD's recognition (option 3);*

- *A third party's certification or enforcement of the IOSCO Code (option 4);*

- *Relying upon rules covering only specific aspects of CRA's activity (option 5);*

- *Monitoring the market developments (option 6).*

152. Respondents generally supported the CESR analysis of the pros and cons of each option, with some small discrepancies.

153. Option 1: The majority of respondents were concerned that this option would create a substantial barrier to entry and limitation on innovation. This was believed to be especially true if the method of implementation meant that CRAs would have to comply with multiple national regulatory regimes, something that would pose a particularly disproportionate burden upon the smaller CRAs and issuers who were struggling to pay for a rating (as at least some of the costs would inevitably be passed on to the issuers).

154. Furthermore, many respondents commented on the fact that it is EU policy to only legislate where there is a demonstrable market failure, yet no evidence of any market failure has been presented that could justify an intrusive approach. Respondents were also concerned that any new regime designed for the securities markets would duplicate elements of the banking regime, the IOSCO Code and the Market Abuse Directive. Such respondents suggested that it was necessary to give these other initiatives time to take effect before deciding if further regulatory action is necessary.

155. Some respondents felt that statutory regulation risks inadvertently giving a quality seal to the ratings (which some respondents commented are only opinions) and threatens the perception of their independence/credibility. Some of these respondents expressed the view that it was not a valid purpose of registration to provide a badge of respectability to new or small rating agencies.

156. Some respondents expressed concern that option 1 posed a danger that ratings from EU CRAs would be viewed differently from those produced by non-EU CRAs, thereby creating an un-level playing field. They also raised a number of extraterritorial concerns. One respondent urged that any regulatory intervention be considered at IOSCO rather than EU level.

157. In contrast, those who favoured option 1 stated that it would allow clear identification of eligible CRAs and provide for an effective system of control, assisting in the prevention of corporate scandals. One respondent referred to known market failures that such an approach could address, although failed to elaborate on what these failures are.

158. These respondents felt the regime would offer incentives for new CRAs to adopt the practices of the leading CRAs and constantly monitor their methodologies. One respondent stated that a regulatory regime would actively encourage new market entrants.

159. **Option 2:** Some respondents viewed the impact to be similar to that of option 1 but on a lesser scale.

160. Comments in favour of a regulatory approach (as a first or second best) supported this option rather than the previous one because this form of registration is less intrusive and more based on international-recognized principle.

161. Some respondents mention that a plan for registration of CRAs judged to be reliable include the requirements laid down in the IOSCO Code and those in the new Basel Accord, not yet transposed into the CRD.

162. **Option 3:** Several respondents who commented on this option felt it to be overly complicated and they were not entirely sure how it would work (they pointed to the different aims of the regulations).

163. One respondent did comment that the CRD provisions could provide valuable regulatory underpinning for the IOSCO Code. Another respondent supported a single central register for banking and securities purposes 9given the inevitability of a banking register and a desire to avoid duplication).

164. One respondent expressed concern that the CRD is not a truly pan EU regime as it does not require mutual recognition (although voluntary recognition is possible). In this context the respondent felt the option could be unduly burdensome as they favoured a single regulatory regime covering the entire EU.

165. This option was generally discussed in the context of a desire to minimise duplication in the regulatory regimes applied to CRAs, and in doing so minimise the cost of regulation.

166. **Option 4:** Some respondents questioned who could perform the role of certification/enforcement body in a truly independent manner. One respondent noted that CRAs themselves are better placed to certify compliance or explain areas of non-compliance. It was suggested that the proposed certification/enforcement body was not necessary given the development by CRAs of internal processes for ensuring compliance with published policies and procedures.

167. One respondent was concerned that the existence of an arbitration body which considered individual ratings could cause the rating process to degenerate into a bargaining process.

168. Finally, one respondent asked if such a regime risked annihilating the subjective component of ratings, whilst another was concerned that such a body would put a brake on the process of amending or updating ratings.

169. In contrast, two respondents supported the development of such a body with a view to hearing appeals and promoting compliance with the IOSCO Code, although one noted that a public body could perform this role as efficiently.

170. **Option 5:** Some respondents were not entirely sure what this model would entail. A few referred to the 'comply or explain' method for implementing the IOSCO Code, possibly supported by auditor verification. Respondents noted similarities to options 1 and 2, and

therefore to the pros and cons of options 1 and 2, although one respondent noted that it was better to have a targeted regime than one that covers all aspects of a CRAs business.

171. Option 6: This option was favoured by the majority of respondents, who suggested that it represented the strongest, most cost-efficient and most immediate answer to current regulatory concerns. It was felt to preserve flexibility to innovate and avoid an increase in barriers to entry.

172. Furthermore, it was suggested that this is not a 'do nothing' option as there is much work underway in the context of the IOSCO Code, the Market Abuse Directive and the Capital Requirements Directive. The 'comply or explain' approach in relation to the IOSCO Code was also supported in the context of this option.

173. The probability of success of market forces in increasing standards in the ratings market was felt to have been improved by the threat of regulatory intervention, although some respondents commented that, in any case, market sanctions are real and reputational risk provides a sufficient incentive to ensure that CRAs continue to work towards improving standards.

174. Regulators were strongly encouraged to review progress in the market and revisit the other options should CRAs not be seen to be performing strongly against regulatory goals. Some respondents urged this work to go ahead in close co-ordination with the SEC and the rest of the IOSCO membership.

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

175. The majority of respondents favoured option 6, monitoring market developments, with a number of responses commenting that this is not a 'do nothing' option but rather that it could involve the proactive assessment of the impact of significant international initiatives (the IOSCO Code , the Capital Requirements Directive and the Market Abuse Directive) upon CRA practice.

176. It was generally felt to be appropriate for CESR to review both the effect of specific provisions and the implementation/enforcement issue as part of its review work. A number of respondents referred to a review taking place in 'a couple of years'.

177. Two respondents favoured option 5, relying on rules covering only specific aspects of CRA's activity. These respondents did not believe it was appropriate to introduce a comprehensive regulatory system at this point in time. They supported implementing the IOSCO Code on a self-regulatory basis, citing in particular the need to ensure that it is implemented into day to day business. Like the respondents who favoured option 6, both respondents supported monitoring by CESR of the impact of the regime, with the potential for changes to be made should key goals not be achieved.

178. One respondent felt that, given the unavoidability of a European registration system in the context of the CRD, a single European central register for banking and securities purposes would be optimal. This view was expressed in the context of concerns about increasing the regulatory burden upon small CRAs.

179. Two respondents advocated the imposition of a stricter regulatory regime (option 1 or 2), covering provisions from the IOSCO Code and Basel 2, given the significant influence CRAs can have upon financial and credit markets. The respondents expressed the view that such a regime could increase the reliability, validity and quality of ratings and overcome the present oligopolistic environment. A third respondent also supported some sort of recognition/regulation, covering similar issues, whilst at the same time outlining its procedures for creating a ratings quality 'yardstick' as an alternative to 'bureaucratic state control' (an alternative supported by one other respondent).

180. CESR acknowledges the complexity of analysing the multiple options put forward in the consultation paper and the fact that there are multiple combinations of these. Nevertheless, after the consultation CESR has decided that the regulatory spectrum could be simplified for the purpose of an analytical study, to four main alternatives, as set out in section III of the advice. A description of the pros and cons of these four options has also been included under that section. In addition, in the conclusive section of the advice, the options have been narrowed to those two that have been considered as most convenient by CESR members.

Question 3: Do you think the IOSCO Code is conducive to reducing or increasing competition?

181. A handful of respondents commented upon the likely impact of the IOSCO Code upon competition.

182. A few respondents felt it would have a limited impact, citing the need to develop credibility based upon a proven track record as the key determinant of market structure.

183. A small number of respondents however expressed concern that an over rigid implementation of the Code could be detrimental to competition, whilst a more flexible interpretation could actually be beneficial.

184. The Code was generally considered to have the right scope and content for promoting an efficient market.

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

185. The majority of respondents did not feel that it would be necessary to go beyond the IOSCO Code at EU level.

186. Nevertheless, one respondent felt that the use of the phrase 'where applicable' created too much flexibility in the Code.

187. Another respondent stated that the IOSCO Code should be extended to corporate governance and in particular that it should require disclosure of the precise nature of any arrangements with affiliated/group members (for the avoidance of confusion in a local market).

188. A number of respondents commented that it would be necessary to review the impact of the Code in practice before determining if additions or alterations were necessary.

189. CESR agrees with the feeling of most respondents and 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 it will improve the quality and integrity of the rating process and enhance the transparency of CRAs' operations

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

190. Responses were mixed in relation to the optimality of joint treatment of rating agencies by banking and securities regulators.

191. A small majority of respondents felt that a joint approach would help minimise the regulatory burden imposed upon CRAs and therefore the cost of producing ratings. Such respondents felt that much of the same information would be required by banking and securities regulators for the purposes of assessing matters of concern to them. They were concerned not only with potential duplication of requirements but also with the potential for conflicting banking and securities rules.

192. Other respondents expressed concern at the complexity of a joint approach.

193. Although CESR is aware of the need of a close cooperation between the banking regulators and CESR, in its final advice, CESR has decided not to enter into a detailed discussion in relation to the CRD and more specifically the recognition of ECAIs. The reason is that CESR thinks that this process must be seen separate from the issue of conduct rules for CRAs. The CRD has its own objectives and the recognition system must be set up according to those objectives. However, in any case it is important that exchange of information takes place, specially if a recognition system is to be set for CRAs.