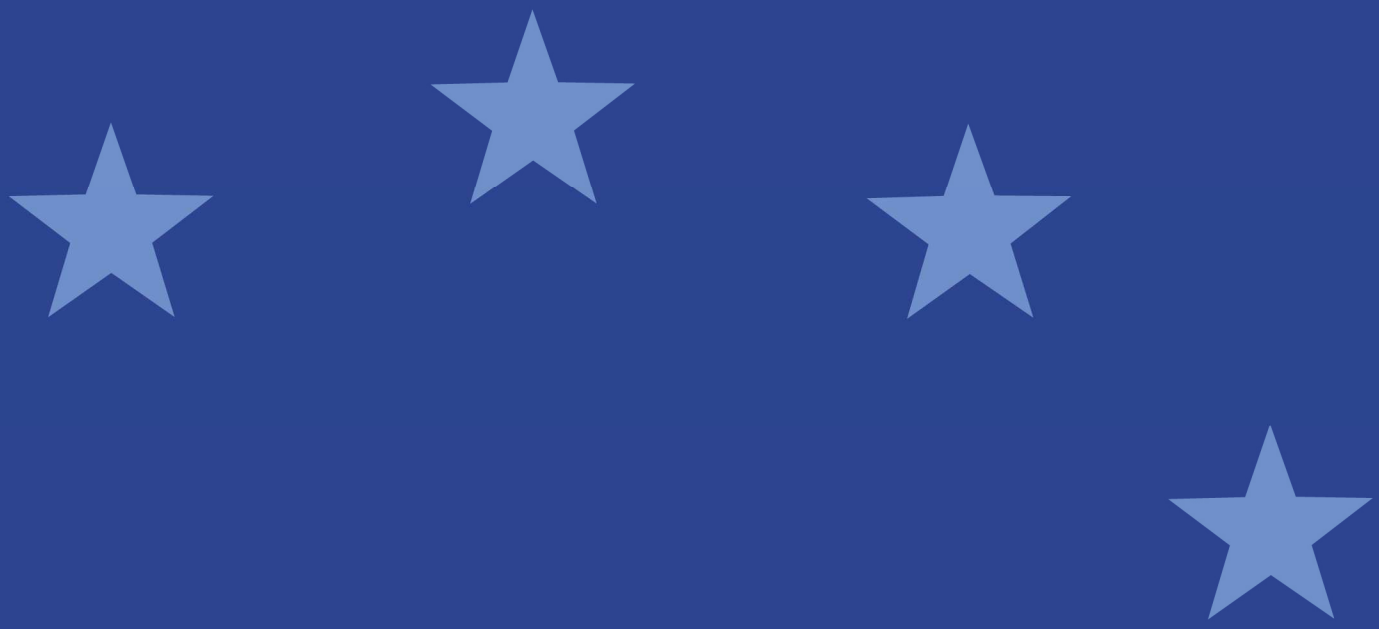
esma European Securities and Markets Authority

Final report

Technical advice on CRA regulatory equivalence - US, Canada and Australia



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Executive summary

On 12 June 2009 the European Commission requested CESR, now ESMA, to provide its technical advice on the equivalence between the legal and supervisory framework of Japan, The United States, and Canada with the EU regulatory regime for credit rating agencies. (Regulation (EC) No. 1060/2009 of the European Parliament and the Council on credit rating agencies1). On 17 November 2009, the Commission also requested CESR to provide its technical advice on Australia.

On 28 September 2010, the European Commission published an equivalence decision on Japan.

With regard to the compliance with the EU requirements on endorsement, ESMA had already indicated that it considers the legal and regulatory regime for CRAs supervision of the following countries as "as stringent as" the EU requirements:

- On 22 December 2011, Japan and Australia;

- On 15 March 2012, US, Canada, Hong Kong and Singapore.

This report sets out ESMA's advice to the European Commission in respect of the equivalence between the US (Part I), Canada (Part II) and Australia (Part III) respective legal and supervisory frameworks and the EU regulatory regime for credit rating agencies.

The equivalence assessment conducted by ESMA follows an objective-based approach, where the capability of the regime in the third country to meet the objectives of the EU Regulation is assessed from a holistic perspective.

With regard to the US legal and supervisory framework for credit rating agencies, the updated technical advice to the European Commission published on 20 May 2010 (CESR/10-332) concludes that the requirements directly introduced (through "self-executing" provisions) by the Dodd Frank Act, together with the statutory rules that the SEC is required to issue, provide a solid background for a positive decision on the equivalence of the US legal and supervisory framework for credit rating agencies. In May 2010, CESR had already concluded that the US legal and supervisory framework was sufficiently robust for CESR to conclude that the US framework was broadly equivalent to the EU regulatory regime for credit rating agencies. So therefore we now provide the equivalence technical advice to the European Commission.

With regard to Canada, following ESMA's decision to consider the Canadian regulatory regime as being in line with the requirements defined in Article 4(3) of the EU Regulation on CRA, the assessment concludes that the Canadian legal and supervisory framework for credit rating agencies is equivalent to the EU regulatory regime for credit rating agencies. However, only if all the conditions set out in Article 5(1) of the EU Regulation are met, can a third country CRA be granted certification.

The same conclusions apply to the Australian legal and supervisory framework for credit rating agencies, where the assessment is also to deem the regime to be equivalent to the EU regulatory regime for credit rating agencies.

[1] Hereafter the Regulation.

Section I - Introduction

1. The European Commission mandated CESR on 12 June 2009 to provide it with technical advice on the equivalence between the US, Canadian and Japanese legal and supervisory frameworks and the EU regulatory regime for credit rating agencies (Regulation (EC) No. 1060/2009 of the European Parliament and the Council on credit rating agencies[2]).
2. An additional mandate relating to the equivalence of the Australian legal and supervisory framework followed on 17 November 2009.
3. Since then, on 28 September 2010, the European Commission has published an equivalence decision on Japan.
4. With regard to the compliance with the EU requirements on endorsement, ESMA indicated it considers the legal and regulatory regime for CRAs supervision of the following countries as "as stringent as" the EU requirements:
   (i) Japan and Australia (22 December 2011);
   (ii) US, Canada, Hong Kong and Singapore (15 March 2012).
5. This report sets out ESMA's advice to the European Commission in respect of the equivalence between the US (Part I), Canada (Part II) and Australia (Part III) respective legal and supervisory frameworks and the EU regulatory regime for credit rating agencies.

Purpose and use of the European Commission's equivalence decision

6. Once an equivalence decision has been made by the European Commission, it will enable certain aspects of the EU Regulation, relating to the use of credit ratings issued outside the EU, to become operational, provided other conditions are met.
7. There are two methods in the EU Regulation through which credit ratings issued outside the EU can be used in the EU for regulatory purposes.
8. The first method is referred to as certification and is set out in Article 5 of the EU Regulation. It will allow a third country credit rating agency, whose activities are not considered to be of systemic importance[6] to the financial stability or integrity of the financial markets of one or more Member States, to enable its credit ratings which are not considered to be of systemic importance[3] to the financial stability or integrity of the financial markets of one of more Member States to be used in the EU for regulatory purposes[4].
9. A positive equivalence determination is required to enable a third country credit rating agency to apply for certification, however ESMA reiterates that a determination of equivalence is one of a number of

[2] Hereafter the Regulation.
[3] For further details see the draft Regulatory technical standards on the information for registration and certification of credit rating agencies published by ESMA on 22 December 2011 (http://www.esma.europa.eu/system/files/2011_463.pdf).
[4] According to Article 3(1)(g) of the EU Regulation, "regulatory purposes" means the use of credit ratings for the specific purpose of complying with Community law, as implemented by the national legislation of the Member States. Article 4(1) of the Regulation refers to the use of credit ratings for regulatory purposes by "credit institutions as defined in Directive 2006/48/EC, investments firms as defined in Directive 2004/39/EC, insurance undertakings subject to the First Council Directive 73/239/EEC of 24 July 1973 on the coordination of laws, regulations and administrative provisions relating to the taking-up and pursuit of the business of direct insurance other than life assurance, assurance undertakings as defined in Directive 2002/83/EC of the European Parliament and of the Council of 5 November 2002 concerning life assurance, reinsurance undertakings as defined in Directive 2005/68/EC of the European Parliament and the Council of 16 November 2005 on reinsurance, undertakings for collective investment in transferable securities (UCITS) as defined in Directive 85/611/EEC and institutions for occupational retirement provision as defined in Directive 2003/41/EC"

criteria that have to be met as set out in Article 5(1) of the EU Regulation. A positive equivalence determination should not be understood as meaning that a third country credit rating agency will automatically be granted certification and as such its credit ratings issued from such a third country may be used in the EU for regulatory purposes.

10. Only if all the other conditions set out in Article 5(1) of the EU Regulation are met, can a third country credit rating agency be granted certification.

11. These conditions are that:

    a) the credit rating agency is authorised or registered and is subject to supervision in that third country;

    b) cooperation arrangements are operational;

    c) the credit ratings issued by the credit rating agency and its credit rating activities are not of systemic importance to the financial stability or integrity of the financial markets of one or more Member States.

12. Cooperation arrangements, as set out in Article 5(7) of the EU Regulation are necessary in order to enable home competent authorities in the EU and the relevant third country competent authority to (i) exchange information and (ii) coordinate supervision.

13. The second method is endorsement, through which an EU registered credit rating agency will be able to endorse credit ratings issued in a third country through the endorsement process set out in Article 4(3)-(6) of the EU Regulation and further specified in ESMA guidance published in May 2011 (ESMA/2011/139).

14. One of the certification conditions for a foreign credit rating agency is that the Commission has adopted an equivalence decision recognising the legal and supervisory framework of the third country as equivalent to the requirements of the Regulation. The equivalence decision would state that the legal and supervisory framework of a third country ensures that credit rating agencies authorised or registered in that third country comply with legally binding requirements which are equivalent to the requirements resulting from the Regulation and which are subject to effective supervision and enforcement in that country (Article 5(6)).

ESMA's Approach to Assessing Equivalence

15. Concerning the assessment approach taken during this technical advice, ESMA used the same approach than the methodology attached to ESMA Guidelines on the application of the endorsement requirements (ESMA/2011/139) published by ESMA on 17 May 2011[5].

16. The equivalence assessment conducted by ESMA, in fact, follows an objective-based approach, where the capability of the regime in the third country to meet the objectives of the EU Regulation is assessed from a holistic perspective.

17. Accordingly, while determining the ability of the non-EU countries to achieve the main objectives of the relevant EU requirements, the analysis grid is based upon the following seven areas:

    (i) Scope of the regulatory and supervisory framework

[5] The methodology of assessment is available at the following address: http://www.esma.europa.eu/system/files/2011_144.pdf

(ii) Corporate Governance

(iii) Conflicts of interests management

(iv) Organisational requirements

(v) Quality of methodologies and of credit ratings

(vi) Disclosure of:

- credit ratings
- the activities of the credit rating agency

(vii) Effective supervision and enforcement.

Section II. Assessments of US, Canada and Australia

Part I- Update of the Technical Advice to the European Commission on the Equivalence between the US Regulatory and Supervisory Framework and the EU Regulatory Regime for Credit Rating Agencies

Executive Summary

18. This report complements the Technical Advice to the European Commission on the equivalence between the US legal and supervisory framework and the EU regulatory regime for credit rating agencies issued by ESMA (CESR) at the end of May 2010 (CESR/10-332). It updates the content of that Advice by taking into account the amendments of the US regulatory framework regarding credit rating agencies introduced by the Dodd-Frank Wall Street Reform and Consumer Protection Act, approved in July 2010.

19. In May 2010, the Technical Advice concluded that the US legal and supervisory framework was broadly equivalent to the EU regulatory regime for credit rating agencies. That conclusion was reached by looking at what ESMA considered to be the overall objectives of the equivalence assessment:

"assuring that users of ratings in the EU would benefit from equivalent protections in terms of the credit rating agencies integrity, transparency, good governance and reliability of the credit rating activities"

20. The Technical Advice issued in 2010 highlighted some differences between the approach taken in the EU and that of the US as regards regulation and supervision of credit ratings and credit rating agencies. In two areas, the Technical Advice identified a more significant misalignment between the US legal and supervisory framework and the EU regulatory regime. This gap regarded: (i) the quality of methodologies and of credit ratings, (ii) the disclosure of credit ratings.

21. The Dodd-Frank Act has introduced new requirements in the two areas mentioned above, that have bridged the gaps identified in 2010, strengthening the equivalence of the US legal and supervisory framework with the EU regulatory regime for credit rating agencies.

22. In some parts of those areas the provisions in the Dodd-Frank Act require the SEC ("SEC shall prescribe") to adopt implementing rules. The statutory text of the Exchange Act, as amended by the Dodd-Frank Act, constitutes the baseline for these implementing rules, which means that the SEC has consulted on and will finally adopt rules that meet at least this baseline.

23. Other provisions in the Dodd-Frank Act leave larger room to the SEC as regards the content and also whether to adopt secondary rules at all ("SEC may prescribe"). In these areas, the SEC has consulted market participants on a number of possible relevant rules during the summer of 2011.

24. At the time of writing the SEC is still in the process of finalising this secondary legislation, as it has publicly announced that it is likely to adopt the implementing rules during the second half of 2012.

25. ESMA is comfortable that the requirements directly introduced (through "self-executing" provisions) by the Dodd Frank Act, together with the statutorily required rules that the SEC shall issue, already provide a solid background for a positive decision on the equivalence of the US legal and supervisory framework for credit rating agencies. The remaining few uncertainties linked to some secondary measures, where the SEC has larger discretion, are not capable to materially detract from this conclusion, as explained in detail in this report.

26. The equivalence assessment conducted by ESMA, in fact, follows an objective-based approach, where the capability of the regime in the third country to meet the objectives of the EU Regulation is assessed from a holistic perspective.

27. The analysis presented in this report is based upon ESMA's understanding of the amendments of the US legislative and regulatory framework introduced by the Dodd Frank Act. ESMA has conducted frequent dialogues with the Staff of the SEC in order to ensure the correctness of this understanding. In doing so, ESMA concluded that, while introducing the improvements mentioned above, neither the Dodd-Frank Act, nor the SEC implementing measures, have removed or will remove any existing rules upon which CESR's Technical Advice relied.

28. In light of the above, ESMA believes that the US legal and supervisory framework is equivalent to the EU Regulation on CRAs.

29. ESMA will keep monitoring the evolution of the US legal and supervisory framework for credit rating agencies on an ongoing basis, also via the cooperation agreement that the two Authorities have recently signed in that field. It will update the European Commission in the event of future amendments to the US regime that may necessitate a change in the conclusions of this report.

Introduction

30. The European Commission mandated CESR[6] on 12 June 2009 to provide it with technical advice on the equivalence between the US, Canadian and Japanese legal and supervisory frameworks and the EU regulatory regime[7] for credit rating agencies (CRAs). Later on, the Commission extended the mandate to include Australia.

31. On 21 May 2010 CESR published its Technical Advice to the European Commission on the equivalence between the US legal and supervisory frameworks and the EU regulatory regime for credit rating agencies (CESR /10-332). The Technical Advice[8] indicated the US legal and supervisory framework as "*broadly equivalent*" to the EU Regulation.

32. In coming to this conclusion, CESR had grouped the requirements of the EU Regulation into seven areas, and assessed the ability of the US legal and supervisory framework to achieve the main objectives of the relevant EU requirements in each of those areas. The seven areas are:

(i) Scope of the regulatory and supervisory framework

(ii) Corporate Governance

(iii) Conflicts of interests management

(iv) Organisational requirements

(v) Quality of methodologies and of credit ratings

(vi) Disclosure of:

- credit ratings
- the activities of the credit rating agency

(vii) Effective supervision and enforcement.

33. The Technical Advice considered the US system to be stronger in some areas and weaker in others in terms of the ability to achieve the relevant objectives of the EU Regulation. Among the weaknesses, a more significant regulatory gap was identified in two areas:

(i) Quality of methodologies and of credit ratings

(ii) Disclosure of credit ratings

34. On July 21 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act passed into law in the US. The Dodd Frank Act has introduced a number of new provisions in respect of credit rating agencies in the US (NRSROs), including in the aforementioned two areas where CESR had identified weaknesses vis-a-vis the EU Regulation.

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[6] The mandate was conferred to CESR, which ceased to exist transferring all its operations to ESMA on the 1st of January 2011, when ESMA was established by the Regulation (EU) No.1095/2010.

[7] Regulation (EC) No. 1060/2009 of the European Parliament and the Council on credit rating agencies, hereinafter, "the EU Regulation".

[8] Any reference in this report to ESMA's Advice refers to the Technical Advice to the European Commission on the equivalence between the US Regulatory and Supervisory Framework and the EU Regulatory Regime for Credit Rating Agencies (CESR/10-332) published on 21 May 2010.

35. Some of the new requirements concerning NRSROs introduced by Dodd-Frank became immediately effective, as they were established by adding "self-executing" provisions to the Securities and Exchange Act. As the name suggests, those requirements have entered directly into force as part of the US law, without requiring the SEC to take any additional steps.

36. Other provisions in the Dodd-Frank, instead, make reference to the need for the SEC to issue secondary implementing rules; such provisions only become law once those rules are adopted.

37. The SEC has published a first release of the proposed secondary rules for consultation between 18 May 2011 and 8 August 2011, and is at the current time still in the process to finalise those rules. In indicative terms, the SEC has estimated that it will adopt its final implementing rules during the second semester of 2012.

38. There are important differences between the provisions of the Dodd-Frank Act that refer to the existence of secondary legislation from the SEC. In some areas the Dodd-Frank Act mandates the SEC ("SEC shall prescribe") to adopt implementing rules, while in other circumstances it leaves larger room to the SEC as regards the content and also whether to adopt implementing rules at all ("SEC may prescribe").

39. ESMA has understood that, in the first case above, the statutory text of the Exchange Act constitutes the base-line for the implementing rules, which means that the SEC has consulted on and will finally adopt rules that meet at least this base-line.

40. On 20 May 2010 CESR stated[9] that it would update the European Commission in the event of changes to the US regime that may necessitate a change in its Advice. Accordingly, ESMA has issued this report with the purpose to integrate the Technical Advice provided on 20 May 2010 to the European Commission on the equivalence between the US legal and supervisory framework and the EU regulatory regime for credit rating agencies. This report updates the content of that Advice by taking into account the innovations and amendments of the US regulatory regime introduced by the Dodd-Frank Wall Street Reform and Consumer Protection Act.

41. The analysis presented in this report is based upon ESMA's understanding of the amendments of the US legislative and regulatory framework for credit rating agencies introduced by the Dodd-Frank Act. ESMA has conducted frequent dialogues with the Staff of the SEC in order to ensure the correctness of this understanding. In doing so, ESMA has concluded that the amendments of the US regime introduced by the Dodd-Frank Act have bridged the gaps identified by CESR in May 2010.

42. ESMA has also concluded that, while introducing the improvements mentioned above, neither the Dodd-Franck Act, nor the SEC implementing measures, have removed or will remove any existing rules upon which the Technical Advice relied in May 2010. On the contrary, part of the provisions introduced by the Dodd-Frank regarding credit rating agencies have reinforced even further some of the areas where CESR had already considered in May 2010 the US regime equivalent, and in some cases even stronger, to the EU requirements.

[9] Paragraph 1142 of the Technical Advice.

Overall conclusions

Box 1

43. The Dodd-Frank Act has added a number of new requirements into the US legal and supervisory framework concerning NRSROs, including in the two areas where CESR's Technical Advice had identified weaknesses.

44. In addition to setting out requirements directly, the Dodd-Frank has reinforced the existing rule making powers of the SEC in respect of NRSROs. In many instances it gives direct instructions to the SEC to either explicitly introduce rules to implement the provisions in the law, or to add additional rules where it sees fit to do so.

45. ESMA is comfortable that the requirements directly introduced (through "self-executing" provisions) by the Dodd Frank Act, together with the statutory implementing rules that the SEC is required to issue, have bridged the gaps identified in 2010, strengthening the equivalence of the US legal and supervisory framework with the EU regulatory regime for credit rating agencies. The remaining few uncertainties linked to some secondary measures, where the SEC has statutory discretion, are not able to materially detract from this assessment.

46. In parallel to introducing those improvements, the Dodd-Franck Act has not determined the withdrawal or change of any existing rules upon which the Technical Advice relied in May 2010. As a consequence, the conclusions reached in May 2010 regarding the areas where CESR had already considered the US regime equivalent are not affected.

47. In light of the above, ESMA believes that the US legal and supervisory framework concerning credit rating agencies is equivalent to the EU Regulation.

Quality of methodologies and of ratings

48. The weaknesses in the area of the quality of methodologies and of credit ratings identified in the Technical Advice were linked to the absence in the US legal and supervisory framework of specific requirements:

(i) Reviewing credit ratings, models, methodologies and key rating assumptions:

- to monitor methodologies and to have a review function;
- to monitor credit ratings on an ongoing basis and at least annually,

(ii) Quality of credit ratings and analysis of information used in assigning credit ratings:

- to refrain from issuing a credit rating – or to withdraw an existing rating- if the NRSRO does not have information of a sufficient quality on which to base the rating;

(iii) Quality of methodologies and changes to them:

- to use credit rating methodologies that are rigorous, systematic, continuous and subject to validation based on historical experience and back testing;
- to apply changes to methodologies and models consistently to existing ratings, and immediately disclose the likely scope of credit ratings affected by the change;
- to immediately disclose the likely scope of credit ratings to be affected;

I.A Monitoring and reviewing of methodologies and credit ratings, and review function

49. The Dodd-Frank introduces a number of provisions that enable the objectives of this requirement to be met. The main new provision is one that requires that the NRSROs management be entrusted with the responsibility to establish and maintain an effective internal control structure governing the implementation of, and adherence to, credit rating methodologies.

50. The effectiveness of the internal control structure will need to be assessed at least on an annual basis in the report that NRSROs will need to submit yearly to the SEC. ESMA understands that, in order to assess the effectiveness of the internal control structure, an NRSRO would be expected to assess also the effectiveness of the methodologies used for determining the credit ratings. Credit rating methodologies need, therefore, to be monitored at least on an annual basis.

51. Namely, Section 15(E)(c)(3) of the Exchange Act provides that:

"(3) INTERNAL CONTROLS OVER PROCESSES FOR DETERMINING CREDIT RATINGS.—

"(A) IN GENERAL.—Each nationally recognized statistical rating organization shall establish, maintain, enforce, and document an effective internal control structure governing the implementation of and adherence to policies, procedures, and methodologies for determining credit ratings, taking into consideration such factors as the Commission may prescribe, by rule.

"(B) ATTESTATION REQUIREMENT.—The Commission shall prescribe rules requiring each nationally recognized statistical rating organization to submit to the Commission an annual internal controls report, which shall contain—

"(i) a description of the responsibility of the management of the nationally recognized statistical rating organization in establishing and maintaining an effective internal control structure under subparagraph (A);

"(ii) an assessment of the effectiveness of the internal control structure of the nationally recognized statistical rating organization; and

"(iii) the attestation of the chief executive officer, or equivalent individual, of the nationally recognized statistical rating organization."

52. Moreover, as set out in Section 15(E)(r)(1) of the Exchange Act, Dodd Frank has required the SEC to introduce rules for the protection of investors and the public interest in respect of the procedures and methodologies, including qualitative and quantitative data models that are used by NRSROs.

53. The new provision requires each NRSRO to ensure that credit ratings are determined using procedures and methodologies approved by the Board and developed in accordance with internal policies and procedures.

"(r) CREDIT RATINGS METHODOLOGIES.—The Commission shall prescribe rules, for the protection of investors and in the public interest, with respect to the procedures and methodologies, including qualitative and quantitative data and models, used by nationally recognized statistical rating organizations that require each nationally recognized statistical rating organization—

(1) to ensure that credit ratings are determined using procedures and methodologies, including qualitative and quantitative data and models, that are—

(A) approved by the board of the nationally recognized statistical rating organization, a body performing a function similar to that of a board…"

Box 2

Conclusions on the requirements concerning:

Monitoring and reviewing of methodologies and credit ratings, and review function

54. Dodd-Frank requires NRSROs to "*establish, maintain, enforce, and document an effective internal control structure governing the implementation of and adherence to policies, procedures, and methodologies for determining credit ratings*". In addition, the Dodd-Frank mandates the SEC to issue some specific rules in this area (while others may be prescribed), providing indications for their content.

55. ESMA believes that the requirements above, coupled with the disclosure of the procedures in the internal control structure[10], and in combination with the disclosure that applies to the methodologies, reproduce the effects of the relevant requirements set out in the EU Regulation, by meeting their final objectives. Namely, these objectives are: i) transparency of methodologies, ii) assessment of their effectiveness on an on-going basis (which is the same objective of the review function), and iii) supervision of the process of development and maintenance of the methodologies but with no interference.

56. As regards the monitoring of credit ratings, the US regime encompasses the need to constantly monitor ratings in order for NRSROs to assess whether or not new information has an impact on them. Moreover, each review of a rating triggers a disclosure requirement if it implies some form of rating action.

I.B Quality of information used in assigning credit ratings

57. The Dodd-Frank introduces a number of new provisions that address these requirements through the disclosure that an NRSRO is required to make through a form to be published for each rating.

58. Dodd-Frank has introduced a whole new section to the Exchange Act, namely Section 15E(s), that deals exclusively with this form and its content. The SEC is required to adopt rules is this area.

59. The form shall accompany the publication of each credit rating and include information regarding the reliability, accuracy and quality of the data analysed to determine the rating. In order to be able to comply with this obligation, the NRSRO will need to assess the quality of the information used to issue the rating.

"15(E)(s)(3) CONTENT OF FORM.—

(A) QUALITATIVE CONTENT.—Each nationally recognized statistical rating organization shall disclose on the form developed under paragraph (1)

[10] This procedure is to be required to be disclosed in an exhibit of form NRSRO.

(iv) information on the uncertainty of the credit rating, including—

(I) information on the reliability, accuracy, and quality of the data relied on in determining the credit rating;

(ii) a statement relating to the extent to which data essential to the determination of the credit rating were reliable or limited, including—

(aa) any limits on the scope of historical data; and

(bb) any limits in accessibility to certain documents or other types of information that would have better informed the credit rating;"

(vii) a statement containing an overall assessment of the quality of information available and considered in producing a rating for an obligor, security, or money market instrument, in relation to the quality of information available to the nationally recognized statistical rating organization in rating similar issuances;"

"15(E)(v) INFORMATION FROM SOURCES OTHER THAN THE ISSUER.—In producing a credit rating, a nationally recognized statistical rating organization shall consider information about an issuer that the nationally recognized statistical rating organization has, or receives from a source other than the issuer or underwriter, that the nationally recognized statistical rating organization finds credible and potentially significant to a rating decision."

60. ESMA understands that, in order to carry out the disclosure indicated above, or to assess the impact of the information indicated in the new Section 15E(v) of the Exchange Act (above), an NRSRO will be expected to establish adequate procedures so as to ensure the reliability, accuracy, and quality of the information collected and processed to issue the credit ratings.

61. These new provisions address aspects that are linked to some important requirements set out by the EU Regulation, namely to:

- adopt, implement and enforce adequate measures to ensure that the credit ratings they issue are based on a thorough analysis of all the information that is available to them and that is relevant to their analysis according to their rating methodologies
- adopt all necessary measures so that the information they use in assigning a credit rating is of sufficient quality and from reliable sources;
- refrain from issuing a credit rating or withdrawing an existing rating if it does not have sufficient quality information to base its ratings on.

62. The EU requirement to establish internal arrangements to monitor the impact of changes in macroeconomic or of financial market conditions, is embedded in the general obligation for the NRSROs to assess whether or not new information has an impact on credit ratings.

Box 3

Conclusions on the requirements concerning:

Quality of information used in assigning credit ratings

63. Looking at the new provisions introduced in this area by the Dodd-Frank, ESMA has concluded that the US regulatory regime has embraced the objectives of the EU requirements which deal with the quality of the information underlying credit ratings.

64. The EU requirements to adopt measures to ensure that credit ratings are based on a thorough analysis of all available information - or to refrain from issuing a credit rating if the information is not of a sufficient quality -are not reproduced in the US regulatory regime through explicit identical provisions. However, ESMA considers that the practical implementation of the (form) disclosure requirements introduced by the Dodd-Frank, under the assumption that this happens in a credible and sensible manner and reflecting all the information that is used in determining the ratings, brings the US regime in line with the objectives pursued in the this area by the EU Regulation.

I.C. Use of rating methodologies that are rigorous, systematic, continuous and subject to validation based on historical experience, including back testing

65. This is an area where the US and the EU approaches tend to vary the most, while still achieving equivalent objectives.

66. As mentioned in previous paragraphs, with the introduction of Section 15(E)(r)(1) in the Exchange Act, the Dodd Frank has reinforced the rule making power of the SEC in respect of the procedures and methodologies to be adopted by the NRSROs. The new provisions in the Dodd-Frank require the SEC to ensure, via its implementing rules, that credit ratings are determined using procedures and methodologies that are approved by the Board and developed in accordance with the internal policies and procedures established and disclosed by the NRSRO.

67. In addition, the Dodd Frank has introduced a new provision in respect of credit rating methodologies (Section 15E(r)), that instructs the SEC to prescribe rules:

"*for the protection of investors and in the public interest, with respect to the procedures and methodologies, including qualitative and quantitative data and models, used by nationally recognized statistical rating organizations that require each nationally recognized statistical rating organization to…..*"

68. ESMA has discussed this are a several times with the SEC Staff, with the purpose to consolidate its understanding of how the US legal and supervisory framework addresses this subject, and to share its assessment of such approach with the SEC. In conclusion, ESMA has reached comfort that also in this area the US regime encompasses objectives that are equivalent to those of the EU Regulation. Those objectives are met indirectly by means of:

(i) the general obligation of the board to:

- establish maintain and enforce policies and procedures for determining credit ratings;
- ensure the effectiveness of the internal control system with respect to the policies and procedures for determining credit ratings (Section 15E(t)(3)(A) & (C), and Section15E(c)(3)).
- submit an annual report to the SEC regarding the internal control structure (Section 15E(c)(3)).

Section 15E(t)(3)(A) & (C)

"15E(t)(3) DUTIES OF BOARD OF DIRECTORS.—In addition to the overall responsibilities of the board of directors, the board shall oversee—

(A) the establishment, maintenance, and enforcement of policies and procedures for determining credit ratings;

(C) the effectiveness of the internal control system with respect to policies and procedures for determining credit ratings;"

Section 15E(c)(3)

"15E(c)(3) INTERNAL CONTROLS OVER PROCESSES FOR DETERMINING CREDIT RATINGS.—

(A) IN GENERAL.—Each nationally recognized statistical rating organization shall establish, maintain, enforce, and document an effective internal control structure governing the implementation of and adherence to policies, procedures, and methodologies for determining credit ratings, taking into consideration such factors as the Commission may prescribe, by rule.

(B) ATTESTATION REQUIREMENT.—The Commission shall prescribe rules requiring each nationally recognized statistical rating organization to submit to the Commission an annual internal controls report, which shall contain—

(i) a description of the responsibility of the management of the nationally recognized statistical rating organization in establishing and maintaining an effective internal control structure under subparagraph (A);

(ii) an assessment of the effectiveness of the internal control structure of the nationally recognized statistical rating organization; and

(iii) the attestation of the chief executive officer, or equivalent individual, of the nationally recognized statistical rating organization.

(ii) the fact that the requirement to have methodologies that are rigorous, systematic, continuous and subject to validation based on historical experience, including back testing, is met through the practical application of the provisions above. In fact, to verify the effectiveness of the internal control mechanism there must be an assessment of the procedures used to determine credit ratings, which would then cover the methodologies used to establish them.

Box 4

Conclusions on the requirements concerning:

<u>Use of rating methodologies that are rigorous, systematic, continuous and subject to validation based on historical experience, including back testing</u>

69. In conclusion, ESMA is of the opinion that in the US the requirement to use rating methodologies that are rigorous, systematic, continuous and subject to validation based on historical experience, including back testing, is indirectly addressed through other form of provisions. Those other provisions relate mainly to the governance, disclosure and effectiveness of the internal control structure, which is responsible to implement and maintain the rating methodologies.

I.D. Applying changes in methodologies and models consistently to existing ratings and immediately disclose the likely scope of the credit ratings affected by change

70. The Technical Advice of 2010 had already pointed out how the US regime included requirements (Rule 17g-1 and Form NRSRO, Exhibit 2) mandating NRSROs to disclose to the public a description of the procedures and methodologies used to determine credit ratings. This information (in Exhibit 2) must be sufficiently detailed to allow for verification, leading ESMA to understand that, where different procedures and methodologies are used in relation to different types of credit ratings, those differences shall be reflected in Exhibit 2 of the Form NRSRO.

71. The information above must be promptly amended when it becomes materially inaccurate. Consequently, ESMA had concluded that NRSROs shall disclose material changes to their credit rating methodologies, models and metrics. Moreover, the Technical Advice took also into account that NRSROs must provide an annual certification (on Form NRSRO) stating that the information presented there, including the description of procedures and methodologies, is accurate in all significant respects, hence appropriately up to date.

72. In addition to the existing rules, the Dodd-Frank has introduced new specific provisions in Section 15E(r) of the Exchange Act, which require NRSROs to ensure that material changes to credit rating procedures and methodologies, including the surveillance process, are applied consistently to all relevant ratings within a reasonable period of time.

73. The new provisions (Section 15E(r)(2)(A)&(B)) also require NRSROs to notify users of credit ratings in the event of a material change to a methodology, or when a significant error in a methodology is identified. In those circumstances, the users of ratings shall receive information about the likelihood that the material change in the methodology will result in a change to current credit ratings.

Section 15E(r)

CREDIT RATINGS METHODOLOGIES.—The Commission shall prescribe rules, for the protection of investors and in the public interest, with respect to the procedures and methodologies, including qualitative and quantitative data and models, used by nationally recognized statistical rating organizations that require each nationally recognized statistical rating organization—

"(1) to ensure that credit ratings are determined using procedures and methodologies, including qualitative and quantitative data and models, that are—

"(A) approved by the board of the nationally recognized statistical rating organization, a body performing a function similar to that of a board; and

"(B) in accordance with the policies and procedures of the nationally recognized statistical rating organization for the development and modification of credit rating procedures and methodologies;

"(2) to ensure that when material changes to credit rating procedures and methodologies (including changes to qualitative and quantitative data and models) are made, that—

"(A) the changes are applied consistently to all credit ratings to which the changed procedures and methodologies apply;

"(B) to the extent that changes are made to credit rating surveillance procedures and methodologies, the changes are applied to then-current credit ratings by the nationally recognized statistical rating organization within reasonable time period determined by the Commission, by rule; and

"(C) the nationally recognized statistical rating organization publicly discloses the reason for the change; and

"(3) to notify users of credit ratings—

"(A) of the version of a procedure or methodology, including the qualitative methodology or quantitative inputs, used with respect to a particular credit rating;

"(B) when a material change is made to a procedure or methodology, including to a qualitative model or quantitative inputs;

"(C) when a significant error is identified in a procedure or methodology, including a qualitative or quantitative model, that may result in credit rating actions; and

"(D) of the likelihood of a material change described in subparagraph (B) resulting in a change in current credit ratings.

74. In light of the above, ESMA believes that the intervention of the Dodd-Frank has removed any weaknesses indentified in this area by the 2010 Technical Advice, introducing specific and direct provisions that have integrated the previous framework. As a consequence, the US regimes encompasses requirements that ensure appropriate transparency of the nature and potential impact of changes of rating methodologies and models, pursuing the same objectives of the rules that apply in the EU.

Box 5

Conclusions on the requirements concerning:

<u>Applying changes in methodologies and models consistently to existing ratings, and immediately disclose the likely scope of the credit ratings affected by change</u>

75. In conclusion, ESMA believes that the requirement to apply the changes in methodologies and models consistently to existing ratings is met through a direct provision introduced by the Dodd-Frank. Similarly, the requirement to immediately disclose the likely scope of the credit ratings potentially affected by a change of a methodology is also appropriately and explicitly addressed.

Disclosure of ratings

76. The weaknesses in the disclosure of credit ratings identified in the Technical Advice were linked to the absence in the US legal and supervisory framework of specific requirements:

- to identify unsolicited credit ratings to the public (information only available to the SEC), including whether or not a rated entity has participated to the rating process by providing access to its books and records or other confidential information;
- to explain the key elements underlying the credit rating when it is announced;
- to disclose the sources of information that were material in determining the credit rating;
- to disclose limitations and attributes of individual credit ratings;
- for the additional disclosures regarding credit ratings on structured finance instruments.

77. On the overall, in this area the Dodd-Frank Act has:

- mandated the SEC to adopt rules requiring an NRSRO to use a form to accompany the publication of each credit rating (Section 15E(s) of the Exchange Act);
- included catch all provisions enabling the SEC to add additional disclosure requirements that are not specifically set out in explicit list of what the form needs to include in order to enable investors and other users of credit ratings to better understand credit ratings in each class of issued rating (Section 15E(s)(1)(B); and
- included in the Qualitative content of the form an instruction to the SEC to add "such additional information as the Commission may require" (Section 15E(s)(2)(A)(ix)).

II.A. Identifying Unsolicited Ratings

78. The Dodd-Frank has introduce in Section 15E(s)(3)(A)(iv)(II)(bb) of the Exchange Act (which obliges the SEC to adopt rules) a provision that requires to disclose:

"(iv) information on the uncertainty of the credit rating, including—

(I) information on the reliability, accuracy, and quality of the data relied on in determining the credit rating; and

(II) a statement relating to the extent to which data essential to the determination of the credit rating were reliable or limited, including—

(aa) any limits on the scope of historical data; and

(bb) any limits in accessibility to certain documents or other types of information that would have better informed the credit rating;"

Box 6

Conclusions on the requirements concerning:

Explaining the key elements underlying the credit ratings

79. ESMA understands that through the additional disclosure to be made (on a Form) when publishing ratings, the Dodd–Frank has made possible for the users of ratings to identify whether or not the rating is unsolicited, or whether the rated entity or a related third party has participated to the rating process.

II.B. Explaining the key elements underlying the credit ratings

80. Dodd-Frank has introduced 3 new requirements related to this issue, that together have bridged the gap in this area:

a. Section 15E(s)(1)(A)(i) & (ii) of the Exchange Act introduces a requirement that an NRSRO discloses in a form to accompany the publication of each rating - the data and assumptions underlying credit ratings;[11]

b. Section 15E(s)(3)(B)(i) of the Exchange Act requires that this form also includes an explanation of the potential volatility of the rating;

[11] Note that CESR sought confirmation form the Staff of the Sec that the reference in the provision to "credit rating procedures and methodologies' and not to credit ratings - does in practice mean that the disclosure will be about the assumptions from which the credit rating was derived.

c. Section 15E(s)(3)(B)(III)(i)&(ii) of the Exchange Act requires that this form also identifies the 5 most important assumptions in the ratings process.

Section 15E(s)(1)(A)(i) & (ii)

"(1) FORM FOR DISCLOSURES.—The Commission shall re-quire, by rule, each nationally recognized statistical rating organization to prescribe a form to accompany the publication of each credit rating that discloses—

(A) information relating to—

(i) the assumptions underlying the credit rating procedures and methodologies;

(ii) the data that was relied on to determine the credit rating;"

Section 15E(s)(3)(B)(i)

"QUANTITATIVE CONTENT.—Each nationally recognized statistical rating organization shall disclose on the form developed under this subsection—

(i) an explanation or measure of the potential volatility of the credit rating, including…"

Section 15E(s)(3)(B)(III)(i)&(ii)

"(I) 5 assumptions made in the ratings process that, without accounting for any other factor, would have the greatest impact on a rating if the assumptions were proven false or inaccurate; and

(II) an analysis, using specific examples, of how each of the 5 assumptions identified under sub-clause (I) impacts a rating;"

Box 7

Conclusions on the requirements concerning:

Key elements underlying the credit ratings

81. ESMA believes that this requirement is met in light of the new provisions introduced by the Dodd-Frank and the rules to be statutorily adopted by SEC in order to implement the law.

II.C. Sources of information that were material in determining the credit rating

82. Dodd-Frank has introduced a number of provisions that deal with this subject:

- Section 15E(s)(3)(A)(v) of the Exchange Act introduces a provision requiring NRSRO's to make disclose their use and the content of third part due diligence.

- Section 15E(s)(3)(A)(vi) of the Exchange Act introduces a provision that requires NRSROs to disclose a description of the data about any obligor, issuer, security or money market instrument that were relied upon for the purposes of the rating.

- Section 15E(s)(1)(A)(ii) of the Exchange Act introduces a provision that requires NRSROs to disclose the data that was relied upon to determine the credit rating.

- Section 15E(s)(1)(A)(iii) of the Exchange Act introduces a provision that requires NRSROs to disclose how they used servicer remittance reports to conduct surveillance.

83. The provisions introduced by Dodd Frank clearly meet the objectives of the EU requirements:

Section 15E(s)(3)(A)(v)

"(3) CONTENT OF FORM.—

(A) QUALITATIVE CONTENT.—Each nationally recognized statistical rating organization shall disclose on the form developed under paragraph (1).....— (v) whether and to what extent third party due diligence services have been used by the nationally recognized statistical rating organization, a description of the information that such third party reviewed conducting due diligence services, and a description of the findings or conclusions of such third party;"

Section 15E(s)(3)(A)(vi)

"(3) CONTENT OF FORM.—

(A) QUALITATIVE CONTENT.—Each nationally recognized statistical rating organization shall disclose on the form developed under paragraph (1).....— (vi) a description of the data about any obligor, issuer, security, or money market instrument that were relied upon for the purpose of determining the credit rating;"

Section 15E(s)(1)(A)(ii)

"(A) information relating to—.....

(ii) the data that was relied on to determine the credit rating;"

Section 15E(s)(1)(A)(iii)

"(A) information relating to—....

(iii) if applicable, how the nationally recognized statistical rating organization used servicer or remittance reports, and with what frequency, to conduct surveillance of the credit rating;".

Box 8

Conclusions on the requirements concerning:

Sources of information that were material in determining the credit rating

84. ESMA concludes that this area has been covered through the new provisions introduced by Dodd-Frank Act.

II.D. Limitations and attributes of individual credit ratings

85. The Dodd-Frank Act has introduced a number of new provisions which deal with this requirement:

- Section 15E(s)(3)(A)(iv)(I) of the Exchange Act introduces a provision that imposes the obligation on NRSROs to include in the form to be published for each rating an assessment of the quality of the information relied upon in producing the rating.

- Section 15E(s)(3)(A)(iii) of the Exchange Act introduces a provision that imposes the obligation on NRSROs to disclose in the form to be published for each rating the potential limitations of the credit rating, and the types of risks excluded from the assessment underlying the rating.

- Section 15E(s)(3)(A)(iv) of the Exchange Act introduces a provision that imposes the obligation on NRSROs to include in the form be published for each rating information about the uncertainty of the credit rating.

- Section 15E(s)(3)(A)(viii) of the Exchange Act introduces a provision that imposes the obligation on NRSROs to include in the form to be published for each rating information about conflicts of interest.

Section 15E(s)(3)(A)(iv)(I)

(*iv) information on the uncertainty of the credit rating, including—*

(I) information on the reliability, accuracy, and quality of the data relied on in determining the credit rating;

Section 15E(s)(3)(A)(iii)

(iii) the potential limitations of the credit ratings, and the types of risks excluded from the credit ratings that the nationally recognized statistical rating organization does not comment on, including liquidity, market, and other risks;

Section 15E(s)(3)(A)(iv)

(iv) information on the uncertainty of the credit rating, including—

(I) information on the reliability, accuracy, and quality of the data relied on in determining the credit *rating; and*

(II) a statement relating to the extent to which data essential to the determination of the credit rating were reliable or limited, including—

(aa) any limits on the scope of historical data; and

(bb) any limits in accessibility to certain documents or other types of information that would have better informed the credit rating;

Section 15E(s)(3)(A)(viii)

(viii) information relating to conflicts of interest of the nationally recognized statistical rating organization;

Box 9

Conclusions on the requirements concerning:

Limitations and attributes of individual credit ratings

86. ESMA concludes that, taking into account the four new provisions introduced in this area by the Dodd-Frank Act, the US regime meets the EU requirements concerning the disclosure of any attributes and limitations of a credit rating.

II.E. Additional disclosures regarding credit ratings on structured finance instruments.

87. The Dodd-Frank Act has introduced a number of provisions that are relevant for the disclosure applicable to credit ratings that relate to structured finance instruments.

88. The US regime does not include requirements concerning the use of specific symbols to differentiate ratings on structured finance instruments. However, Section 15E(s)(1)(B) has introduced a provision instructing the SEC to require by rule that NRSROs disclose in the form to be published for each rating information that can be used by investors to better understand the meaning of every class of credit ratings issued.

15E(s)(1) FORM FOR DISCLOSURES.—The Commission shall require, by rule, each nationally recognized statistical rating organization to prescribe a form to accompany the publication of each credit rating that discloses—

(B) information that can be used by investors and other users of credit ratings to better understand credit ratings in each class of credit rating issued by the nationally recognized statistical rating organization.

89. In addition, Section 938 of Dodd-Frank Act has introduced a provision to foster the universal use of rating symbols. This imposes an obligation on the SEC to require by rule each NRSRO to establish, maintain and enforce policies and procedures that:

"(2) clearly define and disclose the meaning of any symbol used by the NRSRO to denote a credit rating; and

(3) apply any symbol described in paragraph (2) in a manner that is consistent for all types of securities and money market instruments for which the symbol is used"

90. From exchange of view s with the SEC Staff, ESMA understands that the requirements above can be construes as meaning that NRSROs are neither prohibited from using a symbol for structured finance ratings nor required to introduce one.

91. The Dodd-Frank has not introduced additional provisions in respect of the particular guidance to be disclosed for credit ratings on structured finance products. However, the new general disclosure requirements, that shall apply for each rating, address some of those issues, as per the:

- assumptions underlying the credit rating procedures and methodologies (Section 15E(s)(1)(A)(i));

- assumptions and principles used in constructing the procedures and methodologies, including qualitative methodologies and quantitative inputs and assumptions about the correlation of defaults across underlying assets used in rating structured finance products (Section 15E(s)(3)(A)(ii));
- the potential limitations of the credit ratings and the types of risks excluded from the credit ratings that the NRSRO does not comment on, including liquidity, market and other risks; (Section 15E(s)(3)(A)(iii));
- information on the uncertainty of the credit rating (Section 15E(s)(3)(A)(iv).

92. In general, The Dodd-Frank has not introduced provisions to require the disclosure of all structured finance products submitted to the NRSRO for initial review or preliminary rating. However, it includes specific provisions in this respect regarding the Asset Backed securities as defined in Section 949 of Dodd Frank.

93. Dodd-Frank has introduced a provision in Section 15E(s)(3)(B)(i)(I)&(II) of the Exchange Act to require NRSROs to disclose on a rating by rating basis an explanation (or measure) of the potential volatility of the credit rating. This disclosure shall include any factor that might lead to a change in the relevant rating, and the magnitude of the change that a user can expect under different market conditions.

94. The Dodd-Frank Act has introduced (Section 15E(s)(3)(B)(iii)(I)&(II)) the requirement for NRSROs to disclose, for each rating, the 5 assumptions made in the rating process which without would have the greatest impact on the rating if proven false and inaccurate.

95. Dodd-Frank has added a number of requirements that deal with the disclosure of the due diligence processes, carried out at the level of underlying financial instruments or other assets, for rating on structured finance instruments. The relevant provisions have been introduced in:

- Section 15E(s)(4) of the Exchange Act. It introduces a provision in relation to asset back securities, which instructs the SEC to adopt rules requiring an NRSRO to publically disclose certification of a 3rd party due diligence provider if the issuer, underwriter or NRSOR uses a 3rd party due diligence provider;
- Section 15E(s)(4)(C) of the Exchange Act. This spells out the need for the SEC to establish the format and content of this certification which needs to ensure that the providers of the due diligence services have conducted a thorough review of data, documentation, and other relevant information necessary for the provision of an accurate rating.
- Section 15E(s)(4)(D) of the Exchange Act. This provision instructs the SEC to adopt rules requiring the NRSRO, when producing a rating, to disclose the certification to the public in a manner that allows the public to determine the adequacy and level of due diligence services provided by the third party.

96. In addition, Section 15E(s)(4)(A) of the Exchange Act requires the issuer or underwriter of any asset back security to make publically available the findings and conclusions of any third-party due diligence report obtained by the issuer or underwriter.

15E(s)(4) DUE DILIGENCE SERVICES FOR ASSET-BACKED SECURITIES.—

(A) FINDINGS.—The issuer or underwriter of any asset-backed security shall make publicly available the findings and conclusions of any third-party due diligence report obtained by the issuer or underwriter.

Box 10

Conclusions on the requirements concerning:

Additional disclosures regarding credit ratings on structured finance instruments.

97. ESMA is of the opinion that, in respect of the additional disclosure requirements concerning credit ratings on structured finance instruments, the Dodd-Frank Act has introduced some new important provisions. Altogether, these new requirements make the US regime equivalent to the EU Regulation in this area.

Conclusions

98. On 21 May 2010 CESR published its Technical Advice to the European Commission on the equivalence between the US legal and supervisory frameworks and the EU regulatory regime for credit rating agencies (CESR /10-332).

99. The Technical Advice highlighted some differences between the approach taken in the EU and that of the US as regards regulation and supervision of credit ratings and credit rating agencies. In two areas, the Technical Advice identified a more significant misalignment between the US and the EU regulatory regime. This gap regarded: (i) the quality of methodologies and of credit ratings, (ii) the disclosure of credit ratings.

100. On July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act passed into law in the US. The Dodd Frank Act has introduced a number of new requirements for credit rating agencies in the US (NRSROs), including in the aforementioned two areas where CESR had identified weaknesses vis-a-vis the EU Regulation.

101. In May 2010, CESR stated that it would update the European Commission in the event of changes to the US regime that may necessitate a change in its Advice. Accordingly, ESMA has issued this report with the purpose to integrate the Technical Advice provided 2010 by taking into account the amendments of the US regulatory regime introduced by the Dodd-Frank Act.

102. Some of the new requirements concerning NRSROs introduced by Dodd-Frank became immediately effective, as they were established by adding “self-executing” provisions to the Securities and Exchange Act.

103. In parts of the two mentioned areas, instead, the provisions in the law require the SEC to adopt implementing rules. The statutory text of the Exchange Act, as amended by the Dodd-Frank Act, constitutes the baseline for these implementing rules. As a consequence, ESMA believes that SEC has consulted on and will finally adopt rules that meet at least this baseline.

104. Other provisions in the Dodd-Frank Act leave larger room to the SEC regarding the content and also whether to adopt implementing rules at all. In these areas, the SEC has consulted market participants on a number of possible relevant rules during the summer of 2011.

105. At the time of writing the SEC is still in the process of finalising the implementing rules, as it has publicly indicated that it should be able to adopt the rules during the second half of 2012.

106. ESMA is comfortable that the requirements directly introduced (through "self-executing" provisions) by the Dodd Frank Act, together with the statutorily required implementing rules that the SEC shall issue, have substantially bridged the gaps identified in 2010, strengthening the equivalence of the US legal and supervisory framework with the EU regulatory regime for credit rating agencies. The remaining few uncertainties linked to some secondary measures, where the SEC has larger discretion, are not capable to materially impair this assessment.

107. The equivalence assessment conducted by ESMA, in fact, follows an objective-based approach, where the capability of the regime in the third country to meet the objectives of the EU Regulation is assessed from a holistic perspective.

108. This entails that not only the individual provisions in the law or regulation are relevant, but also the combined effects of the requirements set out by those provisions, as well as the scope and extent of the supervisory powers available to the competent authority in the third-country. In the case of the US, all those aspects are ample and robust enough as to support equivalence.

109. In parallel to introducing the aforementioned improvements, the Dodd-Franck Act has not determined the withdrawal or change of any existing rules upon which the Technical Advice relied in May 2010. As a consequence, the conclusions reached in May 2010 regarding the areas where CESR had already considered the US regime equivalent are not affected.

110. All this said, ESMA believes that the **US legal and supervisory framework is equivalent to the EU Regulation on credit rating agencies**.

111. ESMA will keep monitoring the evolution of the US legal and supervisory framework for credit rating agencies on an ongoing basis, also via the cooperation agreements that the two Authorities have recently signed in that field. It will update the European Commission in the event of future changes to the US regime that may necessitate a change in the conclusions of this report.

Part II - Assessment of Canada

Key to the references and terms used in this advice:

CRA: credit rating agencies

CROs: credit rating organizations

CSA: Canadian Securities Administrators

DRO: designated rating organisations

OSC: Ontario Securities Commission

NI: National Instrument 25-101

Executive summary

112. Following ESMA's decision to consider the Canadian regulatory regime as being in line with the requirements defined in Article 4(3) of the EU Regulation on CRA, this document sets out the technical advice of ESMA in relation to the equivalence between the Canadian legal and supervisory framework and the EU regulatory regime for credit rating agencies, in accordance with the European Commission's mandate of 12 June 2009.

113. ESMA concludes that, overall, the Canadian legal and supervisory framework is equivalent to the EU regulatory regime for credit rating agencies in terms of achieving what ESMA considers to be the overall objective of:

"assuring that users of ratings in the EU would benefit from equivalent protections in terms of the credit rating agencies integrity, transparency, good governance and reliability of the credit rating activities".

114. In coming to this conclusion, ESMA has verified whether the Canadian legal and regulatory framework for Credit Rating Agencies met the requirements of the EU Regulation grouped for the purpose of this assessment into seven areas[12], in relation to each of which ESMA has assessed the ability of the Canadian legal and supervisory framework to achieve the main objectives of the relevant EU requirements. However, only if all the conditions set out in Article 5(1) of the EU Regulation are met, can a third country CRA be granted certification, for example that the CRA is authorised or registered in and is subject to supervision in that third country

115. ESMA considers the Canadian framework to be comprehensive and in many instances similar to the EU Regulation.

116. There are no areas where the Canadian requirements do not meet the objectives of the EU requirements; there are no shortcomings, and as such ESMA has no recommendations to make in respect of the Canadian legal and supervisory framework as a whole for the purposes of an equivalence determination by the European Commission.

117. ESMA will keep monitoring the evolution of the Canadian legal and supervisory framework for credit rating agencies on an on-going basis, also via the cooperation agreements that the Canadian Authorities and ESMA have recently signed in that field. It will update the European Commission in the event of future changes to the Canadian regime that may necessitate a change in the conclusions of this report.

[12] These seven areas are:
1. The scope of the regulatory and supervisory framework
2. Corporate Governance
3. Conflicts of interest management
4. Organisational requirements
5. Quality of methodologies and quality of ratings
6. Disclosure
7. Effective supervision and enforcement.

Assessment of Canada

118. This section of the report explains how ESMA assesses the equivalence between the Canadian regulatory and supervisory framework and the EU regulatory regime for credit rating agencies.

119. This section is divided as follows:

a) The Canadian legal and supervisory framework

b) The assessment of the equivalence on that framework to that of EU

120. This section outlines the general differences between the EU and the Canadian approach on implementing the credit rating agency registration and oversight regime.

a) The Canadian legal and supervisory framework

Overall philosophy of approach

121. As a whole, unlike the situation which applied prior to the adoption of the National Instrument on 27 January 2012, the Canadian legislative and regulatory framework is very close to that of the EU Regulation in terms of the legal and supervisory framework that has been established for the oversight of credit rating agencies.

122. On October 6, 2008, the CSA published a consultation paper entitled Securities Regulatory Proposals in Response to the 2007-08 Credit Market Turmoil and its Effect on the ABCP Market in Canada (the Consultation Paper).

123. Primary proposals contained in the Consultation Paper included:

(i) Implementation of a regulatory framework applicable to CROs

(ii) Provide the CSA with the ability to perform compliance reviews and bring proceedings against CROs in the event of a breach of conduct contrary to the public interest.

124. However, CROs were not currently subject to formal securities regulatory oversight in Canada. Thus, on the basis that CROs play a significant role in the credit markets, and ratings issued by CROs continue to be referred to within securities legislation (e.g. short-term debt with a specified credit rating can be distributed exempt from the prospectus and registration requirements; An issuer can file a short-form prospectus for debt that has a specified credit rating; short-term debt with a specified credit rating can be eligible for investment by money market mutual funds), the supervision of CROs has gradually evolved into an oversight approach close to the EU one.

The 2010 Proposal

125. The CSA initially published for comment the National Instrument related policies and consequential amendment on July 16, 2010 (the 2010 Proposal). The proposal was significantly modified in light of the public comments received and the desire of the CSA to be attentive to international developments regarding the regulation of the CRAs with particular reference to what was taking place in the United States and in the EU.

126. The 2010 Proposal would have required that a Designated rating organization (DRO) establishes, maintains and ensures compliance with the Code of Conduct that complies with each provision of the

IOSCO Code of Conduct Fundamentals for CRAs (the IOSCO Code). However, in the spirit of the IOSCO Code, the 2010 Proposal would have also permitted a DRO to deviate from a provision or provisions of the IOSCO Code in certain circumstances. This was referred to as a "comply or explain model.

127. The initial 2010 proposal resulted in a combination of mandatory elements with a "comply or explain" approach. The mandatory elements include requirements that a DRO must:

- Establish, maintain and enforce a Code of Conduct
- Establish policies and procedures reasonably designed to identify and manage any conflicts of interest that arise in connection with the issuance of credit ratings;
- Not issue or maintain a credit rating in the face of specified conflicts of interest;
- Appoint a compliance officer to be responsible for monitoring and assessing the DRO's compliance with its code of conduct and the proposed regulatory framework;
- Have policies and procedures reasonably designed to prevent the inappropriate use and/or dissemination of certain material non-public information, including a pending undisclosed rating action, and
- File on an annual basis a form containing prescribed information.

128. A failure to comply with the provisions would amount to a breach of securities law.

129. In addition, the required Code of Conduct had to comply with each provision of the IOSCO Code. Deviations from the IOSCO Code were allowed but the DRO had to indicate how it had to deviate and nonetheless achieve the objectives of that provision of the IOSCO Code. A DRO's Code of Conduct, together with any amendments, had be filed with securities regulators and prominently displayed on the DRO's website. A Code of Conduct must also specify that waivers of the Code of Conduct are prohibited.

130. According to the mandate from the EU Commission (para2.3 page 7) "the regulatory framework of the third country must include mandatory requirements of the registered CRAs; voluntary regimes are not to be considered equivalent to the regulatory supervisory framework introduced by the CRA Regulation". While the 2010 Proposal contained mandatory requirements, its combination with a "comply explain approach" was not sufficiently balanced to support the demonstration of the equivalence with the EU requirements due to the potential for deviations from the IOSCO code.

131. Since then, the EU has implemented a regulatory framework for CRAs in the forms of Regulation (EC) No 1060/2009 (the EU Regulation). The EU regulation contains some provisions which that are also found in the IOSCO Code but that are now legally binding. A registration process so that a specific oversight system have thus been introduced to enable ESMA to monitor the activities of CRAs. In order to recognise the ratings issued by CRAs outside of the EU, the EC must take a decision confirming that the standards of regulation on a non-European country are "equivalent" to the EU Regulation.

The 2011 Proposal

132. To be consistent with the developing international standards and to facilitate a positive equivalency determination from the EC the CSA republished for comment the National Instrument, related poli-

cies and consequential amendments on March 18 2011 (the 2011 Proposal), which also included feedback received from the European Security Markets Authority on whether the proposed Canadian regulatory framework was "equivalent" to the EU Regulation. Following comments received by investors and marketplace participants on the 2011 Proposal, minor amendments have been made to enhance the rule.

133. The 2011 Proposal departs from the "comply or explain" approach which had been hitherto used and required DRO to establish, maintain and comply with a code that incorporates a list of provisions set out in the Instrument. The provisions are now based substantially on the IOSCO Code and have been supplemented and modified to meet developing international standards and to clarify the conduct the Canadian authorities' expect of DRO. Under the 2011 Proposal, unless a DRO obtains exemptive relief, its Code of Conduct would not be permitted to deviate from the provisions enumerated in the Instrument thereby effectively ending the "comply or explain" approach.

b) The assessment of the equivalence on Canada's framework to that of EU

134. Following the approval by OSC Board on 20 December 2011 of the final rules, the regulatory regime regarding CRAs in Canada has been established.

135. Against this background, an assessment of the regulatory regime adopted in Canada has been conducted. In carrying out that assessment, ESMA has verified its understanding of the relevant provisions through on-going informal contacts in particular with the Ontario Securities Commission (OSC) which acts as lead supervisor in Canada given that all the CRAs are located in Ontario.

136. The regime adopted in Canada has been tested against the objectives pursued by the EU Regulation in the seven areas where it establishes requirements, which are identified in ESMA's Guidelines on Endorsement (ESMA/2011/139, Annex II). These areas are:

(i) the scope of the regulatory and supervisory framework;

(ii) corporate governance;

(iii) management of conflicts of interest;

(iv) organisational requirements;

(v) quality of methodologies and of ratings;

(vi) general disclosure and presentation of ratings;

(vii) effective supervision and enforcement.

137. As a background to this advice, on 15 March 2012 ESMA informed market participants that it considered the recently adopted regulatory regime for CRAs in Canada embeds requirements which follow closely those in place in the EU. As a consequence, the regulatory regime in Canada is assessed as fulfilling the "as stringent as" test set out in Article 4(3) (b) of Regulation No 1060/2009[13].

*i) **The scope of the regulatory and supervisory framework***

138. On 27 January 2012, the CSA announced the adoption of NI 25-101 Designated Rating Organizations, which imposes requirements on credit rating organizations wishing to have their credit ratings eligible

[13] The analysis conducted on the Canadian regime is presented in detail in an assessment table that has been reviewed by the Technical Committee members and can be made available to Board members if desired.

for use in securities legislation. In some jurisdictions, proclamation of legislation or proclamation of legislation and ministerial approvals are required.

139. Meanwhile, all jurisdictions except Ontario are adopting amendments to Multilateral Instrument 11-102 Passport System to permit the passport system to be used for applications for designations by credit rating organizations and exemptive relief applications by designated rating organizations. NP 11-205, which was also published and to which Ontario is a party, is the equivalent policy that sets out how the process would work for filing and the review of an application to become a designated rating organization in Ontario and the passport jurisdictions. Subject to obtaining all necessary approvals, the rule will come into effect on April 20, 2012. The CSA, the council of the securities regulators of Canada's provinces and territories, co-ordinates and harmonizes regulation for the Canadian capital markets.

The Instrument

140. The rule establishes a regulatory framework for the oversight of credit rating organizations by requiring them to apply to become a "designated rating organization" and adhere to rules concerning conflicts of interest, governance, conduct, a compliance function and required filings. The rule is also designed with the intent to be consistent with international regimes and European Commission endorsement and certification provisions, so that European market participants can rely on ratings of Canadian credit rating organizations associated with those registered in Europe.

141. The Instrument, together with the related legislative amendments (described below), are intended to implement an appropriate Canadian regulatory regime for CROs. The CSA announced the adoption of a new national instrument, related policies and consequential amendments to impose regulatory oversight for designated credit rating agencies and organizations.

142. The new NI 25-101, first proposed in draft form in July 2010 and amended in March 2011 requires DRO to establish, maintain and comply with a Code of Conduct substantially based on the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies unless exemptive relief is obtained. The instrument also sets out requirements with respect to compliance, filing, and the maintenance of books and records.

Summary of Key Changes Made to the Instrument

143. The OSC had made some revisions to the 2011 Proposal, including minor drafting changes made only for the purposes of clarification or in response to comments received:

(i) CROs that wish to have their credit ratings eligible for use in securities legislation must apply to become a designated rating organization (DRO).

(ii) In that respect they must apply on a voluntary basis – If a CRO does not want its ratings to be eligible for use, the Instrument does not apply to such CRO; DRO must also comply with each of the provisions of the Instrument described below.

Application of the Instrument to DRO Affiliates Outside of Canada

144. The 2011 Proposal clarified that CROs applying to be designated rating organizations (DROs) pursuant to the Instrument will have to ensure that the application for designation is made by the entity or entities that want to have their credit ratings used in Canada.

145. A "DRO affiliate" is defined as an affiliate of a DRO that issues credit ratings in a foreign jurisdiction and that has been designated as a DRO affiliate under the terms of the DRO's designation. Therefore,

DRO affiliate is not required to comply with all of the Instrument, although where appropriate, references to a DRO affiliate are included in the Instrument and the prescribed Code of Conduct provisions in Appendix A to the Instrument.

146. The suitability of an affiliate to be designated as a "DRO affiliate" under a designation order of a CRO will be determined on a case-by-case basis at the time of designation. A CRO applying for a designation should provide the name of each affiliate proposed as a DRO affiliate, the jurisdiction of incorporation, or equivalent, and the address of the principal place of business of such an affiliate.

147. In determining whether a CRO in a foreign jurisdiction should be designated as a DRO affiliate, the OSC will consider the legal and supervisory framework of the foreign jurisdiction, including whether the CRO is authorized or registered in that foreign jurisdiction and whether the CRO is subject to effective supervision and enforcement. We may also consider the ability of the competent regulatory authority of the foreign jurisdiction to assess and monitor the compliance of the CRO established in the foreign jurisdiction.

148. Finally, to make the Instrument as a rule and fully implement the regulatory regime it contemplates, certain amendments to local securities legislation are required. In addition to rule-making authority, changes to the local securities legislation may include:

(i) the power to designate a CRO under the legislation,

(ii) the power to conduct compliance reviews of a CRO, and to require a CRO to provide the securities regulatory authority with access to relevant books, information and documents,

(iii) the power to make an order that a CRO submit to a review of its practices and procedures, where such an order is considered to be in the public interest, and

(iv) confirmation that the securities regulatory authorities may not direct or regulate the content of credit ratings or the methodologies used to determine credit ratings.

149. Finally, in Québec, Ontario, Alberta, British Columbia, Manitoba, New Brunswick and Nova Scotia the enabling legislation is either already in force or awaiting proclamation. In Saskatchewan, the enabling legislation will be proclaimed later in the spring.

The Canadian legal and regulatory framework for CRA **BOX 1**

150. Canada has a comprehensive and legally binding framework in relation to CRAs and the use of credit ratings. This framework, which will become effective as of 20 April 2012, was introduced on 27 January 2012 and it is intended to replace the previous regime marked by the combination of binding requirements and the compliance with the "comply or explain" approach.

151. Overall, since the adoption of the new regulatory framework in Canada, it is clear that both the EU and Canadian regimes share the same overall objectives namely, to ensure that CRA ratings are carried out fairly and from an independent standpoint.

*ii) **Corporate governance***

152. The EU mandate on assessing the equivalence between certain non-EU countries and the EU regulatory regime for CRAs required ESMA to at least check that" two independent directors of the CRA's administrative or supervisory board are tasked with monitoring the credit rating policies, effectiveness of the internal quality control system as well as the internal controls and measures established to deal with conflicts of interest".

Canadian approach to corporate governance

153. Pursuant to the adoption of the National Instrument 25-101 (NI) last 27 January 2012, the OSC Board (OSCB) requires the designation of CRAs (Designated Rating Organizations (DRO)) so that credit ratings issued by the DRO could be used in the Canadian Securities law.

154. Consequently, a DRO, or a DRO affiliate that is a parent of the DRO, must have a board of directors composed of a minimum of three members and at least one-half, but not fewer than two, members must be independent. Independence requirements would include:
   (i) Employees of DRO of DRO affiliate
   (ii) Members receiving fees for consulting or advisory services
   (iii) Any other relationships that could be reasonably expected to interfere with the exercise of a director's independent judgment

155. With regard to the level of expertise in financial services the issuance of credit ratings, the NI (Section 2.22) requires independent directors have "sufficient expertise in financial services to fully understand and properly overs the business activities of the DRO". As for the issuance of structured finance ratings the NI also requests that at least one independent directors and one other member must have "in-depth knowledge and experience at senior level regarding the securitized product".

156. The board of directors which must monitor the following:

   (i) the development of the credit rating policy and of the methodologies used;

   (ii) the effectiveness of any internal quality control system;

   (iii) the effectiveness of measures and procedures instituted to ensure that any conflicts of interest are identified and either eliminated or managed and disclosed,

   (iv) the compliance and governance processed.

157. Furthermore, the requirements clearly ensure that the compensation of the independent members of the supervisory boards is not linked to the business performance of the DRO and is arranged so as to ensure their independence.

Corporate Governance **BOX 2**

158. Overall, corporate governance is an adequate building block of the Canadian regime for CRAs.

159. ESMA considers that the requirements that are in place meet the objectives of this section on the basis of the following:

- there is a general obligation for the CRAs, its officers and staff to fulfil their tasks from an independent standpoint;

- the Board has to designate independent members so that at least one-third of the members are independent

- independence of Board members is achieved through specific policies and is to be demonstrated to the OSC

160. Overall, since the adoption of the new regulatory framework in Canada, ESMA believes that the objectives of the EU- Regulation in the corporate governance section are met by the Canadian regulatory framework.

iii) Conflict of interest Management

161. The EU mandate required ESMA to check at least the following issues in this section:

(i) a CRA identifies and eliminates (or manages and discloses) conflicts of interest;

(ii) a CRA ensures that business interest does not impair the independence and accuracy of ratings

(iii) a CRA does not provide consultancy or advisory services

(iv) A CRA refrains from issuing a rating when it has direct or interest interest in the entity asking for a rating

(v) rating analysts cannot make proposals or recommendations on the design of structured finance products

(vi) rating analysts are not involved on the negotiation of the fees or payments with any rated entity, related third parties or any person directly or indirectly linked with the rated entity by control

(vii) rating analysts compensation and performance evaluation is de-linked from the revenue they generate from the CRA

(viii) a stringent rotation policy is put in place.

Canadian approach to conflict of interests management

162. As regards the management and avoidance of conflicts of interest, Section 3 in Appendix A of the NI stipulates a specific set of requirements.

(i) Section A sets out the principles and this is supplemented with specific procedures and policies that have to be in place by the DRO in order to identify and either eliminate or manage and disclose, clearly and prominently, any actual or potential conflicts of interest that may influence the opinions and analyses of ratings employees. Furthermore, pursuant to section 3.12 of the NI, DROs are required to be organised in a manner that ensures that its business interest does not impair the independence and accuracy of its credit rating activities.

(ii) Section B sets out the procedures and policies to identify and eliminate or manage and publicly disclose any actual or potential conflicts of interest that may influence the opinions and analyses or ratings employees;

(iii) Section C sets out:

- the reporting lines for a rating employee or DRO employee and their compensation arrangements in order to eliminate or manage actual and potential conflicts of interest;
- the procedures ensuring that the DRO employees who have the responsibility for developing or approving procedures or methodologies used for determining credit ratings do not initiate or participate in discussions or negotiations regarding fees or payments with any rated entity or its affiliates or related entities;
- the rules and policies prohibiting employees to participate in or otherwise influence the determination of a credit rating as well as the "look back" review that a DRO must conduct regarding any employees that leaves the DRO and joins a rated entity (section 3.13 to 3.18).

163. **As regards the ancillary services**, a DRO must keep separate, operationally and legally, its credit rating business and its rating employees from any ancillary businesses (including the provision of consultancy or advisory services) of the DRO and must ensure that the provision of such services does not present conflicts of interest with its credit rating activities. A DRO must also define and publicly disclose what it considers, and does not consider, being an ancillary business. A DRO must disclose in each ratings report any ancillary services provided to a rated entity, its affiliates or related entities.

164. **As regards the internal control procedures and mecchanisms**, the NI (Section 2.25 and 2.26 of Appendix A to NI 25-101) requires the DRO to ensure the effectiveness of internal control mechanisms, procedures for risk assessment and control and safeguard arrangements for information processing system in order to ensure compliance with all relevant requirements set out by law or regulation.

Conflict of interest management **BOX 3**

165. Overall, ESMA considers the Canadian requirements in terms of conflicts of interest management meet the objectives of the EU requirements. In particular, DRO is requested to:

- establish a general obligation to identify and eliminate or manage and disclose conflicts of interest and to establish organisational and administrative arrangements;

- be organised in a manner that ensures that its business interest does not impair the independence and accuracy of its credit rating activities;

- identify eliminate or manage and disclose clearly any actual or potential conflicts of interest that may influence the analyses and judgment of ratings analysts;

- ensure that the provision of ancillary services does not present conflicts of interest with its credit rating activity

- ensure compensation and performance to be delinked from the amount of revenue they generate

- conduct a review when a rating analyst terminates his or her contract joins a rated entity

- Finally, with regard to the establishment of a gradual rotation mechanism for rating analysts, although this provision does not exist in the Canadian framework, ESMA considers that, as a whole, the Canadian framework meets the same objectives as the EU Regulation.

Overall, ESMA believes that the objectives of the EU Regulation in the management of conflict of interest section are met by the Canadian regulatory framework.

iv) ***Organisational requirements:***

166. The EU mandate required ESMA to check that as a minimum a CRA keeps records and audit trails of all its activities and has a compliance function which operates independently. In addition, ESMA's approach to assessing the equivalence of the regulation's organisational requirements can be divided into the following areas:

(i) general organisational requirements

(ii) outsourcing

(iii) confidentiality

(iv) record keeping.

167. The overall objective the organisational requirements is that they contribute to ensuring the objectivity, independence, integrity and quality of the credit rating activities.

Canadian approach to organisational requirements

168. With regard to **the general organisational requirements**, a DRO must design sound administrative and accounting procedures, internal control mechanisms, procedures for risk assessment, and control and safeguard arrangements for information processing systems. A DRO must also implement and maintain decision-making procedures and organizational structures that clearly, and in a documented manner, specify reporting lines and allocate functions and responsibilities.

169. With regards to the **compliance officer** (Part 5 of the NI), the NI requires that DRO have a compliance officer that monitors and assesses compliance by the designated rating organization and its DRO employees with the organization's code of conduct and with securities legislation. In terms of the scope of responsibilities, the compliance officer must report to the board of directors any circumstances indicating that the DRO or its employees may be in non-compliance with the organization's code of conduct or securities legislation. While serving in such capacity, the compliance officer must not participate in any of the development of credit ratings, methodologies or models or being involved in the establishment of compensation policies.

170. With regard to the resources devoted to the continuity and regularity on the performance of DRO's credit rating activities and their ongoing monitoring, the NI is fully equivalent to the EU requirements (section 2.27, 2.28 and 2.7 of Appendix A to NI 25-101).

171. **With regard to the outsourcing**, Section 2.28 of the NI provides that a DRO must not outsource functions if doing so impairs materially the quality of the designated rating organization's internal controls or the ability of the securities regulatory authority to conduct compliance reviews of the designated rating organization's compliance with securities legislation or its Code of Conduct. Notwithstanding the foregoing, a designated rating organization must not outsource the functions of the designated rating organization's compliance officer as required by securities legislation.

172. With regard to the **confidentiality requirements**, the Canadian legal framework covers EU requirement by Section 4.16 to 4.23 of the NI both in terms of the scope of the persons subject to the confidentiality requirements or the measures to be established in order to protect all property and records relating to credit rating activities. Therefore, the NI requires DRO to take all reasonable measures to protect confidential 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.

173. Moreover, DRO must take all reasonable measures to protect confidential 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.
174. The Canadian regulatory framework contains an extensive **record-keeping requirements** detailed in Part 6 of the NI. Overall, a "DRO must keep such books and records and other documents as are necessary to account for the conduct of its credit rating activities, its business transactions and financial affairs and must keep such other books, records and documents as may otherwise be required under securities legislation".

Organisational requirements **BOX 4**

175. Overall, ESMA considers the Canadian legal and regulatory framework meets the objectives of the EU requirements in respect of the organisational requirements that a DRO needs to have in place in the areas of the general organisational, outsourcing, confidentiality and record keeping

v) ***Quality of methodologies and of ratings***

176. As specified in the EU commission mandate, the objective of this section is to assess the following criteria:

(i) that competent authorities do not interfere with the content of ratings or the CRAs methodologies

(ii) a CRA has a function devoted to the periodical review of methodologies and models

(iii) A CRA applies consistently the changes in methodologies and models to existing ratings

(iv) a CRA monitors its ratings and methodologies on an on-going basis and at least annually

Canadian approach to quality of rating methodologies and ratings

177. The overall approach towards quality of methodologies and credit ratings in Canada is close to that of the EU in terms of having specific requirements set out in the National Instrument (NI).
178. Section B of the Appendix A to NI requires DROs to establish a committee responsible for implementing a **rigorous and formal process for reviewing**, **on at least an annual basis**, and making changes to the methodologies, models and key ratings assumptions it uses. This review must include consideration of the appropriateness of the DRO's methodologies, models and key ratings assumptions if they are used or intended to be applied to new types of instruments or securities. This process must be conducted independently of the business lines that are responsible for credit rating activities. The responsible committee must report to the board of directors of the DRO.
179. When a methodology, model or key ratings assumption used in a credit rating activity is changed, the NI requires that the DRO will do each of the following:

(a) promptly identify each credit rating likely to be affected and to be re-rated using the new methodology, models or key ratings assumptions and, using the same means of communication the DRO generally uses for the credit ratings, disclose the scope of credit ratings likely to be affected by the change in methodologies, models or key ratings assumptions;

(b) promptly place the affected credit ratings (such as defined in (a)) under observation;

(c) within six months of the change, review each credit ratings affected (defined in (a)) with respect to its accuracy;

(d) re-rate a credit rating if, following its review (defined in (c)), the change, alone or combined with all other changes, affects the accuracy of the credit rating.

180. Similarly to the EU requirements, Section 2.2 of Appendix A to the NI requires DRO to include a provision in its Code of Conduct that it will use only rating methodologies that are rigorous, systematic, continuous and subject to validation based on experience, including back-testing. Moreover, Section 2.8 and 2.9 provide that a DRO must ensure continuity and regularity and avoid bias, in the rating process and assess whether existing methodologies [2]and models for determining credit ratings of securitized products are appropriate when the risk characteristics of the assets underlying a securitized product change significantly.

181. Therefore, the NI further specifies that if the quality of the available information is not satisfactory or if the complexity of a new type of instrument or security raises concerns about whether the DRO can provide a credible rating, the DRO must not issue or maintain a credit rating.

182. In terms of the quality of the information that the DRO uses in assigning a credit rating is of sufficient quality and from reliable sources, Section 2.7 of the NI requires DRO using information from a reliable source.

183. With regard to the knowledge and experience for the duties assigned to credit analysts, the Canadian framework (Section 2.3 of Appendix A to National Instrument 25-101) requires DROs to have sufficient personnel with sufficient skill sets to make credible credit assessments. In addition, Section 2.13 of Annex A to the NI requires DRO to ensure that adequate personnel and financial resources are allocated to monitoring and updating its credit ratings.

Quality of rating methodologies and ratings **BOX 5**

184. Overall, ESMA considers the Canadian legal and regulatory framework meets the objectives of the EU requirements in respect of the quality of methodologies and ratings.

vi) ***Disclosure of credit rating***

185. For the purpose of this advice, ESMA has divided the requirement related to disclosure of credit rating into the following categories:

(i) the presentation and disclosure of credit ratings, and

(ii) general and periodic disclosure about CRA.

186. With regard to the **disclosure of credit ratings**, a DRO must disclose to the public, in a timely manner and on a non-selective basis and free of charge, any ratings decision regarding rated entities that are reporting issuers or the securities of such issuers, as well as any subsequent decisions to discontinue such a rating, if the rating decision is based wholly or in part on material non-public information. Therefore the DRO must publicly disclose its policies, methodologies and key rating assumptions.

187. Ratings report must include the meaning of each rating category and the definition of default or recovery, and the time horizon the DRO used when making a rating decision, any attributes and limitations of the credit rating and all material sources that were used to prepare the credit rating.

188. In addition, the DRO must initiate a review of the status of a 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 must promptly update the rating, as appropriate, based on the results of such review. Subsequent monitoring must incorporate all cumulative experience obtained.

189. Except for "private ratings" provided only to the rated entity, a DRO must disclose to the public, on a non-selective basis and free of charge, any ratings decision regarding rated entities that are reporting issuers or the securities of such issuers, as well as any subsequent decisions to discontinue such a rating, if the rating decision is based in whole or in part on material non-public information.

190. As in the EU Regulation, the NI encompasses additional obligations, regarding ratings on structured finance instruments. In particular, a DRO must:

(i) differentiate ratings of securitized products from traditional corporate bond ratings through a different rating symbology,

(ii) disclose how this differentiation functions; define a given rating symbol, and apply it in a consistent manner for all types of securities to which that symbol is assigned;

(iii) in each rating report, disclose all information about loss and cash-flow analysis, how sensitive a rating is to changes in the rating assumptions, the level of due diligence processes and reliance on an assessment provided by a third party.

191. The OSC (Items 9, 10, 12, 13 and 14 of the Form 25- 101F1) mandates DRO to publish:

(i) the largest users of credit rating services of the applicant by the amount of net revenue earned by the applicant attributable to the user during the most recently completed financial year.

(ii) the 20 largest issuers and subscribers in terms of net revenue. Then, add to the list any obligor or underwriter that, in terms of net revenue during the financial year, equalled or exceeded the 20th largest issuer or subscriber.

(iii) the applicant's internal control mechanisms designed to ensure quality of its credit rating activities;

(iv) the applicant's policies and procedures regarding record-keeping

Disclosure of credit ratings **BOX 6**

192. Overall, ESMA considers the Canadian legal and regulatory framework meets the objectives of the EU requirements in respect of the disclosure of credit ratings.

vii) Effective supervision and enforcement

193. ESMA considers essential that equivalent supervisory powers than those in place in the EU are embedded in the relevant third country regulatory and legal framework. The necessary powers is the power to a access to any document, request information from any person, carry out on-site inspections and require records of telephone and traffic data.

194. In addition, the third country needs to be able to take supervisory measures following the establishment of a breach by a CRA.

195. In particular, the CSA will have authority to:

(i) bring proceedings against a DRO in the event of a breach;

(ii) use any of the powers currently available in the event of a breach of securities legislation.

196. In addition, Canadian supervisor (the CSA) might resort to the following remedies:

(i) Make an order in the public interest that DRO enact changes to its practices and procedures as may be ordered by the securities regulatory authority

(ii) Make an order revoking the designated status of a DRO.

Effective supervision and enforcement **BOX 7**

197. For the purposes of carrying out its oversight tasks, ESMA considers the Canadian legal and regulatory framework empowered the CSA with an equivalent range of powers than those in place in the EU.

Conclusion on the equivalence status regarding the Canadian legislative and regulatory framework

Global assessment **BOX 8**

198. ESMA concludes that overall the Canadian legal and supervisory framework is equivalent to the EU regulatory regime for CRA in terms of what ESMA considers to be the overall objective of:

"assuring that users of ratings in the EU would benefit from equivalent protections in terms of the CRAs integrity, transparency, good governance and reliability of the credit rating activities"

199. However, only if all the other conditions set out in Article 5(1) of the EU Regulation are met, can a third country credit rating agency be granted certification.

200. These conditions are that:

a) the credit rating agency is authorised or registered in and is subject to supervision in that third country;

b) cooperation arrangements are operational;

c) the credit ratings issued by the credit rating agency and its credit rating activities are not of systemic importance to the financial stability or integrity of the financial markets of one or more Member States.

Part III - Equivalence of Australia

Key to the references and terms used in this advice:

AFP: Australian Federal Police
AFS: Australian Financial Service
ASIC: Australian Securities & Investments Commission

Executive summary

201. Following ESMA's decision to consider the Australian regulatory regime as being in line with the requirements defined in Article 4(3) of the EU Regulation on CRA, this document sets out the technical advice of ESMA in relation to the equivalence between the Australian legal and supervisory framework and the EU regulatory regime for credit rating agencies, in accordance with the European Commission's mandate of 17 November 2009.

202. ESMA concludes that, overall, the Australian legal and supervisory framework is equivalent to the EU regulatory regime for credit rating agencies according to what is provided for in Art. 5(6) of the CRA Regulation.

203. In coming to this conclusion, ESMA has grouped the requirements of the EU Regulation into seven areas, as detailed in the ESMA Guidelines of 17 May 2011, in relation to each of which ESMA has assessed the ability of the Australian legal and supervisory framework to achieve the main objectives of the relevant EU requirements.

204. ESMA considers the Australian framework to be comprehensive and in many instances similar to the EU Regulation.

205. ESMA will keep monitoring the evolution of the Australian legal and supervisory framework for credit rating agencies on an ongoing basis, also via the cooperation agreements that the Australian Authority and ESMA have recently signed in that field. It will update the European Commission in the event of future changes to the US regime that may necessitate a change in the conclusions of this report.

Introduction

206. This document sets out the assessment of ESMA in relation to the equivalence of the legal and supervisory framework of Australia.

207. This assessment is based on a review of the Australian legal texts in relation to credit rating agencies, namely (i) the Corporations Act (2001) (CA), (ii) the ASIC Act (2001), (iii) the Regulatory Guides relating to the business of credit rating agencies, and (iv) the information sheets, as well as on explanations of relevant provisions provided by the staff of the ASIC.

208. The Australian legal and regulatory framework for credit rating agencies was introduced on the 1st of January 2010.

209. the Australian legal and supervisory framework is characterised by:

a. integration of Credit Rating Agency registration and supervision into an existent licensing system applicable to all financial service providers in Australia, including credit rating agencies;

b. general requirements are set out in the legislation on financial services that have to be met by everyone seeking an Australian Financial Service (AFS) licence. In addition, there are requirements specifically tailored to a particular industry. These requirements are set out in the licence itself as licencing conditions;

c. a differentiation between wholesale licencing and retail licencing;

d. the use of supervisory guidelines for licencesees, that act as a guide to both the supervisors and the market regarding the approach adopted in Australia for the day-to-day supervision of all licensees including credit rating agencies and what is expected in terms of the processes and procedures that a credit rating agency has to have in place in order to be eligible for registration;

e. supervising the activity (issuing ratings) and not the entity (credit rating agency);

f. a treatment of groups of credit rating agencies that, differently to the EU, allows such groups to leverage off certain processes and procedures that exist at a group level for the purposes of eligibility.

210. As a background to this advice, on 21 December 2011 ESMA informed market participants that it considered the regulatory regime for CRAs in Australia embeds requirements which follow closely those in place in the EU. As a consequence, the regulatory regime in Australia is assessed as fulfilling the "as stringent as" test set out in Article 4(3) (b) of the CRA Regulation.

211. ESMA concludes that, overall, the Australian legal and supervisory framework is as stringent as the EU regulatory regime for credit rating agencies according to Art. 4(3) of the CRA Regulation.

212. The regime adopted in Australia has been tested against the objectives pursued by the EU Regulation in the seven areas where it establishes requirements, which are identified in ESMA's Guidelines on Endorsement (ESMA/2011/139, Annex II). These areas are:

(i) the scope of the regulatory and supervisory framework;

(ii) corporate governance;

(iii) management of conflicts of interest;

(iv) organisational requirements;

(v) quality of methodologies and of ratings;

(vi) general disclosure and presentation of ratings;

(vii) effective supervision and enforcement.

I. The scope of the regulatory and supervisory framework.

Definition of credit rating

213. AFS licences granted to CRAs define 'Credit rating' in the licence as 'a statement, opinion or research dealing with: (a) the creditworthiness of a body; or (b) the ability of an issuer of a financial product to meet its obligations under the financial product'.

214. Credit rating fall within the definition of financial product advice. 'Financial product advice' is defined as 'a recommendation or statement of opinion, or a report of either of those things, that: (i) is intended to influence a person or persons in making a decision in relation to a financial product or class of financial products, or an interest in a particular financial product or class of financial products; or (ii) could reasonably be regarded as being intended to have such an influence.'

215. Other parts of financial services laws applying to CRAs would include: insider trading; market manipulation; financial records, statements and audit; certain consumer protection aspects of the ASIC Act; misleading statements.

Definition of CRA

216. The Australian system regulates the activity instead of the entity that carries it out. 'Credit rating agency' is then not defined by the Corporations Act 2001 or in the AFS licences granted to CRAs. As stated above, CRAs that carry on a business of providing financial product advice in Australia must hold an Australian financial services (AFS) licence.

Corporate form accepted

217. While it is in principle possible to provide financial product advice as a single person, ASIC may refuse to grant a licence to a person where ASIC has reason to believe that the applicant will not comply with the obligations under the Australian CA (including the requirement to comply with the conditions on the licence).

218. Similarly, it is possible for a partnership of individuals to provide financial product advice. In considering an AFS licence application from such a partnership, ASIC would have to assess whether the partnership would have available adequate human resources to meet its obligations.

219. Only corporations have so far applied for an AFS licence authorising the provision of general advice in a credit rating.

Licensing regime

220. CRAs that carry on a business of providing credit ratings in Australia must hold an AFS licence, because everyone who wants to provide financial product advice has to have an AFS licence irrespective of any regulatory purposes.

221. Under the AFS licensing regime, general licensee obligations that apply to all AFS licensees require CRAs to (inter alia): (i) manage conflicts of interest that may arise in their businesses; (ii) have resources available (including financial, human and information technology re-sources) that are adequate for the nature, scale and complexity of their businesses; (iii) ensure their credit analysts are trained and competent to be involved in the preparation of credit ratings; (iv) ensure credit rating services are provided efficiently, honestly and fairly; (v) have in place risk management systems; (vi) comply with the conditions of their AFS licence; (vii) report significant breaches of the financial services laws to ASIC; and (viii) where requested, give assistance to ASIC in relation to whether it is complying with the financial services laws, and in relation to the performance of ASIC's other functions. All CRAs had to register from 1 January 2010.

222. The IOSCO Code of Conduct has a prominent role within the licensing system. A condition of a AFS licence for CRAs requires the CRA to comply with the IOSCO Code on a mandatory basis since 1 July 2010 (subject to a small number of carve-outs where it is impractical for CRAs operating in Australia to comply). Compliance with the IOSCO Code on a mandatory basis means adopt, publish and adhere to a code of conduct that complies with the IOSCO Code as if all references to 'should' were omitted and replaced by 'must', and as if Provision 4.1 of the IOSCO Code were omitted to the extent it provides that a CRA may deviate from its provisions and explain how the deviations nonetheless achieve the objectives of the provisions.

Provisions concerning outsourcing

223. Licensed CRAs are responsible for general advice provided, or caused or authorised by the CRA to be provided, to investors in Australia even if work in relation to the creation of the rating will be done outside Australia. If the Australian licensee outsources functions (including research and analysis) that relate to its AFS licence to other entities within a corporate group overseas, the licensee remains responsible for complying with its obligations as a licensee. The licensee would need to demonstrate to ASIC that the functions per-formed overseas complied with the licensee's obligations.

Non-interference with ratings

224. ASIC does not have any power to interfere with the content of credit ratings methodologies or credit ratings. ASIC does not have the power to prescribe a rating or methodology or report content in a particular case. Interfering with the content of ratings or CRAs' methodologies would be contrary to the objects of Chapter 7 of the Corporations Act 2001 and ASIC's objects.

225. Chapter 7 of the Corporations Act 2001 concerns the regulation of financial services and financial markets in Australia. The main objects of Chapter 7 include the promotion of: (i) confident and informed decision-making by consumers of financial products and services while facilitating efficiency, flexibility and innovation in the provision of those products and services; and (ii) fair, orderly and transparent markets for financial products.

226. However, ASIC is not restrained from making inquiries or taking action against a CRA where necessary to ensure compliance with prohibitions against misleading or deceptive conduct or the financial services laws, including licence conditions requiring:

- a CRA's analysts to use methodologies established by the CRA and apply them in a consistent manner,

-a CRA and its analysts to 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.

The Australian legal and regulatory framework for CRA **BOX 1**

227. ESMA considers that the scope of the regulatory and supervisory framework for credit rating agencies is as stringent as to that of the EU Regulation.

228. The Australian regime is in force since 1 January 2010. Six CRAs are registered and supervised by the Australian Securities and Investment Commission (ASIC).

229. All relevant laws and regulations have entered into force.

230. The last remaining issue with regard to the non-interference with ratings or methodologies was resolved by ASIC through publicly stating that "ASIC has no power to interfere with the content of credit ratings methodologies or credit ratings."

II. Corporate governance.

Corporate form

231. There is no express requirement that a CRA (or other licensee) should have an administrative or supervisory board. Nor is there an express requirement that a licensee is a corporation. But each CRA currently licensed in Australia is a corporation and, as it can be seen from section 1 above, given the registration requirements, it is very unlikely that a CRA that is not a corporation would apply for a licence in the future.

232. The Corporations Act spells out the legal and the fiduciary responsibilities of members of the board and not the structure or the individual functions of each board member as it is the case in the EU.

Director duties

233. An Australian corporation is required to have directors. The duties of directors and officers under the Corporations Act include that they must exercise their powers with the degree of care and diligence that a reasonable person would exercise and in good faith in the best interests of the company. The responsibilities of a board are not codified in the Corporations Act but include: (i) overseeing the company including its control and accountability systems; (ii) reviewing, ratifying and monitoring systems of risk management and internal control, codes of conduct and legal compliance. In general, Board members are responsible for and legally liable for any activity they cause or authorise the corporation to undertake.

Corporate governance structure

234. The required compliance with the IOSCO Code together with the managing conflict of interest rules ensure the independence between a CRAs business interest and its rating activities. The licence conditions, by requiring adherence to the provisions of the IOSCO Code (including those provisions concerning independence and management of conflicts of interest), require a CRA to be organised in a manner that ensures its business interest does not impair the independence and accuracy of its credit rating activities

235. While under the Australian regime there is no prescriptive requirement for a CRA to have an administrative or supervisory board, the regime does have stringent rules on how administrative and supervisory functions are carried out by the CRA. Australian corporations need to have a corporate governance structure.

236. ASIC requires licensees to demonstrate as part of the licensing process, and as an ongoing obligation that they have the organisational competence to provide the financial services and products that they are or will be authorised under the licence to provide. Licensees must nominate in their application the people on whom they will depend for their organisational competence. These people are defined as 'responsible managers'. Responsible managers are responsible for the quality of the business' financial services. At a minimum, licensees must have enough of these people with appropriate knowledge and skills that they have the competence to provide all of their financial services efficiently, honestly and fairly.

237. Moreover, relevant sections of the IOSCO Code apply to all licensed CRAs, in particular the IOSCO Code provisions that relate to administrative or supervisory functions, including the assigning of a rating, the reviewing of the feasibility of rating particular products, and the reviewing of methodologies.

The IOSCO Code also requires an independent person to be assigned to ensure compliance with the IOSCO Code and with applicable laws and regulations.

238. The licence conditions, by requiring adherence to the provisions of the IOSCO Code (including those provisions concerning independence and management of conflicts of interest), require a CRA to be organised in a manner that ensures its business interest does not impair the independence and accuracy of its credit rating activities. In addition, AFS licensees, including CRAs, must have in place adequate arrangements for the management of conflicts of interest that arise in their business. ASIC's Regulatory Guide 181 sets out its general approach to appropriately managing conflicts of interest in accordance with the CA. Depending on the circumstances, appropriately managing a conflict of interest may involve avoidance of the conflict, disclosure of the conflict, or controls that mitigate the conflict. Finally, the IOSCO code has a series of requirements that helps ensure a CRA's business interest does not impair the independence and accuracy of its credit rating activities.

The monitoring functions

239. There is no requirement to have two independent directors in Australia. Instead senior management are ultimately responsible for the monitoring activity. For equivalence purposes, the monitoring activities assigned by the CRA Regulation to independent directors do not need to be undertaken by independent members of the board but have to be part of the overall responsibility of the senior management, and can be carried out by someone who is not involved in credit rating activities and whose compensation is arranged in such a way to ensure the independence of their judgment and the absence of links to the business performance of the credit rating agency.

a) Monitoring the development of credit rating policy and of the methodologies used by the credit rating agency in its credit rating activities;

240. CRAs in Australia have obligations in relation to monitoring the development of credit rating policy with reference to the IOSCO principles that state that: (i) a 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; (ii) a CRA should ensure that it has and devotes sufficient resources to carry out high-quality credit assessments of all obligations and issuers it rates; (iii) a CRA should establish and implement a rigorous and formal review function responsible for periodically reviewing the methodologies and models and significant changes to the methodologies and models it uses. Where feasible and appropriate for the size and scope of its credit rating services, this function should be independent of the business lines that are principally responsible for rating various classes of issuers and obligations.

241. The IOSCO Code also includes the need to have a rigorous and formal review function, with particular reference to the need that this function must be independent of the business lines that are mainly responsible for rating various classes of issuers and obligations. There is no explicit requirement that the development of credit rating policy is monitored. However, ASIC expects this to be covered through the application of the IOSCO Code in combination with the compliance function.

242. CRAs in Australia must establish and maintain compliance measures that ensure, as far as it is reasonably practicable, that the licensee complies with the provisions of the financial services laws (including the licence conditions). In this respect, ASIC requires the licensee to ensure the area responsible for compliance: (a) is independent enough to do its job properly; (b) has adequate staff, resources and systems; and (c) has access to relevant records. The combination of these requirements provides for an independent monitoring of the development of credit rating policy.

b) Monitoring the effectiveness of the internal quality control system

243. The licence conditions, by requiring adherence to the IOSCO Code, require a CRA to: (i) establish a review function made up of one or more senior managers with appropriate experience to review the feasibility of providing a credit rating for a type of structure that is materially different from the structures the CRA currently rates; and (ii) establish and implement a rigorous and formal review function responsible for periodically reviewing the methodologies and models and significant changes to the methodologies and models it uses. Where feasible and appropriate for the size and scope of its credit rating services, this function must be independent of the business lines that are principally responsible for rating various classes of issuers and obligations. Finally, the licence conditions require a CRA to specify a person responsible for compliance by the CRA and its analysts with its code of conduct and applicable laws.

c) Monitoring of measures and procedures instituted to ensure that any conflicts of interest are identified, eliminated or managed and disclosed

244. CRAs give such tasks to the compliance officer or to another officer who is in any case required to report to the board. This monitoring function is required by adherence to the IOSCO Code which provides that a compliance officer who has independent reporting lines and compensation should be responsible, among other things: to identify and eliminate, or manage and disclose, conflicts of interest. ASIC guidance also requires licensees to identify actual and potential conflicts of interest. Compliance monitoring records must be kept. Arrangements need to be regularly reviewed. Those responsible for monitoring and supervising and deciding what appropriate action to take should not be significantly affected by the conflict themselves.

d) Monitoring the compliance and governance processes

245. The Compliance officer as identified above in c) has also the duty of monitoring the compliance and governance associated with the review functions according to the IOSCO Code provisions.

Expertise by the board members and CRAs' representatives in financial services and in structured finance products

246. In determining whether it has adequate human resources to carry out its supervisory function, a CRA must (among other things) have regard to the nature, scale and complexity of its business (including whether it rates structured finance products) and the experience of its employees. All AFS licensees, including CRAs, must ensure that their representatives are adequately trained and are competent to provide financial services.

247. In addition, CRAs must comply with organisational competence requirements and ASIC assesses compliance with the obligation by looking at the skills and knowledge of "responsible managers" (not necessarily directors). CRAs must demonstrate their responsible manager meets combinations of training, qualifications and experience.

248. Taking into account the principles-based requirements concerning training and competence of representatives, the requirement that board members should also have in-depth knowledge and experience at a senior level of the markets in structured finance instruments is also met, in respect of credit analysts and members of rating committees.

Corporate Governance	**BOX 2**
249. ESMA considers that, overall the Australian legal and supervisory framework achieves the objectives of the EU regulatory requirements in relation to corporate governance although the Australian regime follows a different philosophy.	
250. Corporate Governance is achieved through reporting to the board and compliance.	

III. Conflicts of interest management

251. AFS licensees, including CRAs, must have in place adequate arrangements for the management of conflicts of interest that arise in their business. Depending on the circumstances, appropriately managing a conflict of interest may involve avoidance of the conflict, disclosure of the conflict, or controls that mitigate the conflict. In addition, CRAs are required to comply with the conditions on their licence. The licence conditions, by requiring adherence to the provisions of the IOSCO Code (including those provisions concerning independence and management of conflicts of interest), require a CRA to be organised in a manner that ensures its business interest does not impair the independence and accuracy of its credit rating activities.

Disclosure of names of main rated entities

252. The licence conditions, by requiring adherence to the IOSCO Code, require a CRA to disclose if it receives 10% or more of its annual revenue from a single issuer, originator, arranger, client or subscriber (including any affiliates of that issuer, originator, arranger, client or subscriber). Disclosure is intended as disclosure to the public, unless a contrary intention appears (e.g. provisions relating to protection of confidential information).

Ownership of financial instruments

253. CRAs are required to abide by the provisions of the IOSCO Code that prevent employees participating in or influencing a rating where they own securities or derivatives of the rated entity or where they have had a relationship with a rated entity or related party. The IOSCO Code also provides that CRAs disclose actual and potential conflicts of interest to be complete, timely, clear, concise, specific and prominent.

254. CRAs are required to have in place adequate arrangements for the management of conflicts of interest that may arise wholly, or partially, in relation to activities undertaken by the licensee or a representative of the licensee in the provision of financial services as part of the financial services business of the licensee or the representative. More specifically, ASIC expects CRAs to refrain from: (i) direct or indirect investment in financial instruments that it rates and the financial instruments of a rated entity; and (ii) issuing a rating if the CRA or a related party had a direct or indirect interest in financial instruments of the rated entity or related third party of the rated entity.

255. As implemented in Australia, no CRA employee is permitted to participate in or otherwise influence the determination of the CRA's rating of any particular entity or obligation if the employee: (i) owns securities or derivatives of the rated entity, other than holdings in a collective investment scheme; (ii) owns securities or derivatives of any entity related to a rated entity, the ownership of which may be perceived as causing a conflict of interest, other than holdings in a collective investment scheme (iii)

has or had any relationship with the rated entity or any related entity thereof that may cause or may be perceived as causing a conflict of interest.

256. In addition, CRAs must structure their rating teams so as to avoid bias in the rating process. A CRA and its analysts must also use care and professional judgment to maintain both the substance and appearance of independence and objectivity, and a 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 a diversified collective investment scheme.

Rotation of rating analysts and persons approving credit ratings

257. ASIC conducted industry consultation on a proposal to require CRAs to establish an appropriate gradual rotation mechanism with regard to rating analysts and persons approving credit ratings. Submissions noted that CRAs with fewer than 50 employees operating in the EU will be exempt from this requirement. Following the consultation ASIC decided not to implement the proposal because: (i) of the three major CRAs in Australia, two have fewer than 50 employees and the other has fewer than 50 analysts involved in credit ratings activities (even though it has slightly more than 50 employees); (ii) of industry concerns about the possible effect of this requirement on the quality of ratings in Australia because of the relatively small size of the market for rating expertise; and (iii) the licence conditions require mandatory compliance with the IOSCO Code provisions, which include a general requirement to structure rating teams to avoid bias.

Consultancy or advisory services

258. In accordance with IOSCO Code provisions, Australian CRAs and their analysts are prevented from making proposals or recommendations regarding the design of structured finance products that a CRA rates. On the other hand, CRAs are not explicitly required to not provide consultancy or advisory service. However, a CRA must have in place adequate arrangements to manage any conflicts of interest that arise in its business.

Involvement of rating analysts in the negotiation of fees

259. Australian CRAs must abide with the provision of the IOSCO Code that prohibits a CRA from having employees who are directly involved in the rating process initiate, or participate in, discussions regarding fees or payments with any entity they rate.

Ancillary services

260. Australian CRAs are required to abide with the provision of the IOSCO Code which requires that CRAs must define what they consider, and do not consider, to be an ancillary business and why. Disclosure to ASIC is required as part of the Annual Compliance Report. In addition, licensed CRAs must have in place adequate arrangements for the management of their conflicts of interest. ASIC Regulatory Guide 181 acknowledges that disclosure helps investors to assess the service they are being offered in light of the licensee's own interests and to decide on the extent (if any) to which they will rely on the service. Having adequate arrangements in place to manage conflicts of interest will include ensuring that there is adequate disclosure of conflicts to investors, who can then consider their impact before making investment decisions.

Conflicts of interest management **BOX 3**

261. ESMA considers that, overall, the Australian legal and supervisory framework achieves the objectives of the EU regulatory requirements in relation to conflicts of interest management, and points out that the framework includes provisions which are similar in their large majority to those of the EU Regulation.

262. Conflicts of interest management is dealt with directly through the application of requirements in Australian law, which are compliant with the ones indicated in the IOSCO Code.

263. In addition, ASIC's Regulatory Guide181 *Licensing: Managing conflicts of interest*, sets out the general approach to appropriately managing conflicts of interest.

IV. Organisational requirements

264. The conditions on a CRA's AFS licence require the CRA to establish and maintain compliance measures that ensure, as far as practicable, that the CRA complies with the provisions of the financial services laws. In addition, all AFS licensees, including CRAs, must take reasonable steps to ensure that its representatives comply with the financial services laws, and have adequate risk management systems and resources (including financial, technological and human resources).

265. The licence conditions, by requiring adherence to the IOSCO Code, require CRAs to clearly specify persons responsible for compliance with its code of conduct and applicable laws. To obtain an AFS licence, CRAs must demonstrate that they have the organisational competence to provide a credit rating service in Australia. In its application, a CRA must nominate 'responsible managers' on which it depends for organisational competence. These responsible managers must have the necessary knowledge and skills to carry out their roles. More in general, CRAs must establish and maintain compliance measures that ensure, as far as is reasonably practicable, that the licensee complies with the provisions of the financial services laws (including the licence conditions). In addition, CRAs are required to have available adequate resources (including financial, technological and human resources) to provide credit ratings and to carry out supervisory arrangements.

Outsourcing

266. Australian CRAs are ultimately responsible for the services outsourced: if a CRA outsources functions that relate to its AFS licence, the CRA remains responsible for complying with its obligations as a licensee. Moreover, ASIC expects that the CRA has sufficient staff to control, monitor and supervise the outsourced functions and requires CRAs to regularly provide proof of that. Generally, any function can be outsourced. No limitations are provided with respect to the service provider, which can be member of the group or any third company.

267. As part of the licensing process a licensee is asked whether they will be outsourcing any substantial activities under their AFS licence. Before granting a licence, ASIC must be satisfied that the applicant: (a) will take due skill and care in choosing a suitable service provider; (b) will be monitoring the ongoing performance of the service provider; and (c) can deal effectively with any breaches of the outsourcing agreement or actions that lead, or might lead, to a breach of the licensee obligations.

268. More in detail, ASIC requires a description of: (i) an applicant's processes for determining the suitability of external service providers they will engage to perform any substantial activities under their AFS licence; (i) how they will engage external service providers, including whether they have written agreements setting out service standards, dispute resolution processes etc.; and (iii) how often and by what means they will monitor and review external service providers (including monitoring and reporting compliance with service standards and/or written agreements). This should include: i. details of

who the service provider will report to within an applicant's business, and how often; ii. the format in which such reports will be given (e.g. written report, verbal feed-back, signed monthly risk register); and iii. how a licensee will satisfy themselves that the outsourced activity is adequate for them to meet their AFS licensee ob-ligations. This proof also includes a table describing out-sourcing arrangements which must include details of the activities that will be outsourced, the service provider, how they will monitor the provision of the service, and who will do the monitoring and how often.

269. ASIC can exercise its powers in respect of an entity to which functions were outsourced by the CRA. For instance, ASIC is entitled to inspect any books that the corporation's legislation requires the entity to keep, e.g. financial records. This entitlement may include a right of entry onto the property. ASIC is also empowered to serve a notice on a body corporate. The body corporate does not need to be the subject of ASIC's investigation or inquiry. Therefore, ASIC may serve a notice on an entity to which functions have been outsourced, where ASIC considers it necessary to ensure compliance with the corporation's legislation, where it suspects a CRA has contravened the corporation's legislation, or is conducting a formal investigation.

270. In order to obtain information about outsourcing activities by a CRA, ASIC may also issue a notice seeking a written statement from the CRA on its outsourcing activities, and a notice requiring production of documents from the CRA relevant to its outsourcing activities, such as agreements between the CRA and an entity and details of payments made by the CRA to the entity.

271. If the provider of the outsourced function is acting on behalf of the CRA (i.e. a representative of the CRA) or is itself an AFS licensee, the provider must give such assistance to ASIC as is reasonably requested in relation to compliance with the financial services laws, and in the performance of ASIC's other functions.

Record keeping

272. The licence conditions require that a CRA must retain for 7 years: (i) records documenting the procedures, methodologies and assumptions used to determine a rating; and (ii) internal records, including non-public information and work papers, used to form the basis of a credit rating.

Confidentiality

273. The licence conditions, by requiring adherence to the provisions of the IOSCO Code (including provisions concerning the treatment of confidential information), require a CRA to protect confidential information and issuer's property from abuse.

274. The Australian legal regime applicable to CRAs ensures that, in the case an AFS licensee carry out other financial services in addition to the credit rating activities, the information gathered in the performance of the credit rating activities is not shared with or used by the staff who are involved in the other services or activities. For example: (i) A CRA must use confidential information only for purposes related to its rating activities or otherwise in accordance with any confidentiality agreements with the issuer; (ii) CRA employees must not share confidential in-formation 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; (iii) CRA employees must 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; (iv) a CRA must separate, operationally, its credit rating business and CRA analysts from any other business of the CRA that may present a conflict of interest. In addition, CRAs must have in place adequate arrangements to manage their conflicts of interest.

Organisational requirements **BOX 4**

275. ESMA considers that, overall, the Australian legal and supervisory framework achieves the objectives of the EU regulatory requirements in relation to organisational requirements, including outsourcing, record keeping and confidentiality.

276. CRAs in Australia are in general not prohibited to outsource or limited in outsourcing rating activities or other business functions. CRAs in Australia must establish and maintain compliance measures that ensure that the licensee complies with the provisions of the financial services laws (including the license conditions).

V. Quality of methodologies and quality of ratings

277. The licence conditions, by requiring adherence to the IOSCO Code, require CRAs to establish and implement a rigorous and formal review function responsible for periodically reviewing the methodologies and models and significant changes to the methodologies and models it uses. Where feasible and appropriate for the size and scope of its credit rating services, this function must be independent of the business lines that are principally responsible for rating various classes of issuers and obligations. Moreover, there is no specific requirement to monitor the methodologies, this is considered to be part of the review function under IOSCO Code.

Key rating assumptions

278. Key rating assumptions are included in the required review function, although it is not specified as a separate item since it is considered as an intrinsic part of the methodology and models. The review of the key rating assumptions is then part of the review function.

Periodicity of the review

279. Australian CRAs are required to review ratings and methodologies according to the IOSCO code (i.e. regular and periodic reviewing) except where there has been a material change to the methodology or assumption, in which case all affected ratings must be reviewed within 6 months of the change. The review takes place only after material changes, and there is no requirement to place the ratings under observation until they are reviewed, although the scope of ratings affected by material changes must be disclosed.

12-hour rule

280. The licence conditions, by requiring adherence to provision 3.7 of the IOSCO Code, require a CRA to inform the issuer of the critical information and principal considerations upon which the rating will be based to afford the issuer an opportunity to clarify any misperceptions or other matters. Where feasible and appropriate, this information must be given before publishing the rating. Following industry consultation, ASIC decided not to implement a proposal to specify that the rating information be given to the issuer at least 12 hours before publishing the rating because of concerns that the period of time that the issuer is in possession of the information ahead of the market: (i) is inconsistent with Australian continuous disclosure requirements; and (ii) may increase the risk of insider trading.

281. As already mentioned in the assessment section of the advice for equivalence on Japan, a different timeframe is acceptable.

Minimum quality of information

282. The licence conditions, by requiring adherence to the IOSCO Code, require a CRA to: (i) assess whether its analysts will have access to sufficient information to rate or continue to rate an obligation or issuer; and (ii) to refrain from issuing a rating where there are serious questions about whether the CRA can determine a rating in light of the complexity or structure of a new product or a lack of robust data about the assets underlying a structured product.

283. If an Australian CRA issues a rating where it does not have sufficient quality of information on which to base its rating, it may breach prohibitions on engaging in misleading or deceptive conduct because it would not have a reasonable basis for its opinion.

Dynamic assessment of methodologies

284. CRAs are required to comply with the IOSCO code which provides that a CRA must 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. The requirement does not expressly state that the methodology must be continuous and that validation is mandatory. However, in its Information Sheet *Credit rating agencies: Guidance on certain AFS licence conditions*, ASIC issued guidance to CRAs that compliance with obligations that a CRA's methodologies must be rigorous, systematic and consistently applied requires, among other things, that methodologies must be applied in a continuous manner.

285.

Changes in methodologies and model

286. If the licensee makes a material change to a methodology or material assumption that relates to an entity or product of a particular kind that the licensee has used in the preparation or review of a credit rating, the licensee must: (i) as soon as possible disclose the class of credit ratings (affected credit ratings) that are likely to be affected by the change using the same means of communication as was used for the distribution of the affected credit ratings; and (ii) as soon as possible and in any case within six months after the change review the affected credit ratings, and if necessary, modify the affected credit ratings to reflect the change. This condition does not apply to an affected credit rating that clearly indicates that it does not entail ongoing review. Changes in model are also covered in this requirement as part of the methodology.

Quality of methodologies and quality of ratings **BOX 5**

287. ESMA considers that, overall, the Australian legal and supervisory framework does achieve the objectives of the EU regulatory requirements in relation to the quality of methodologies and quality of ratings.

288. ESMA understands that CRAs in Australia are required to review ratings as advised by the IOSCO code (i.e. regular and periodic reviewing) except where there has been a material change to the methodology or assumption, in which case all affected ratings must be reviewed within 6 months of the change.

VI. Disclosure of ratings

(a) Disclosure of credit ratings

Timely and non-selective disclosure

289. A CRA may either apply for an AFS licence that authorises it to issue credit ratings to: (i) retail and wholesale clients; or (ii) wholesale clients only. On 1 January 2010, each of the three major CRAs in Australia obtained a wholesale-only licence authorisation, which means they must prevent disclosure of credit ratings to retail investors in a manner that could reasonably be regarded as being intended to influence their decisions in relation to a financial product or class of products. In July 2010, ASIC granted an AFS licence to Australia Ratings Pty Ltd authorising it to provide credit ratings to retail investors. Australia Ratings therefore must publicly disclose ratings decisions (including decisions to discontinue a credit rating). This provision is to be considered as compliant with the EU regulatory framework for CRAs since even though there is a distinction between wholesale and retail licensees, publication of a rating to a retail investor in the EU does not breach the Australian wholesale licence restrictions under Australian law.

Unsolicited ratings

290. Australian CRAs are required to have a clear and fair policy in relation to unsolicited ratings. In particular, Australian CRAs are required to: (i) disclose whether the issuer participated in the rating process; (ii) identify unsolicited ratings as such; and (iii) disclose its policies and procedures regarding unsolicited ratings.

291. As regards whether CRAs are required to prominently state in the credit rating whether or not the rated entity or related third party participated in the credit rating process and the CRA had access to the accounts and other relevant internal documents of the rated entity or its related third party, in Australia this requirement is to be articulated in the CRA's policies and procedures for unsolicited ratings, which must be disclosed to the public. In addition, the licence conditions, by requiring adherence to the IOSCO Code, require CRAs to clearly indicate the attributes and limitations of each rating.

Historical performance of ratings

292. The licence conditions, by requiring adherence to the IOSCO Code, require a CRA to disclose data about the historical default rates of its ratings categories.

Material sources

293. Several provisions in the licence conditions require information about how the rating was reached, which methodology was used and any key elements underlying the rating opinion. Considered together they have the same net outcome as a requirement to indicate all material sources used to prepare a credit rating.

294. Moreover, CRAs have to indicate the principal methodology or methodology version that was used in determining the rating and where a description of that methodology can be found. Where the rating is based on more than one methodology, or where a review of only the principal methodology might cause investors to overlook other important aspects of the rating, the CRA must explain this fact in the ratings announcement, and indicate where a discussion of how the different methodologies and other important aspects factored into the rating decision.

Release date and update of credit ratings

295. Australian CRAs are required to indicate clearly and prominently the date at which the rating was last updated. Although the Australian law does not impose as an additional requirement that the date on which the credit rating was first released for distribution should be disclosed, the objectives of the EU

Regulation on CRAs are anyway satisfied. In fact, the IOSCO Code does not require a specific disclosure of this nature, and Australian law does not impose such an additional requirement.

Disclosure of quality of information used in the rating process

296. The licence conditions, by requiring adherence to the IOSCO Code, require CRAs to: (i) assess whether its analysts will have access to sufficient information to rate or continue to rate an obligation or issuer; and (ii) clearly indicate the attributes and limitations of each rating, and the limits to which the CRA verifies information provided to it by the issuer or originator. Moreover, the IOSCO Code states that a CRA and its analysts must 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.

297. By operation of the licence condition and the IOSCO Code provisions mentioned above, a CRA will not be able to issue a credit rating (and would have to discontinue a credit rating) if it is not satisfied with the quality of the information on which it has based the rating. There is therefore no need for any specific requirement for a CRA to indicate its view of the quality of the information on which it bases its ratings: it should always be satisfied that it has enough information for high quality ratings. In addition, where a CRA issues a rating where it does not have sufficient quality of information on which to base its rating, the CRA may breach Australian law prohibitions on engaging in misleading or deceptive conduct because it would not have a reasonable basis for its opinion.

298. Finally, CRAs are required to state clearly and prominently when disclosing credit ratings any attributes and limitations of the credit rating.

Disclosure of information on structured finance ratings

299. The licence conditions, by requiring adherence to the IOSCO Code, require a CRA (i) to provide sufficient information about its loss and cash flow analysis for a structured finance product; (ii) to analyse the sensitivity of the rating to changes in the CRA's rating assumptions.

300. These provisions meet the objectives of the EU requirement, namely sufficient information to enable investors to understand the basis for the rating and to provide information on potential changes to the rating assumptions.

(b) Disclosure concerning the credit rating agency and its activities

Public register of CRAs

301. No entity is able to provide credit ratings in Australia unless they are registered as an AFS licensee. CRAs that provide credit ratings to retail clients must include their AFS licence number and other prescribed information in a Financial Services Guide. In turn, ASIC is required to maintain a register of AFS licensees which is accessible to the public.

Ancillary services

302. The IOSCO Code requires a CRA to define what it considers, and does not consider, to be an ancillary business and why. Besides, ASIC requires as part of the Annual Compliance Report disclosure to the public of the list of ancillary services provided by CRAs.

Compensation arrangements

303. Under the licence condition a CRA must disclose (i) the general nature of its compensation arrangements with rated entities; (ii) where a CRA receives from a rated entity compensation unrelated to its

ratings service, such as compensation for consulting services, a CRA must disclose the proportion such non-rating fees constitute against the fees the CRA receives from the entity for ratings services; and (iii) a CRA must disclose if it receives 10% or more of its annual revenue from a single issuer, originator, arranger, client or subscriber (including any affiliates of that issuer, originator, arranger, client or subscriber). On the other hand, there is no IOSCO requirement for a CRA to list its largest 20 clients by revenue, and Australian law does not impose such an additional requirement.

Other items subject to disclosure

304. The licence conditions, by requiring adherence to the IOSCO Code, also require CRAs to disclose (i) their policy concerning publication of credit ratings and other communications; (ii) the general nature of their compensation arrangements; (iii) the description of methodologies, models and key rating assumptions such as mathematical or correlation assumptions used in its credit rating activities; (iv) any material modifications to its methodologies and significant practices, procedures and processes; (v) the CRA's code of conduct.

Periodical disclosure

305. The licence conditions require CRAs to disclose data about the historical default rates of their ratings categories. The IOSCO Code does not require a CRA to present the data in a manner that distinguishes be-tween the main geographical areas of the issuers in Australia, and Australian law does not impose such an additional requirement. Because of the uniform nature of Commonwealth (i.e. federal) corporations legislation as it applies across Australia, geographical distinctions are probably not as significant as they may be in the EU.

Annual disclosure

306. As part of the licensing process an applicant must provide an organisational chart illustrating the overall structure of their business and clearly identifying: (a) the number of employees and authorised representatives in each functional area; (b) the position(s) held by each of the responsible managers; (c) the person responsible for monitoring ongoing compliance with AFS licence obligations, and their reporting lines; (d) the person responsible for reporting breaches of AFS licence obligations directly to ASIC; and (e) if applicable, the relationship between the applicant entity, and any ultimate holding company or other companies in the corporate group. This information is not made available to the public.

Disclosure of ratings **BOX 6**

307. There are two distinct types of disclosure requirements in the EU Regulation: (i) those relating to the disclosure that a credit rating agency needs to make on a rating-by-rating basis, and (ii) those relating to the credit rating agency itself.

(a) Disclosure of credit ratings

308. ESMA considers that the Australian legal and supervisory framework, overall, does achieve the objectives of the EU requirements that relate to disclosure of credit ratings.

309. A CRA may either apply for an AFS licence that authorises it to issue credit ratings to retail and wholesale clients or wholesale clients only.

310. On 1st January 2010, each of the three major CRAs in Australia obtained a wholesale-only licence authorisation, which means they must prevent disclosure of credit ratings to retail investors in Australia in a manner that could reasonably be regarded as being intended to influence their decisions in relation to a financial product or class of products.

311. Even though there is a distinction between wholesale and retail licensees, publication of a rating to a retail investor in the EU does not breach the Australian wholesale licence restrictions under Australian law.

(b) Disclosure concerning the credit rating agency and its activities

312. ESMA considers that, the Australian legal and supervisory framework, overall, achieves the objectives of the EU requirements that relate to disclosure regarding the credit rating agency and its activities.

VII. Effective supervision and enforcement.

313. Under the Australian Securities and Investments Commission Act 2001, ASIC is responsible for: maintaining, facilitating and improving the performance of the financial system; promoting confident and in-formed participation in the financial system; administering laws effectively and reducing regulatory costs; managing information and making it publicly available; and enforcing the law.

Powers of the relevant authority

314. ASIC is directly responsible for the supervision of CRAs in Australia.

315. ASIC may directly exercise information gathering powers under the ASIC Act and Corporations Act, including power to: (i) enter the property and inspect any books that the corporation's legislation requires the CRA to keep (e.g. financial records); (ii) serve a notice requiring production of books and records relating to the affairs of a CRA where necessary to ensure compliance with the corporation's legislation, where it suspects a CRA has contravened the corporation's legislation, or is conducting a formal investigation; (iii) serve a notice requiring the CRA to provide a written statement about its financial services business or financial services it has provided; (iv) in connection with an investigation of a suspected contravention of law, require a person to appear for examination on oath and to answer questions. In addition, a licensed CRA must give such assistance to ASIC as is reasonably requested in relation to compliance with the financial services laws, and in the performance of ASIC's other functions

316. ASIC may apply for and be granted a warrant to seize books not produced by CRAs and may apply for a search warrant under the Australian Crimes Act 1914. However, a warrant issued under either of these sections will be executed by the Australian Federal Police (AFP).

317. ASIC also has power under the ASIC Act and the Crimes Act to apply for a warrant, however the AFP has responsibility for enforcing Commonwealth law and accordingly is the body that executes the warrant.

318. ASIC may also enter into arrangements with other bodies to facilitate cooperation between regulators in performing supervisory and investigative functions. For example, memoranda of understanding between ASIC and other regulatory bodies typically set out the parties' intent to cooperate with each other in executing the laws and regulations applicable in the respective jurisdictions in relation to the discharge of their responsibilities in relation to regulated entities.

319. In addition, foreign regulators may make requests for assistance under the Mutual Assistance in Business Regulation Act 1992 (MABRA) and the Mutual Assistance in Criminal Matters Act 1987 (Cth).

320. Where ASIC wishes to search premises, it is empowered to apply to the relevant judicial authorities, being a magistrate under s 36 of the ASIC Act and a magistrate or a justice of the peace or other person employed in a court of a State or Territory who is authorised to issue search war-rants under s 3E of the Crimes Act.

321. ASIC is empowered by the Corporations Act to (without holding a hearing) decide to vary, suspend or revoke a CRA's AFS licence where: (i) the CRA ceases to carry on a financial services business; or (ii) the licensee enters external administration (i.e. a receiver, administrator or liquidator is appointed because of corporate insolvency).

322. ASIC may (after a hearing) decide to vary, suspend or revoke a CRA's AFS licence where: (i) the CRA has not complied, or ASIC has reason to believe it will not comply, with its general licensee obligations; (ii) a banning order or disqualification order is made against the CRA; (iii) ASIC is no longer satisfied that the CRA or the CRA's representatives are of good fame or character; or (iv) the application for the licence was false in a material particular or materially misleading, or if there was an omission of a material matter from the application.

323. Similarly, ASIC may make a banning order prohibiting a person (e.g. a CRA or a representative of a CRA) from providing any financial service permanently or for a specified period where: (i) ASIC has suspended or cancelled an AFS licence held by the person; (ii) the person has not complied, or ASIC has reason to believe they will not comply, with a financial services law; (iii) the person becomes an insolvent under administration; or (iv) the person has been convicted of fraud.

324. ASIC may also make application to a federal court for orders where ASIC cancels an AFS licence. As such, if ASIC were to cancel the licence of a CRA, it would be able to apply directly to a court for orders including an order permanently disqualifying the CRA from issuing credit ratings in Australia. ASIC may also apply for orders under the Corporations Act where a CRA has contravened the relevant financial services laws.

Effective supervision and enforcement **BOX 7**

325. ESMA considers that the Australian legal and supervisory framework ensures that the ASIC is entrusted with sufficient powers to enable effective supervision and enforcement over credit rating agencies.

Global assessment **BOX 8**

326. ESMA concludes that overall the Australian legal and supervisory framework is equivalent to the EU regulatory regime for CRA in terms of what ESMA considers to be overall objective of:

"assuring that users of ratings in the EU would benefit from equivalent protections in terms of the CRAs integrity, transparency, good governance and reliability of the credit rating activities".

327. ESMA will keep monitoring the evolution of the Australian legal and supervisory framework for credit rating agencies on an ongoing basis, also via the cooperation agreements that ASIC and ESMA have recently signed in that field (ESMA/2011/460). It will update the European Commission in the event of future changes to the Australian regime that may necessitate a change in the conclusions of this report.