



European Securities and
Markets Authority

Final Report

Guidelines on the application of the endorsement regime under Article 4(3) of the Credit Rating Agencies Regulation – supplementary guidance on how to assess if a requirement is “as stringent as” the requirements set out in CRAR

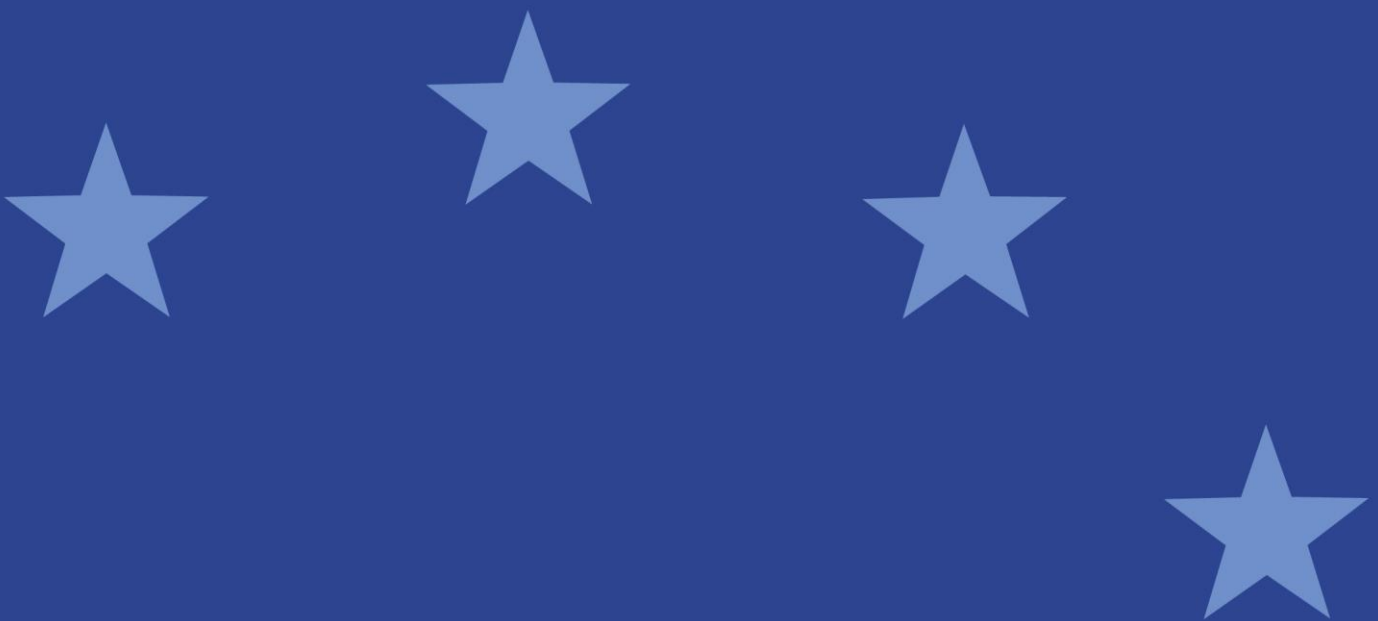


Table of Contents

Definitions, legislative references and acronyms	3
1 Executive Summary	5
2 Feedback Statement	7
2.1 General remarks	7
2.1.1 General concerns about the new approach to endorsement	7
2.1.2 Admissibility of potential alternative internal requirements which are not set out in the guidelines	8
2.1.3 ESMA’s assessment of additional alternative internal requirements	9
2.1.4 Further detail regarding the principles underpinning the as stringent as test	10
2.1.5 CRAs to rely on the IOSCO Code or the third-country legislation	11
2.1.6 Certification vs endorsement	12
2.2 Requirements relating to fees (Q1).....	13
2.2.1 The objectives of the provisions	13
2.2.2 Scope of the provision.....	14
2.2.3 Application of the Fees Provision	15
2.3 Reporting of information about fees to ESMA (Q2).....	18
2.4 Information to accompany the disclosure of a credit rating (Q3 and Q4).....	20
2.5 The transparency report (Q5)	22
2.6 Initial reviews and preliminary ratings (Q6).....	24
2.7 Review and disclosure of methodologies (Q7).....	25
2.8 Reporting to ESMA of errors in methodologies (Q8).....	27
2.9 Rotation of analysts, lead analysts and persons approving credit ratings (Q9)	28
2.10 Cross-shareholdings and directorships (Q10).....	30
2.11 Look-back reviews (Q11).....	32
2.12 Pre-publication issuer notice (Q12)	34

2.13	Treatment of inside information (Q13)	35
2.14	Treatment of confidential information (Q14)	36
2.15	Records and audit trails (Q15).....	36
2.16	Other alternatives internal requirements which could meet the same objective and effects of an EU requirement in practice (Q16)	37
3	Cost Benefit Analysis	38
3.1	Background.....	38
3.2	Reasons for Publication	38
3.3	Impact of the guidelines	39
	Annex I: Guidelines on the application of the endorsement regime under Article 4(3) of the Credit Rating Agencies Regulation	42
	Annex II: Methodological framework for assessing a third country supervisory and legal framework for the purpose of endorsement	51

Definitions, legislative references and acronyms

ESMA	European Securities and Markets Authority
The Commission	The European Commission
CP	Consultation Paper Guidelines on the application of the endorsement regime under Article 4(3) of the Credit Rating Agencies Regulation – supplementary guidance on how to assess if a requirement is “as stringent as” the requirements set out in CRAR (ESMA33-9-235) published on 27 March 2018
CRAR	The CRA Regulation: Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit ratings agencies as amended by Regulation (EU) No 513/2011 of the European Parliament and of the Council of 11 May 2011, Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011, Regulation (EU) No 462/2013 of the European Parliament and of the Council of 21 May 2013, and Directive 2014/51/EU of the European Parliament and of the Council of 16 April 2014
CRA 1	Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit ratings agencies
CRA 2	Regulation (EU) No 513/2011 of the European Parliament and of the Council of 11 May 2011
CRA 3	Regulation (EU) No 462/2013 of the European Parliament and of the Council of 21 May 2013
ESMA Regulation	Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC
The Delegated Regulation on Fees	The European Commission Delegated Regulation (2015/1) of 30 September 2014 supplementing CRAR with regard to regulatory technical standards for the periodic reporting on fees charged by credit rating agencies for the purpose of ongoing supervision by the European Securities and Markets Authority
The 2017 Final Report	Final Report Update of the guidelines on the application of the endorsement regime under Article 4(3) of the Credit Rating Agencies Regulation (ESMA33-9-205) published on 17 November 2017
The 2017 Guidelines	The guidelines published with The 2017 Final Report.
EU CRA	A credit rating agency registered with ESMA
Endorsing CRA	An EU CRA which endorses or has endorsed one or more credit ratings in accordance with Article 4(3) of the CRA Regulation
Third-country CRA	A CRA which is registered and subject to supervision in a non-EU country or jurisdiction

The relevant endorsement provisions of CRAR	The provisions quoted in Article 4(3)(b) of CRAR: Articles 6 to 12 and Annex I of CRAR with the exception of Articles 6a, 6b, 8a, 8b, 8c, 8d and 11a, point (ba) of point 3 and points 3a and 3b of Section B as well as part III of Section D of Annex I of CRAR.
---	--

1 Executive Summary

Reasons for publication

The CRA Regulation (CRAR) allows an EU CRA to endorse a credit rating issued by a third-country CRA if the endorsing CRA can demonstrate that the conduct of the third-country CRA “fulfils requirements which are at least as stringent as” those set out in CRAR.

In November 2017, ESMA published an updated version of its Guidelines on the application of the endorsement regime under Article 4(3) of CRAR (hereinafter: “2017 Guidelines”)¹ clarifying that compliance with the third-country legal framework is not by itself sufficient to prove that a third-country CRA “fulfils requirements which are at least as stringent as” CRAR. Instead, ESMA expects that the endorsing CRA has verified and is able to demonstrate that the third-country CRA has established internal requirements which are at least as stringent as the corresponding requirements in the relevant endorsement provisions of CRAR². To be eligible for endorsement, a third-country CRA has two options: a) it can either fulfil the requirements set out in the relevant endorsement provisions of CRAR; or b) it can establish internal requirements which are different but at least as stringent as the relevant endorsement provisions of CRAR; if a third-country CRA chooses the latter, the endorsing CRA should be able to demonstrate to ESMA that the alternative internal requirement is at least as stringent as the corresponding EU requirement.

During the consultation phase for the 2017 Guidelines, some CRAs expressed a demand for supplementary guidance on how to assess whether internal requirements currently in place in third-country CRAs could be considered as stringent as those set out in the relevant endorsement provisions of CRAR (hereinafter: “the ASA test”). In March 2018, ESMA published a consultation paper (CP)³ which aimed to provide clarity regarding the general principle underpinning the ASA test. Furthermore, the proposed guidance intended to provide transparency and certainty with regard to those areas where practices of third-country CRAs are different from those of the EU CRAs.

The final guidelines clarify that a requirement can be considered to be as stringent as a requirement set out in CRAR within the meaning of Article 4(3)(b) when it achieves the same objective and effects in practice. Furthermore, the final guidelines set out specific eligible alternative internal requirement for the following requirements set out in CRAR: requirements related to fees charged by CRAs; certain rating disclosures; the transparency report; disclosure of initial reviews to preliminary ratings; reporting to ESMA of errors in methodologies; analyst rotation; pre-publication issuer notification; and treatment of certain information as inside information.

¹ ESMA first published the Guidelines on the application of the endorsement regime under Article 4(3) of CRAR in May 2011 (reference: ESMA/2011/139). The 2017 Guidelines (reference number: ESMA33-9-205) are an updated version of the guidelines published in 2011. The 2017 Guidelines will apply to credit ratings issued on or after 1 January 2019 and to existing credit ratings reviewed after that date.

² The provisions quoted in Article 4(3)(b) of CRAR: Articles 6 to 12 and Annex I of CRAR with the exception of Articles 6a, 6b, 8a, 8b, 8c, 8d and 11a, point (ba) of point 3 and points 3a and 3b of Section B as well as part III of Section D of Annex I of CRAR.

³ Reference: ESMA33-9-235

The final guidelines will be added as a new section (Section 5.3) to the 2017 Guidelines and will take effect on 1 January 2019.

Contents

Section 2 contains the feedback statement summarising the responses, which ESMA received as well as ESMA's answers. The feedback statement follows the order of the questions as they were presented in the CP.

Section 3 contains a cost-benefit analysis of the supplementary guidance.

Annex I contains the final guidelines. It is important to stress that the guidelines which were published in the 2017 final report have not changed. As a result of this report, a new section has been added to the guidelines: Section "5.3 Requirements which ESMA considers at least as stringent as those set out in Articles 6-12 and Annex I of CRAR".

Annex II contains ESMA's methodological framework for assessing a third-country supervisory and legal framework for the purpose of endorsement. This annex was included in the final report of the 2017 Guidelines and is republished as a part of this final report for ease of reference.

Next steps

The consolidated final guidelines will apply to credit ratings issued on or after 1 January 2019 and to existing credit ratings reviewed after that date.

2 Feedback Statement

1. This section provides a summary of the responses to the “*Consultation Paper – Guidelines on the application of the endorsement regime under Article 4(3) of the Credit Rating Agencies Regulation – supplementary guidance on how to assess if a requirement is “as stringent as” the requirements set out in CRAR*” (hereinafter: CP) and ESMA’s answers as well as additional clarifications on ESMA’s expectations. ESMA received in total eight responses, of which four were confidential. Responses were received from seven CRAs as well as the American Chamber of Commerce.

2.1 General remarks

2. The feedback statement follows the order of the questions as they were presented in the CP. However, this first subsection addresses the questions and comments which respondents provided in the introduction to their responses. These comments have been grouped under the following headings:
 - General concerns about the new approach to endorsement
 - Admissibility of potential alternative internal requirements which are not set out in the guidelines
 - ESMA’s assessment of additional requirements
 - Further detail regarding the principles underpinning the as stringent as test
 - CRAs to rely on the IOSCO Code or the third-country legislation
 - Transitional period
 - Certification vs endorsement

2.1.1 General concerns about the new approach to endorsement

3. Five CRAs opened their responses with a reiteration of concerns about ESMA’s overall change in approach to endorsement as set out and adopted in ESMA’s Final Report Update of the guidelines on the application of the endorsement regime under Article 4(3) of the Credit Rating Agencies Regulation of 17 October 2017⁴ (hereinafter: the 2017 final report). While two CRAs agreed with the need and objectives of ESMA’s change in approach, they disagreed with the substance. Three CRAS had specific comments which revolved around two key arguments which were addressed in the 2017 final report: (i) ESMA does not provide evidence that the old approach resulted in the endorsement of

⁴ Reference: ESMA-33-9-205

lower quality ratings; and (ii) that it created limitations in ESMA's ability to supervise endorsed credit ratings.

4. **ESMA's response:** With regard to the first assertion, ESMA considers that the responses to the CP provide evidence that there are indeed differences in the way the same group of CRAs elaborates credit ratings within the EU and outside the EU. These supplementary guidelines aim to clarify where the different approach adopted outside of Europe can be considered equally stringent, achieving the same objectives and effects in practice. With regard to the limitations to ESMA's supervision, ESMA considers that the new approach to endorsement simply clarifies ESMA's powers laid down in the Regulation to request information about endorsed credit ratings and act on this information. The overall change in approach to endorsement was addressed in detail in the 2017 final report and is not the subject of this CP. ESMA has responded to these concerns in the 2017 final report (see Section 2.1 of the 2017 final report).
5. Four CRAs highlighted the potential costs and impacts of ESMA implementing the guidelines as set out in the CP without addressing any of the CRAs' concerns. One of these CRAs stated that this would lead to significant additional burdens and costs whilst having limited material benefit. The other three CRAs stated that this would bring into question their cost-benefit analysis for endorsing credit ratings into the EU. In addition, one of these CRAs stated that it plans to largely limit endorsement by a combination of moving a small number of currently endorsed credit ratings to the EU and discontinuing non-essential endorsement of other credit ratings.
6. **ESMA response:** ESMA takes very seriously the risk that additional costs could result from complying with the endorsement guidelines. However, with a few exceptions, responses were not specific about which parts of the guidelines might result in high costs for CRAs and why. This limits ESMA's ability to consider the comments. One response specifically addressed the cost of reporting fees charged for endorsed ratings to ESMA. More generally, the multitude of replies to the requirements related to fees could indicate that this requirement is considered to be particularly costly and burdensome. Sections 2.2 and 2.3 below sets out ESMA's approach to this requirement taking into account, among others, the cost to CRAs.
7. These comments have not lead ESMA to change its cost-benefit analysis (CBA) provided in section 3 compared to the CBA provided in the CP. ESMA maintains that these supplementary guidelines do not in and of themselves propose any additional costs that were not already implied by the 2017 final report and covered in the CBA provided in that document.

2.1.2 Admissibility of potential alternative internal requirements which are not set out in the guidelines

8. While most respondents appreciated the clarifications provided in the CP, many also stated that the CP left some questions unanswered. First, the CP only provided guidance on a limited subset of areas leaving uncertainty around the rest of the requirements.

Second, the proposed guidelines provided no text in a number of areas, where ESMA considered that CRAs did not identify any viable alternatives. In both cases, ESMA recommended that CRAs comply directly with CRAR. As a result, CRAs asked whether this means that ESMA effectively intends to impose the requirements set out in CRAR on endorsed credit ratings except where alternatives are provided in the guidelines.

9. **ESMA's response:** For all requirements set out in CRAR – even those requirements, for which ESMA in the CP explicitly rules out the alternatives proposed by CRAs – it is possible that a CRA could develop a new alternative which ESMA would consider to be as stringent as the one set out in CRAR. It is important to stress that Article 4(3)(b) of CRAR does *not* compel a CRA to fulfil the requirements in Regulation but to fulfil requirements which are at least as stringent. However, where a third-country CRA voluntarily chooses to comply with the requirements set out in CRAR, ESMA as well as the endorsing CRA are relieved of the uncertainty associated with the assessment of alternatives implemented in the third-country CRA.

2.1.3 ESMA's assessment of additional alternative internal requirements

10. Two CRAs stated that the CRAs did not in practice have the possibility to identify and implement alternatives (other than those set out in the guidelines). In addition to only providing its views on a small selection of requirements, the CRAs stated that ESMA has not set forth any specific test for what constitutes “as stringent as” beyond reiterating the principle stated in recital 13 of CRA 1 that an alternative requirement is as stringent as when it “achieves the same objective and effects in practice as the corresponding requirement of CRAR”. According to these CRAs, it is in most cases difficult to discern the distinguishing characteristics between those areas where CRAR compliance is required by ESMA and those where internal requirements put in place by the third-country CRAs are deemed sufficient.
11. **ESMA's responses:** ESMA acknowledges that the principles set out in the guidelines do not provide for a simple test which enables a CRA to determine the admissibility of any one alternative internal requirement with full certainty. On the one hand, ESMA considers this to be a natural consequence of the hybrid nature of the endorsement regime. Endorsement is not the same as direct supervision of third-country entities (which would imply unconditional direct compliance with CRAR) and is also different from equivalence (which would imply simply complying with the rules of an accepted third country). The concept of “fulfilling a requirement which is at least as stringent as CRAR” necessarily implies a degree of flexibility and interpretation compared to fulfilling the requirements of CRAR directly. So whenever a CRA chooses to fulfil an alternative requirement, there will always be an element of judgement of the objectives and intended effects of the EU requirement and the elements of the alternative proposed by the CRA. On the other hand, however, ESMA also recognises the importance of transparency and consistency in the application of the endorsement regime and agrees that it is necessary to find ways to ensure as stringent as means the same for all CRAs.

12. It is true that ESMA's guidelines focus on a limited list of requirements. However, ESMA does not consider it to be among its responsibilities to identify alternative requirements allowing a CRA to avoid complying with the exact wording of CRAR. ESMA will not develop a complete catalogue of alternative internal requirements which are as stringent as those set out in CRAR. The responsibility for identifying and developing alternative requirements lies with the individual CRA which deems direct compliance with a specific requirement in CRAR to be unsuitable or undesirable. Consequently, the CP is limited to areas in the Regulation where clarification is:

- needed (because one or more third-country CRAs is currently not fulfilling the EU requirement); and
- possible (because a CRA has proposed a concrete and detailed alternative for the EU requirement which ESMA could assess).

13. However, to ensure equal treatment of CRAs, ESMA will expand this list over time, whenever a CRA proposes an alternative requirement which ESMA considers to be as stringent as a requirement set out in CRAR.

2.1.4 Further detail regarding the principles underpinning the as stringent as test

14. To address the perceived lack of clarity about the as stringent as test (hereinafter: the ASA test), one CRA proposed that ESMA allows two additional and more specific principles to be taken into account. First, the CRA argued that the purpose of the endorsement regime is inextricably linked to regulatory use. Endorsed ratings are used for regulatory purpose by EU's prudential authorities to oversee the safety and soundness of the financial system. On this basis, the CRA argued that the requirements that support independence are of primary relevance because they work together to support ratings quality. On the other hand, requirements that relate to investor transparency should according to the CRA not be taken into account. Second, the CRA proposed that requirements which relate to the structure of the credit rating market within the EU should be excluded on the basis of recital 48 of CRA 3, which states that "*Some of the provisions introduced by this Regulation should not apply to the equivalence and endorsement assessments. [...] provisions that relate to the structure of the credit rating market within the Union rather than establishing rules of conduct for credit rating agencies should not be considered in this context [...]*"⁵.

15. **ESMA's response:** While ESMA agrees that the objectives of independence and quality are key. However, ESMA also considers that other objectives, such as those related to investor transparency to be relevant to the ASA test. Regulatory use in the EU includes the use of ratings in prospectuses⁶, where the main audience are investors. With regard

⁵ Recital 48 of CRA 3: [...] Some of the provisions introduced by this Regulation should not apply to the equivalence and endorsement assessments. This is the case for those provisions that only establish obligations on issuers but not on credit rating agencies. In addition, provisions that relate to the structure of the credit rating market within the Union rather than establishing rules of conduct for credit rating agencies should not be considered in this context. [...]

⁶ See second paragraph of Article 4(1) as well as Article 3(1)(g) of CRAR.

to recital 48 of CRA 3, ESMA considers that the recital provides the reasoning for the decision of the legislator to exclude certain requirements set out in CRAR from the scope of the endorsement and equivalence regimes⁷. ESMA does not consider that it provides the basis for excluding additional requirements other than those mentioned in Paragraph 34 of the 2017 Final Report⁸ (this argument is further discussed in Section 2.2 below).

16. In order to provide further detail regarding the principles underpinning the ASA test, the final guidelines restate the principle established in Paragraph 1 of Part I of Annex III of CRAR: A CRA only infringes Article 4(3)(b) where the reason for that infringement is within the CRA's knowledge or control. This is, for example, relevant to ESMA's approach to the disclosure of initial assessments and preliminary ratings (see further discussion in section 2.6 below) and to certain requirements relating to CRA staff taking up key management positions in a rated entity (see further discussion in section 2.11 below).

2.1.5 CRAs to rely on the IOSCO Code or the third-country legislation

17. Two CRAs indicated in their responses that ESMA should deem parts of certain third countries' legislation and the IOSCO Code of Conduct as stringent as CRAR. While securities regulators have adopted slightly different versions of the IOSCO provisions, the great majority of the specific rules are very similar. To the extent there are differences, the CRAs consider that ESMA should assess these differences. One of the CRAs argued that it is easily demonstrable that US law/regulations do meet those internationally agreed standards. Consequently, the CRA was surprised to learn that ESMA does not see this as sufficient to pass the ASA test.
18. **ESMA's Response:** As stated in Paragraph 11 of the 2017 final report, ESMA considers that the requirement in Article 4(3)(b) relates to the conduct and internal requirements of a third-country CRA and is separate and in addition to the requirements set out in a third-country legal and supervisory framework. Very often, third-country CRAs will have implemented identical or different but equally stringent internal requirements as those set out in CRAR in order to ensure compliance with local regulatory regimes or indeed international standards such as the IOSCO Code. However, there may also be instances where this is not the case. The subject of the ASA test is the internal requirements and the conduct of the third-country CRA and the benchmark are the requirements and objectives set out in CRAR and the principles of the ASA test set out in these guidelines.

⁷ Articles 6a, 6b, 8a, 8b, 8c and 11a, point (ba) of point 3 and points 3a and 3b of Section B of Annex I of CRAR.

⁸ Paragraph 34 of the 2017 Final Report: 34.

ESMA's response: ESMA understands, and clarifies in the final guidelines, that Article 8d as well as the requirements in Annex I of CRAR relating to sovereign ratings are not to be considered when assessing the conduct of the third-country CRA. This approach is in line with the approach taken in paragraph 5 of Annex III to the CP:

(a) Article 8d: Whilst Article 8d is not explicitly excluded from the scope of Articles 4(3)(b) and 5(6)(b), ESMA considers that Article 8d should not be taken into account when assessing the conduct of a third-country CRA as it does not establish any obligations on CRAs – only on issuers.

(b) Provisions relating to sovereign ratings: Article 8a establishes requirements relating to sovereign ratings and is among the Articles which are explicitly excluded from the scope of Article 4(3)(b) and Article 5(6)(b). Although CRA 3 does not explicitly exclude part III of Section D of Annex I of CRAR, which relates to Article 8a, from the scope of these Articles, ESMA is of the view that part III of Section D of Annex I of CRAR builds on and cannot be read independently of Article 8a.

2.1.6 Certification vs endorsement

19. One CRA stated that these guidelines mean that third-country CRAs relying on endorsement are unnecessarily disadvantaged compared to certified CRAs, which can continue to offer their credit ratings for regulatory use in the EU without needing to comply with EU Rules. Another CRA asks whether these guidelines have an impact on the requirements applicable to certified CRAs.
20. **ESMA response:** Certification is available to CRAs whose ratings and activities are not of systemic importance to any member state⁹. Furthermore, only ratings of certified CRAs relating to non-EU entities and instruments can be used for regulatory purposes in the EU. It is, therefore, in ESMA's view natural that endorsement is a more rigorous system than equivalence. These guidelines have no impact on the requirements applicable to certified CRAs.

⁹ The relationship between endorsement and equivalence is outlined in further detail in Paragraphs 11-19 of the 2017 Final Report.

2.2 Requirements relating to fees (Q1)

21. CRAR contains a requirement for a CRA to ensure that fees charged to its clients for the provision of credit rating and ancillary services are not discriminatory and are based on actual costs.

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

22. The requirements set out in CRAR relating to fees charged to clients prompted the highest number of responses from 6 CRAs as well as the American Chamber of Commerce. The questions and comments focused on the objectives of the requirements as well as their scope and application.

2.2.1 The objectives of the provisions

23. One CRA argued that fair competition is not the objective of the requirement set out in paragraph 3c of Annex I of Section B (the Fees Provision). Although mentioned in Recital 38 of CRA 3, '*facilitating fair competition*' should according to this CRA not be considered as an additional objective of the Fees Provision, since the reference to the Fees Provision in the Articles of CRAR¹⁰ is made in the context of independence and avoidance of conflict of interests.
24. Three CRAs queried how the competition objective interacts with competition and anti-trust laws in different jurisdictions. These CRAs expressed concerns that the Fees Provision actually amounts to price regulation by ESMA and would prevent their clients from being able to negotiate with them on price. They warned that this could be in breach of national competition and antitrust laws and could have the effect of disincentivising CRAs from operating efficiently, for example by investing in systems, or otherwise decreasing costs.
25. One noted that the EU is the only jurisdiction they operate in that has a specific competition objective in the CRAR. This CRA also stated that existing fee related requirements in other jurisdictions are primarily concerned with seeking to ensure appropriate separation between analytical and commercial functions.
26. Finally, one CRA stated that all of the major financial centres have separate competition laws which apply to issues of competition in all industries. This CRA stated that, to the extent the EU fee requirements are intended to address competition issues, ESMA can safely rely on the antitrust laws in those jurisdictions. The CRA, furthermore, stated it was

¹⁰ Article 6(2) of CRAR states that "In order to ensure compliance with [Article 6(1)], a credit rating agency shall comply with the requirements set out in Sections A and B of Annex I" which includes the fees requirement (paragraph 3c of Section B of Annex I).

unclear exactly how the EU fees requirement relates to the mitigation of conflicts of interest.

27. **ESMA's response:** The European Commission's Impact Assessment for CRA 3 (hereinafter: "the Impact Assessment") found that there was a need to further stimulate competition in the CRA industry and presented the Fees Provision as a way to achieve this objective.¹¹ This was reflected in the Recitals to CRA 3, and specifically in Recital 38 regarding the Fees Provision.
28. The Impact Assessment highlighted that the promotion of competition was an important objective of the Fees Provision and that it *'would also contribute to addressing conflicts of interest'* by increasing transparency of pricing and ensuring that fees would not be based on any form of contingency.¹²
29. From a competition perspective, the Fees Provision aims to ensure that CRAs do not engage in pricing practices which *could be conducted against the interest of some issuers, investors or products*.¹³ The Fees Provision is not intended to prevent CRAs from negotiating with their customers. On the contrary, it is designed to help customers make sure they can exercise buyer power to negotiate a fair deal when they purchase credit ratings and ancillary services from the CRA and companies within the CRA's group. It is also not intended to prevent CRAs from developing their businesses, as long as the fees they charge to their clients can be justified by the costs they incur in providing those services.
30. From a conflicts of interest perspective, the Fees Provision aims to ensure that CRAs' credit rating assessments are free from commercial considerations. This means that CRAs should not link the fees charged for credit ratings or ancillary services to the level of the credit rating issued or to any other result or outcome of the work performed for the client.¹⁴
31. As such, the Fees Provision should be read in line with, rather than in contradiction with, EU and third-country competition and antitrust laws and the fees provisions in place in third countries.¹⁵ ESMA would also like to clarify that by supervising the Fees Provision, it should not be seen to be engaging in price regulation. ESMA has no intention to set prices for credit ratings and ancillary services.

2.2.2 Scope of the provision

32. One CRA argued that the competition objective of the Fees Provision should only extend to competition within the EU market. Another CRA further stated that in the endorsement

¹¹ Commission Staff Working Paper Impact Assessment Accompanying the Proposal for a Regulation amending 1060/2009 on credit rating agencies SEC(2001)135 at pages 17 and 44-45.

¹² Ibid.

¹³ Ibid.

¹⁴ Ibid.

¹⁵ These are highlighted in ESMA33-9-207, ESMA's Final Report on Technical Advice on CRA Regulatory Equivalence-CRA 3 Update, 17 November 2017 at pages 20 (Argentina), 28 (Australia), 36 (Brazil), 45 (Canada), 53 (Hong Kong), 61 (Japan), 69 (Mexico), 77 (Singapore) and 86 (United States).

context, the underlying objective of the Fees Provision should be limited to mitigating conflicts of interest, as extending it to regulate competition would go beyond the scope of the endorsement regime. In this regard, the CRA refers to Recital 48 of CRA 3 which states that *'provisions that relate to the structure of the credit rating market within the [EU]...should not be considered in [the endorsement] context.'*¹⁶ The same CRA stated that as ESMA's fee supervisory strategy is still developing, it would be premature to apply the Fees Provision to endorsed ratings.

33. **ESMA's response:** Article 4(3)(b) of CRAR excludes a number of regulatory provisions from applying to endorsed ratings. This was designed to ensure that any extraterritorial effects of CRAR would be limited to those having an impact on CRAs' conduct rather than on market structure. The Fees Provision does not fall within these exemptions. This is because the principles established by the Fees Provision relate to CRAs' pricing practices, which are conduct measures, rather than measures relating directly to the structure of the credit rating market.
34. As noted above, the Fees Provisions aim to protect users of credit ratings and ancillary services in the EU against anti-competitive pricing practices. However, they also aim to stimulate competition in the credit rating industry in the EU.
35. ESMA recognises that its fee supervisory strategy is still being developed. However, it has already given CRAs some guidance on the scope of the application of the Fees Provision, as explained in the next section.

2.2.3 Application of the Fees Provision

36. Two CRAs asked that the final guidelines clarify that ancillary services are excluded from the application of the Fees Provision, since they cannot be endorsed.
37. Two CRAs stated in their responses that ESMA's Thematic Report on Fees charged by CRAs and Trade Repositories (ESMA's Thematic Report)¹⁷ did not provide them with sufficient clarity as to how ESMA expects CRAs to interpret and apply the requirements of the Fees Provision.
38. Two CRAs, questioned how the Fees Provision should be applied in other jurisdictions if these did not have requirements in place linking fees charged to the costs of providing credit ratings and ancillary services.
39. One CRA explained that as they have global pricing and discount policies, they believed that the measures in place in endorsing jurisdictions were as stringent as the Fees Provision. A further CRA felt that as there is no direct equivalent to the Fees Provision

¹⁶ Recital 48, CRA3 ("In addition [to those provisions that only establish obligations on issuers], provisions that relate to the structure of the credit rating market within the Union rather than establishing rules of conduct for credit rating agencies should not be considered in [the endorsement] context".).

¹⁷ ESMA's Thematic Report on Fees Charged by Credit Rating Agencies and Trade Repositories (ESMA80-196-954) published on 11 January 2018

outside the EU, ESMA was effectively mandating that the EU's approach to pricing policies and procedures be introduced into third-country regimes.

40. One CRA stated that it determines the fees charged based on the size, cost and the complexity of the transaction. In the view of another CRA, a CRA could ensure that the fees charged to its clients do not affect the objectivity, independence, integrity, and quality of its credit ratings without applying the criteria set out in the Fees Provision that fees charged for credit ratings and ancillary services should be non-discriminatory and based on actual costs. Specifically, this CRA stated that it could mitigate any potential conflicts of interests by ensuring that the fees charged by a CRA to its clients are determined in a transparent and objective way. This CRA gave some examples of safeguards, which could be used to ensure pricing transparency and objectivity and suggests that these could be used as alternative requirements which would be as stringent as the Fees Provision: i) transparent and objective fee schedules with objective criteria to calculate individual client fees; ii) controls around pricing structure and fee level setting; iii) controls around deviations from fee schedules; iv) controls around client fee discussions.
41. **ESMA's response:** The Fees Provision applies to both credit ratings and ancillary services. ESMA understands that ancillary services are provided by CRAs and companies within CRAs' groups. They can be provided to clients of EU issued and endorsed credit ratings or sold on a standalone basis. Fees for ancillary services should not be charged to EU clients through non-registered entities or third-country companies with the aim of circumventing the CRAR.¹⁸ This is why it is important that ESMA has oversight of the ancillary services provided to clients of endorsed credit ratings and of EU issued credit ratings.
42. ESMA welcomes the use of objective criteria in developing pricing policies and in fee negotiations. However, ESMA expects EU CRAs to take into account both the competition objective and the conflicts of interest objective in applying the Fees Provision, as highlighted above.
43. ESMA's Thematic Report includes dedicated sections which aim to clarify the principles of non-discrimination (paragraphs 12 to 16) and the cost-based/cost-relatedness requirements (paragraphs 17 to 20) that CRAs should take into account when applying the Fees Provision. However, ESMA recognises in the Thematic Report that there are areas where further information, clarification and/or supervisory guidance might be beneficial in future but this should be seen as a supplement to, rather than a substitute for, the general principles set out in the Thematic Report.
44. Whilst ESMA recognises that the application of global pricing policies and procedures is becoming more widespread, ESMA does not require CRAs to export their EU pricing policies and procedures and fee schedules in order to demonstrate that their endorsed ratings and ancillary services comply with measures as stringent as the Fees Provision.

¹⁸ See Article 4(4) of CRAR.

45. Indeed, having regard to the various provisions in place in third-country jurisdictions, ESMA has updated the final guidelines to clarify that ESMA considers that an endorsing CRA has demonstrated to ESMA that the conduct of the credit rating activities by the third-country CRA resulting in the issuing of an endorsed credit rating fulfils requirements which are as stringent as those set out in these provisions, where they ensure that:

- a. the fees charged do not depend on the level of credit rating issued or on any other result or outcome of the work performed; and
- b. the fees charged for credit ratings and ancillary services are established in compliance with the relevant competition and antitrust rules in place in the third country.

2.3 Reporting of information about fees to ESMA (Q2)

46. CRAR contains a set of requirements for CRAs to disclose periodic information to ESMA regarding the fees it charges for credit ratings and ancillary services offered by the CRA (the Fee Reporting Provision).

Article 11(3): A credit rating agency shall provide annually, by 31 March, to ESMA information relating to matters set out in point 2 of Part II of Section E of Annex I.

Point 2 of Part II of Section E of Annex I: Disclosures

[...]

II. Periodic disclosures

A credit rating agency shall periodically disclose the following

[...]

2. annually, the following information:

(a) list of fees charged to each client for individual credit ratings and any ancillary services;

(aa) its pricing policy, including the fees structure and pricing criteria in relation to credit ratings for different asset classes;

[...]

The European Commission Delegated Regulation (2015/1) of 30 September 2014 supplementing CRAR with regard to regulatory technical standards for the periodic reporting on fees charged by credit rating agencies for the purpose of ongoing supervision by the European Securities and Markets Authority (hereinafter: “the Delegated Regulation on Fees”).

47. This section deals with the requirement to report certain information to ESMA related to fees charged by CRAs to their clients. As it is linked closely to the previous section, this section also prompted responses from nearly all CRAs.
48. Three CRAs stressed the high costs of implementing this reporting obligation with regard to fees charged across the world. One stated that the cost of a previous ad-hoc request for such information from ESMA in 2016 cost the company \$ 700,000 to implement. Two CRAs, stressed that these costs affect smaller CRAs disproportionately.
49. Some CRAs stated that requiring EU CRAs to report a full list of fees charged by the third-country CRAs to each client for individual credit ratings and ancillary services would go beyond the objective of the Fee Reporting Provision and be disproportionate in light of the high costs and administrative burden for the CRAs and the sensitive, client-confidential nature of the data.

50. Two CRAs suggested alternative Fee Reporting Provisions. One CRA considered that it would be more proportionate for each non-EU CRA whose ratings are endorsed to be required to retain records of deviations from its pricing policy which could be requested by ESMA from time to time, as part of its examination of those endorsed ratings. Another CRA suggested that ESMA might collect sample data on endorsed ratings on an ad-hoc basis.
51. **ESMA's response:** Whilst it is important for ESMA to be able to effectively supervise the compliance of individual CRAs' practices, it is also important that the requirements of CRAR are imposed in a way which is not unnecessarily burdensome and/or disproportionate to the nature, scale and complexity of an individual CRA.
52. ESMA thanks CRAs for their constructive proposals and agrees that it would be disproportionate to continue to require CRAs to report all the data on endorsed ratings required by Article 11(3) of the CRAR and the Delegated Regulation on Fees as currently formulated. As highlighted in its Thematic Report on Fees Charged by Credit Rating Agencies and Trade Repositories,¹⁹ ESMA is currently considering revising the Delegated Regulation on Fees.
53. ESMA has updated the final guidelines to clarify that until such time as a revised Delegated Regulation on Fees takes effect, ESMA expects CRAs to keep records of its pricing policies, procedures and fee schedules and to record deviations from these. ESMA will request these records and related information on an ad hoc basis.

¹⁹ Paragraph 77 of ESMA's Thematic Report on fees.

2.4 Information to accompany the disclosure of a credit rating (Q3 and Q4)

54. CRAR contains a set of requirements for CRAs to accompany the disclosure of a credit rating with certain information.

Article 10(3): When a credit rating agency issues credit ratings for structured finance instruments, it shall ensure that rating categories that are attributed to structured finance instruments are clearly differentiated using an additional symbol which distinguishes them from rating categories used for any other entities, financial instruments or financial obligations.

[...]

Article 10(5): Where a credit rating agency issues an unsolicited credit rating, it shall state prominently in the credit rating, using a clearly distinguishable different colour code for the rating category, whether or not the rated entity or a related third party participated in the credit rating process and whether the credit rating agency had access to the accounts, management and other relevant internal documents for the rated entity or a related third party.

Unsolicited credit ratings shall be identified as such.

55. Three CRAs' had specific comments to ESMA's guidance on these requirements.

56. Only one CRA requested clarification on ESMA's guidance to this requirement. This CRA pointed out that in some instances, the definition of structured finance instrument (SFI) used in the third-country jurisdiction may conflict with the EU definition. In order to comply with the requirements of the third-country and those of the proposed guidelines, CRAs would need to apply two different 'sf' identifiers. Rather than enhancing transparency, this risks creating unnecessary confusion. The CRA also noted that the "Rating Type" of each endorsed credit rating is disclosed on the European Rating Platform, already allowing users of credit ratings to identify SFI ratings. Finally, the CRA requested the final guidelines would clarify that when there exists a local requirement to identify SFIs using a conflicting definition, the third- country CRA does not need to assign an additional identifier.

57. Another CRA proposed to disclose whether the instrument qualifies as a SFI under EU regulation in the rating announcement or in another publicly available disclosure document.

58. **ESMA's response:** ESMA agrees that the objective of investor transparency is not served by combining the EU disclosure with a third-country mandated disclosure in a way, which is unclear to the rating user. In particular, the use of symbols and colour codes as mandated by the Regulation might create unnecessary confusion. However, ESMA considers that it is important for EU investors to know whether according to EU law:

- a rated instrument is an SFI;

- the rating was solicited; and if not
- whether the rated entity participated.

59. ESMA has updated the guidance to indicate that while these disclosures should be made it may be presented in a different format than what is dictated by CRAR.

2.5 The transparency report (Q5)

60. CRAR contains a requirement for a CRA to annually publish a “transparency report” which must contain certain information, inter alia, about the CRA’s independence and internal controls.

Article 12 Transparency report

A credit rating agency shall publish annually a transparency report which includes information on matters set out in Part III of Section E of Annex I. The credit rating agency shall publish its transparency report at the latest three months after the end of each financial year and shall ensure that it remains available on the website of the agency for at least five years

Part III of Section E of Annex I

III. Transparency report a credit rating agency shall make available annually the following information:

1. detailed information on legal structure and ownership of the credit rating agency, including information on holdings within the meaning of Articles 9 and 10 of Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market (1);
2. a description of the internal control mechanisms ensuring quality of its credit rating activities;
3. statistics on the allocation of its staff to new credit ratings, credit rating reviews, methodology or model appraisal and senior management, and on the allocation of staff to rating activities with regard to the different asset classes (corporate — structured finance — sovereign);
4. a description of its record-keeping policy;
5. the outcome of the annual internal review of its independent compliance function;
6. a description of its management and rating analyst rotation policy;
7. financial information on the revenue of the credit rating agency, including total turnover, divided into fees from credit rating and ancillary services with a comprehensive description of each, including the revenues generated from ancillary services provided to clients of credit rating services and the allocation of fees to credit ratings of different asset classes. Information on total turnover shall also include a geographical allocation of that turnover to revenues generated in the Union and revenues worldwide;
8. a governance statement within the meaning of Article 46a(1) of Council Directive 78/660/EEC of 25 July 1978 on the annual accounts of certain types of companies (1). For the purposes of that statement, the information referred to in Article 46a(1)(d) of that Directive shall be provided by the credit rating agency irrespective of whether it is subject to Directive

61. Four CRAs' had specific comments to ESMA's guidance on this requirement. One CRA expressed concern that the cost of adding further information in the transparency report might not bring proportionate benefit to investors. Another CRA stressed that disclosures made on the basis of US law are accessible to investors as the working language is English.
62. **ESMA's response:** Without further detail, ESMA cannot comment on the first CRA's stated opinion. With regard to the comment of the second CRA, ESMA would like to stress that these guidelines provide potential *alternatives* to direct compliance with CRAR. ESMA could never compel a CRA to implement requirements which are *more* stringent than those set out in CRAR. Hence, a CRA would for example be free to choose to publish a separate transparency report for each jurisdiction from which it endorses credit ratings. It might also choose to disclose the information required under Part III of Section E of Annex I of CRAR (transparency report requirements) in annual publications which are required according to the local law. However, with these guidelines, ESMA clarifies that it considers publication of additional information about endorsed credit ratings as a part of the EU transparency report to be equally stringent.
63. Finally, while agreeing with the principle of adding information in the European Transparency Report about endorsed ratings, one CRA, pointed out two elements of the Guidance which were not clear. First, the CRA found the second bullet of the proposed guidance, which demands that the "*the outcome of the annual internal review of a CRA's independent compliance function should take into account the compliance of endorsed credit ratings;*" was not clear. Second, the CRA noticed inconsistency in the text of the proposed guidelines provided on page 20 and on page 51 of the CP.
64. **ESMA's response:** ESMA agrees with the comment of the CRA and has clarified what it means with this bullet in the final guidelines: "The outcome of the annual internal review of a CRA's independent compliance function should take into account the role of the endorsing CRA's compliance function with respect to endorsed ratings". The inconsistency in the text of the proposed guidelines on page 20 and 51 of the CP was a mistake. The text on page 51, which is preferred by the CRA, is the relevant guidance and will be brought forward in the final guidelines.

2.6 Initial reviews and preliminary ratings (Q6)

65. CRAR contains a requirement for a CRA to disclose on its website and notify to ESMA information about entities or debt instruments submitted to it for initial review or for preliminary rating.

Paragraph 6 of Subsection I of Section D of Annex I: A credit rating agency shall disclose on its website, and notify ESMA on an ongoing basis, information about all entities or debt instruments submitted to it for their initial review or for preliminary rating. Such disclosure shall be made whether or not issuers contract with the credit rating agency for a final rating.

66. Three CRAs' had specific comments on ESMA's guidance on this requirement. All three CRAs welcomed the guidance provided but requested further clarification as to what steps CRAs are expected to take to mitigate rating shopping. The CRAs argued that it is not within the power of a CRA to control this risk, which relies on the conduct of the issuers.
67. **ESMA's response:** As set out in paragraph 51 of the CP "ESMA recognises that the objectives of this provision would not be achieved if this requirement were implemented by a subset of third-country CRAs in a certain jurisdiction. Consequently, ESMA is of the view that this requirement often cannot be fulfilled in a meaningful way by a third-country CRA [...]"
68. ESMA, furthermore, agrees that it may not always be within a CRA's knowledge or control when an issuer is rating shopping. Consequently, ESMA considers that this requirement need not be fulfilled by third-country CRAs, as long as the CRA does not knowingly facilitate rating shopping by issuers. The guidelines have been updated to reflect these points.

2.7 Review and disclosure of methodologies (Q7)

69. CRAR contains a range of requirements relating to the review of methodologies.

Article 8(3): A credit rating agency shall use rating methodologies that are rigorous, systematic, continuous and subject to validation based on historical experience, including back-testing.

Commission Delegated Regulation (EU) No 447/2012 of 21 March 2012 supplementing CRAR by laying down regulatory technical standards for the assessment of compliance of credit rating methodologies (hereinafter: "the Delegated Regulation on Methodologies").

Article 8(5): A credit rating agency shall monitor credit ratings and review its credit ratings and methodologies on an ongoing basis and at least annually, in particular where material changes occur that could have an impact on a credit rating. A credit rating agency shall establish internal arrangements to monitor the impact of changes in macroeconomic or financial market conditions on credit ratings.

Article 8(5a): A credit rating agency that intends to make a material change to, or use, new rating methodologies, models or key rating assumptions which could have an impact on a credit rating shall publish the proposed material changes or proposed new rating methodologies on its website inviting stakeholders to submit comments for a period of one month together with a detailed explanation of the reasons for and the implications of the proposed material changes or proposed new rating methodologies.

Article 8(6): Where rating methodologies, models or key rating assumptions used in credit rating activities are changed in accordance with Article 14(3), a credit rating agency shall:

(a) immediately, using the same means of communication as used for the distribution of the affected credit ratings, disclose the likely scope of credit ratings to be affected;

(aa) immediately inform ESMA and publish on its website the results of the consultation and the new rating methodologies together with a detailed explanation thereof and their date of application;

(ab) immediately publish on its website the responses to the consultation referred to in paragraph 5a except in cases where confidentiality is requested by the respondent to the consultation;

(b) review the affected credit ratings as soon as possible and no later than six months after the change, in the meantime placing those ratings under observation; and

(c) re-rate all credit ratings that have been based on those methodologies, models or key rating assumptions if, following the review, the overall combined effect of the changes affects those credit ratings.

70. While two CRAs expressed general agreement with ESMA's guidelines, two CRAs' had specific comments to this requirement.
71. One CRA, considered the additional specific detailed tests imposed by the Delegated Regulation on Methodologies²⁰ are unnecessary and that requirements set out in the US legal framework are sufficiently robust. Furthermore, with respect to Article 8(5a) of CRAR, the CRA requested that ESMA accept that consultation is only needed when changes are material. Investors do not benefit from excessively frequent consultations of changes to methodologies which are of no or very limited immediate consequence.
72. **ESMA's response:** While ESMA does not have sufficient information regarding the alternatives proposed, ESMA notes that the scope of Article 8(5a) is limited to *material* changes to methodologies, which could have an impact on a credit rating.
73. With regard to Article 8(6)(b) of CRAR, one CRA requested that the final guidelines should allow non-EU CRAs to review credit ratings affected by a change in a methodology within a "reasonable" time period after a criteria change rather than immediately and no later than six month as set out in CRAR.
74. **ESMA's response:** ESMA does not consider that a period longer than six months can be considered as stringent as the requirement set out in Article 8(6)(b) of CRAR.

²⁰ Commission Delegated Regulation (EU) No 447/2012 of 21 March 2012 supplementing CRAR by laying down regulatory technical standards for the assessment of compliance of credit rating methodologies.

2.8 Reporting to ESMA of errors in methodologies (Q8)

75. CRAR contains a requirement to notify ESMA of errors in methodologies:

Article 8(7)(a): Where a credit rating agency becomes aware of errors in its rating methodologies or in their application it shall immediately:

(a) notify those errors to ESMA and all affected rated entities explaining the impact on its ratings including the need to review issued ratings;

76. Three CRAs had specific comments to this requirement. Two CRAs asked that ESMA accept a materiality threshold for reported errors in methodologies. Potentially, non-material errors could be recorded internally for ESMA to review during investigations. Another CRA asked that the frequency could be organised quarterly rather than immediately to limit the impact on its internal policies and procedures.

77. **ESMA's response:** ESMA considers that errors relating to methodologies which are used in the elaboration of endorsed credit ratings or credit ratings issued in the EU should be reported in the same way. ESMA does not consider that CRAs have identified alternative requirements which are at least as stringent as those set out in these provisions.

2.9 Rotation of analysts, lead analysts and persons approving credit ratings (Q9)

78. CRAR contains a requirement to rotate lead analysts, rating analysts and persons approving credit ratings:

Article 7(4): A credit rating agency shall establish an appropriate gradual rotation mechanism with regard to the rating analysts and persons approving credit ratings as defined in Section C of Annex I. That rotation mechanism shall be undertaken in phases on the basis of individuals rather than of a complete team.

Paragraph 8 of Section C of Annex I:

8. For the purposes of Article 7(4):

(a) credit rating agencies shall ensure that the lead rating analysts shall not be involved in credit rating activities related to the same rated entity or a related third party for a period exceeding four years;

(b) credit rating agencies other than those appointed by an issuer or a related third party and all credit rating agencies issuing sovereign ratings shall ensure that:

(i) the rating analysts shall not be involved in credit rating activities related to the same rated entity or a related third party for a period exceeding five years;

(ii) the persons approving credit ratings shall not be involved in credit rating activities related to the same rated entity or a related third party for a period exceeding seven years.

The persons referred to in points (a) and (b) of the first subparagraph shall not be involved in credit rating activities related to the rated entity or a related third party referred to in those points within two years of end of the periods set out in those point.

79. While one CRA expressed general agreement with ESMA's guidelines, two CRAs' had specific comments to this requirement.

80. These two CRAs requested that ESMA accept that only the lead analyst rotates. The CRAs argued that in practice, primary analysts have the majority of analytical interactions with issuers and their related third parties. In comparison, interactions (if any) by other analysts, such as those chairing committees, are generally minimal and not significant enough to justify a rotation requirement, the benefits of which would be outweighed by the potentially detrimental impact rotation can have on rating quality. Meanwhile, another CRA asked that ESMA accept non-rotation compensated by rigorous policies and procedures addressing the risk of long-lasting relationships leading to potential conflicts of interest. Another CRA asks whether six years is enough for lead analysts to rotate.

81. **ESMA's response:** The guidelines, as set out in the CP, required CRAs to ensure that analysts and persons approving credit ratings are subject to an appropriate rotation

mechanism which provides for a gradual change in analytical teams and credit rating committees. ESMA considers that the mechanism should involve both analysts, lead analysts and persons approving credit ratings and have revised the final guidelines to make it clear that all three staff categories should be subject to some form of rotation.

82. However, ESMA acknowledges that what different CRAs may judge as an appropriate and gradual rotation will vary according to the specificities of their internal structures and business activities. The appropriate length and frequency of the rotation in place for different categories of staff may thus be longer than those set out in CRAR, in particular where a CRA has put in place other measures to mitigate the risk of potential conflicts of interests arising from long-standing relationship between an issuer and an analyst.

2.10 Cross-shareholdings and directorships (Q10)

83. CRAR contains a requirement to identify and manage conflicts of interests relating to shareholders of a CRA:

Article 6(1): A credit rating agency shall take all necessary steps to ensure that the issuing of a credit rating or a rating outlook is not affected by any existing or potential conflicts of interest or business relationship involving the credit rating agency issuing the credit rating or the rating outlook, its shareholders, managers, rating analysts, employees or any other natural person whose services are placed at the disposal or under the control of the credit rating agency, or any person directly or indirectly linked to it by control.

Paragraph 3(aa) and (ca) of Section B of Annex I. A credit rating agency shall not issue a credit rating or a rating outlook in any of the following circumstances, or shall, in the case of an existing credit rating or rating outlook, immediately disclose where the credit rating or rating outlook is potentially affected by the following:

[...]

(aa) a shareholder or member of a credit rating agency holding 10 % or more of either the capital or the voting rights of that credit rating agency or being otherwise in a position to exercise significant influence on the business activities of the credit rating agency, holds 10 % or more of either the capital or the voting rights of the rated entity or of a related third party, or of any other ownership interest in that rated entity or third party, excluding holdings in diversified collective investment schemes and managed funds such as pension funds or life insurance, which do not put him in a position to exercise significant influence on the business activities of the scheme;

[...]

(ca) a shareholder or member of a credit rating agency holding 10 % or more of either the capital or the voting rights of that credit rating agency or being otherwise in a position to exercise significant influence on the business activities of the credit rating agency, is a member of the administrative or supervisory board of the rated entity or a related third party;

84. While two CRAs expressed general agreement with ESMA's guidelines, two CRAs had strong objections. Specifically, one CRA argued that the requirements under US law, which prohibit a CRA from issuing or maintaining ratings on any entity directly or indirectly controlling, controlled by or under common control with the CRA, address the objectives of these EU provisions. Both CRAs stated that this requirement might have a disproportionate impact on their business.

85. **ESMA's response:** While ESMA considers that the EU requirement is very specific, ESMA also recognises that the implications of this requirement for the availability to European Investors of endorsed credit ratings from certain CRAs may be significant and sudden. To avoid the risk that this requirement leads to unforeseen consequences for European investors relying on such ratings, ESMA considers that CRAs should be allowed to continue to endorse credit ratings which are affected by a cross-shareholding above 10% as long as the potential conflict of interest is disclosed clearly and prominently, the

third-country CRA has verified that the shareholder or member of the CRA is not in a position to exercise significant influence²¹ on the business activities of that CRA and the third-country CRA has robust internal requirements to ensure that the shareholder or member is not able to exercise any influence on the credit rating. Furthermore, ESMA considers that no shareholding above 20% should be able to benefit from this alternative²². ESMA will in due course evaluate whether it is appropriate to maintain this alternative, i.e. whether the measures put in place by third-country CRAs achieve the objective and intended effects of this requirement.

²¹ Within the meaning of International Accounting Standard no. 28: Investments in Associates and Joint Ventures, paragraphs 5-6.

²² As per Article 2(13) of the Accounting Directive (Directive 2013/34/EU of the European Parliament and of the Council of 26 June 2013 on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings, amending Directive 2006/43/EC of the European Parliament and of the Council and repealing Council Directives 78/660/EEC and 83/349/EEC Text with EEA relevance) "An undertaking is presumed to exercise a significant influence over another undertaking where it has 20 % or more of the shareholders' or members' voting rights in that other undertaking;"

2.11 Look-back reviews (Q11)

86. CRAR contains a requirement to review the work of a rating analyst when he or she leaves the CRA:

Paragraphs (6)-(7) of Section C of Annex I: 6. Where a rating analyst terminates his or her employment and joins a rated entity, which he or she has been involved in rating, or a financial firm, with which he or she has had dealings as part of his or her duties at the credit rating agency, the credit rating agency shall review the relevant work of the rating analyst over two years preceding his or her departure.

7. A person referred to in point 1 shall not take up a key management position with the rated entity or a related third party within six months of the issuing of a credit rating or rating outlook.

87. While two CRAs expressed general agreement with ESMA's guidelines, two CRAs' disagreed with ESMA's guidance on this requirement.

88. One CRA argued that a one-year look-back review should be sufficient and would be as stringent as the two-year period prescribed by CRAR.

89. **ESMA's response:** ESMA does not consider that a look-back review of one year is as stringent as a look-back review of two years.

90. Another CRA argued that further work is needed to understand whether an extension of the requirement in paragraph (7) to third-country CRAs would be consistent with Employment Law in third countries. The CRA argued that there is little if anything, a CRA can do to physically prevent an employee from joining another entity. The ability of EU authorities to impose this requirement on non-EU citizens in third country regimes would appear questionable.

91. The CRA believes the objective of the requirement could be achieved by the existing controls that the CRA has implemented across the Group. At a high level, these controls include:

- Requiring on all staff to notify their supervisor if they become aware that a former employee has joined a rated company
- The requirement to conduct a look-back review where an employee has joined a rated entity where they were involved in the rating of that company.
- The subsequent rating disclosure must explain that the update is a result of the participation of a former rating analyst in a previous rating action related to their current employer.

92. **ESMA's response:** ESMA understands that the requirement set out in paragraph 7 of Section C of Annex I of CRAR may be difficult to implement, in particular for existing staff. Furthermore, ESMA also recognises that there may be national rules preventing CRA's

from providing for a commitment to respecting this requirement in employment contracts. Finally, ESMA recognises that it may not always be within a CRA's knowledge or control when a person mentioned in Paragraph 1 of Section C of Annex I of CRAR²³ takes up a key management position in a rated entity. ESMA has updated the final guidelines to clarify that an endorsing CRA is not deemed to infringe Article 4(3) if "*the reason for that infringement is outside the credit rating agency's knowledge or control*"²⁴.

²³ 1. Rating analysts, employees of the credit rating agency as well as any other natural person whose services are placed at the disposal or under the control of the credit rating agency and who is directly involved in credit rating activities, and persons closely associated with them within the meaning of Article 1(2) of Directive 2004/72/EC (1), shall not buy or sell or engage in any transaction in any financial instrument issued, guaranteed, or otherwise supported by any rated entity within their area of primary analytical responsibility other than holdings in diversified collective investment schemes, including managed funds such as pension funds or life insurance.

²⁴ Paragraph 1 of Part I of Annex III of CRAR.

2.12 Pre-publication issuer notice (Q12)

93. CRAR contains a requirement to notify rated entities at least 24 hours before the publication of a credit rating:

Article 10(2): Credit rating agencies shall ensure that credit ratings and rating outlooks are presented and processed in accordance with the requirements set out in Section D of Annex I and shall not present factors other than those related to the credit ratings.

Paragraph 3 of Subsection I of Section D of Annex I:

3. A credit rating agency shall inform the rated entity during working hours of the rated entity and at least a full working day before the publication of the credit rating or the rating outlook. That information shall include the principal grounds on which the credit rating or rating outlook is based in order to give the rated entity an opportunity to draw attention of the credit rating agency to any factual errors.

94. Three CRAs' and the American Chamber of Commerce had specific comments to this requirement.
95. All CRAs broadly agreed with the approach set out in the CP but requested certain clarifications. Two CRA's and the American Chamber of Commerce highlighted the risk that pre-publication notice could delay the disclosure of market sensitive information and thus raise the risk of insider trading and thus potentially conflict with third-country requirements.
96. To address this concern, one CRA requested that ESMA takes into account exceptional situations where the requirements of third-country regulators to release Market Sensitive information as quickly as possible could contradict ESMA's expectations (e.g. in the context of a mergers or acquisitions). In such situations, it may be necessary to contact a rated entity out of its "normal business hours" and it may be that the time frame for providing feedback is tight. Another CRA requested clarification on the exact time, which ESMA considers appropriate.
97. **ESMA's response:** As set out in the CP, ESMA considers that the amount of time to be provided to a rated entity should be "reasonable". In this regard, a "reasonable" amount of time will be judged according to the broader context in which the rating action is expected to be issued, taking into account, inter alia, other regulatory obligations such as the need to release market sensitive information as quickly as possible. The guidelines have been updated to reflect this.
98. The rated entity should be notified during working hours unless the CRA is prevented from doing so due to third-country legal requirements. Where the rated entity provides confirmation of the absence of factual errors outside of its business hours there is no obligation to delay publication any further.

99. Another CRA requested that ESMA considers alternatives to pre-publication. The CRA argues that the objective of this requirement can be met by checking the accuracy of relevant facts before these are presented to a rating committee and before any publication is sent to the issuer. The CRA considers that the usefulness of the pre-publication notice depends on circumstances, such as sector, practice area and complexity of the issuer or rating. Finally, the CRA requested whether ESMA could consider it equally stringent if a CRA only provided pre-publication notice when required by law or regulation or where otherwise feasible.

100. **ESMA's response:** ESMA does not consider the proposed approach to meet the objectives of the relevant provision. The issuer should receive the principal grounds on which the credit rating or rating outlook are based.

2.13 Treatment of inside information (Q13)

101. CRAR contains a requirement for CRAs to ensure that credit ratings are treated in the same manner as inside information, up until the point of their disclosure. There were no specific comments to this question. As a result, ESMA has not introduced any change into the final guidelines.

2.14 Treatment of confidential information (Q14)

102. CRAR contains a requirement for CRAs to ensure that confidential information is only used for purposes related to credit rating activities and is protected from fraud, theft or misuse.

Article 7(3): A credit rating agency shall ensure that persons referred to in paragraph 1 meet the requirements set out in Section C of Annex I.

Paragraph 3 of Section C of Annex I:

3. Credit rating agencies shall ensure that persons referred to in point 1:

(a) take all reasonable measures to protect property and records in possession of the credit rating agency from fraud, theft or misuse, taking into account the nature, scale and complexity of their business and the nature and range of their credit rating activities;

(b) do not disclose any information about credit ratings or possible future credit ratings of the credit rating agency, except to the rated entity or its related third party;

(c) do not share confidential information entrusted to the credit rating agency with rating analysts and employees of any person directly or indirectly linked to it by control, as well as with any other natural person whose services are placed at the disposal or under the control of any person directly or indirectly linked to it by control, and who is directly involved in the credit rating activities; and

(d) do not use or share confidential information for the purpose of trading financial instruments, or for any other purpose except the conduct of the credit rating activities.

103. Only one CRA had specific comments regarding this requirement. Given ESMA's approach to the question of inside information – a type of confidential information – set forth in the preceding section, in which ESMA relies on the requirements of the locally applicable law, it would seem that a similar approach is appropriate for other types of confidential information.

104. **ESMA's response:** ESMA does not consider it has sufficient information to assess the alternative proposed by the respondent. Generally, ESMA considers the requirements set out in CRAR regarding confidentiality to be very important in light of potentially diverging rules in different jurisdictions for treatment of inside information. The text in the guidelines dealing with inside information has been updated to reflect the link between this requirement and the other requirements in CRAR relating to treatment of confidential information.

2.15 Records and audit trails (Q15)

105. CRAR contains a requirement for CRAs to arrange for adequate records and, where appropriate, audit trails of its credit rating activities to be kept. There were no specific

comments to this question. As a result, ESMA has not introduced any change into the final guidelines.

2.16 Other alternatives internal requirements which could meet the same objective and effects of an EU requirement in practice (Q16)

106. Two CRAs requested that further clarification is provided regarding governance requirements and how they apply to third-country CRAs. The CRAs were concerned that the direct application of EU rules might contradict local legislation. Specifically, one of the CRAs requested that ESMA clarify whether the requirements for independent directors and compliance staff set out in CRAR could be met for non-EU CRAs whose ratings are endorsed, respectively, by the independent directors of the endorsing CRA and the global Compliance Group.
107. **ESMA's response:** While ESMA is not necessarily opposed to the proposed alternative, ESMA does not consider it has sufficient information to provide an assessment. As per Paragraph 13, ESMA will expand this list over time, whenever a CRA proposes an alternative requirement which ESMA considers to be as stringent as a requirement set out in CRAR.
108. One CRA asked that ESMA clarifies the use of exemptions. Under Article 6(3) of CRAR, the circumstances under which exemptions can be granted are limited. The CRA asked whether ESMA would allow for third-country CRAs, through their EU endorsing CRA, to seek other exemptions where they are able to demonstrate that those requirements are not proportionate in view of the nature, scale and complexity of its business and the nature and range of issue of credit ratings.
109. **ESMA's response:** CRAR allows for a CRA to benefit from certain exemptions when they meet the conditions set out in Article 6(3) of CRAR. A third-country CRA can benefit from the same exemptions when the endorsing CRA has verified and is able to demonstrate to ESMA that a third-country CRA meets the conditions for exemptions under this provision. However, ESMA is not empowered to grant exemptions beyond those set out in this provision.

3 Cost Benefit Analysis

3.1 Background

1. In November 2017, ESMA published a final report (the 2017 Final Report)²⁵ with its updated guidelines on Endorsement which outlined two approaches available for endorsing CRAs to ensure that endorsed credit ratings meet the relevant endorsement provisions of CRAR, namely:
 - a) The third-country credit rating agency can fulfil the requirements set out in the relevant endorsement provisions of CRAR; or,
 - b) The third-country credit rating agency can establish and fulfil internal requirements that are different but at least as stringent as the relevant endorsement provisions of CRAR.
2. Under the second of these approaches endorsing CRAs can choose to ensure that the third-country CRA establishes their own requirements which are as stringent as the EU requirements, or they can implement one of the equally stringent internal requirements set out by ESMA in the new “section 5.3” which this report adds to the Guidelines on Endorsement.

3.2 Reasons for Publication

3. The primary purpose of these supplementary guidelines is to provide guidance when CRAs choose to endorse credit ratings according to the second of the above approaches. This is done by proposing internal requirements ESMA recognises as being “as stringent as” the relevant endorsement provisions for endorsed credit ratings.
4. In addition to proposing guidance on these measures, these supplementary guidelines have a secondary purpose, which is to provide clarity as to how the Endorsement regime established under CRAR and ESMA's new Guidelines on Endorsement, is expected to work in practice.
5. This CBA should therefore be read as a continuation of the analysis of the costs and benefits discussed in the 2017 Final Report. Whereas that CBA considered the costs and benefits of the endorsement regime as implemented by those guidelines, this CBA is focused on the costs and benefits resulting from these supplementary guidelines. For this reason, it is argued that these supplemented guidelines do not in and of themselves add any additional costs that were not already implied by the 2017 Guidelines.

²⁵ Final Report Update of the guidelines on the application of the endorsement regime under Article 4(3) of the Credit Rating Agencies Regulation (ESMA33-9-205) published on 17 November 2017

3.3 Impact of the guidelines

6. For those CRAs which currently endorse credit ratings from third-country CRAs by directly implementing all the requirements set out in the relevant endorsement provisions of CRAR, these supplementary guidelines will have no impact on initial or ongoing costs. For those CRAs which currently endorse credit ratings from third-country CRAs which establish internal requirements that are different but at least as stringent as the relevant endorsement provisions of CRAR, the main benefit of these guidelines is that they will lower the initial costs imposed by the 2017 Guidelines. These initial costs will be lowered by reducing the need for CRAs to dedicate time and resources to the development of their own internal policies and procedures to meet the relevant endorsement provisions of CRAR.
7. The following table summarises the potential costs and benefits resulting from the implementation of these guidelines and should be seen as supplementary to the Cost Benefit Analysis set out in Section 3 of ESMA's 2017 Final Report.

Policy objective	To provide guidance and transparency to EU registered CRAs regarding how they can comply with ESMA's Guidelines on Endorsement in situations where there is a divergence between policies and procedures currently applied inside and outside the EU.
Technical proposal	To suggest internal requirements that ESMA considers "as stringent as" EU requirements in key areas where EU CRAs have flagged to ESMA that third-country CRAs from which they are currently endorsing credit ratings are implementing different policies and procedures.
<i>Benefits</i>	<p>ESMA expects that these guidelines will benefit EU CRAs by:</p> <ul style="list-style-type: none"> - Providing clarity on the different approaches available to CRAs as to how they can implement the requirements of CRAR in relation to endorsed ratings. - Providing guidance on each area of CRAR that CRAs have highlighted as being relevant to the requirements for endorsed credit ratings but that are currently subject to different internal policies and procedures outside of the EU. - Facilitating a consistent implementation of the endorsement regime across CRAs through encouraging the adoption of similar internal requirements which meet the ASA test.

	<p>lower costs for ESMA and therefore lower supervisory fees for CRAs.</p> <p>Similarly, a lower uptake of these guidelines means there will be less consistency among the policies and procedures of third-country CRAs a higher supervisory burden on ESMA and therefore higher supervisory fees for CRAs.</p> <p>A higher uptake of implementing EU rules would mean the highest level of consistency among third-country CRAs, the lowest supervisory burden on ESMA and the lowest impact on supervisory fees charged to CRAs.</p>
--	---

Annex I: Guidelines on the application of the endorsement regime under Article 4(3) of the Credit Rating Agencies Regulation

1 Scope

Who?

1. These guidelines apply to credit rating agencies established in the Union and registered with ESMA (hereinafter “EU CRAs”) in accordance with Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies²⁶ (hereinafter “CRAR”) which are endorsing or which intend to endorse credit ratings issued by a third-country CRA in accordance with Article 4(3) of the same Regulation.

What?

2. These guidelines concern particular matters relating to credit ratings issued in third countries and endorsed pursuant to Article 4(3) of CRAR. These guidelines add a new section (Section 5.3) to the “*Guidelines on the application of the endorsement regime under Article 4(3) of the Credit Rating Agencies Regulation*” published by ESMA on 17 November 2017 (ESMA33-9-205).

When?

3. These guidelines will apply to credit ratings issued on or after 1 January 2019 and to existing credit ratings reviewed after that date.

²⁶ OJ L 302, 17.11.2009, p.1.

2 Definitions, legislative references and acronyms

The following definitions apply:

CRA	Credit rating agency
CRAR	The Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit ratings agencies as amended by Regulation (EU) No 513/2011 of the European Parliament and of the Council of 11 May 2011, Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011, Regulation (EU) No 462/2013 of the European Parliament and of the Council of 21 May 2013, and Directive 2014/51/EU of the European Parliament and of the Council of 16 April 2014
CRA 2	Regulation (EU) No 513/2011 of the European Parliament and of the Council of 11 May 2011 amending Regulation (EC) No 1060/2009 on credit rating agencies
CRA 3	Regulation (EU) No 462/2013 of the European Parliament and of the Council of 21 May 2013 amending Regulation (EC) No 1060/2009 on credit rating agencies
ESMA	European Securities and Markets Authorities
ESMA Regulation	Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC (ESMA Regulation)
EU CRA	A credit rating agency registered with ESMA.
Endorsing CRA	An EU CRA which endorses or has endorsed one or more credit ratings in accordance with Article 4(3) of CRAR.
Third-country CRA	A CRA which is registered and subject to supervision in a non-EU country.
Group of CRAs	As per Article 3(1)(m) of CRAR 'group of CRAs' means a group of undertakings established in the Union consisting of a parent undertaking and its subsidiaries within the meaning of Articles 1 and 2 of Directive 83/349/EEC as well as undertakings linked to each other by a relationship within the meaning of Article 12(1) of Directive 83/349/EEC and whose occupation includes the issuing of credit ratings. For the purposes of Article 4(3)(a), a group of credit rating agencies shall also include credit rating agencies established in third countries.
The relevant endorsement provisions of CRAR	The provisions quoted in Article 4(3)(b) of CRAR: Articles 6 to 12 and Annex I of CRAR with the exception of Articles 6a, 6b, 8a, 8b, 8c, 8d and 11a, point (ba) of point 3 and points

3 Purpose

4. CRAR entered into force on 7 December 2009. The amendments introduced by CRA 2 empowered ESMA to undertake the supervision of all CRAs in the European Union. The amendments introduced by CRA 3 created a set of new requirements for EU CRAs. These new requirements entered into force for the purposes of endorsement of credit ratings issued in third countries on 1 June 2018.
5. Article 21(3) of CRAR requires ESMA, in cooperation with EBA and EIOPA, to issue and update guidelines on the application of the endorsement regime under Article 4(3) of CRAR. In order to fulfil the requirements placed upon it by Article 21(3), ESMA is updating the Guidelines on Endorsement published on 18 May 2011.
6. With these guidelines, ESMA aims to bring clarity about the conditions for endorsement laid down in Article 4(3) of CRAR.

4 Compliance and reporting obligations

4.1 Status of the guidelines

7. This document contains guidelines issued pursuant to Article 16 of the ESMA Regulation and Article 21(3) of CRAR. In accordance with Article 16(3) of the ESMA Regulation, CRAs must make every effort to comply with the guidelines.

4.2 Reporting requirements

8. ESMA will assess the application of these guidelines by the CRAs through its ongoing supervision and monitoring of CRAs' periodic reporting to ESMA.

5 Guidelines

5.1 Initial conditions for endorsement

9. An EU CRA should not begin endorsing credit ratings before ESMA has completed two separate assessments, namely: (1) an assessment of the conditions relating to the legal and supervisory framework of the third country as described in the Methodological Framework for Endorsement²⁷; and (2) an assessment of certain conditions relating to the CRAs intending to endorse credit ratings.

²⁷ Annex II of the Final Report (ESMA33-9-246) published on 17 July 2018.

5.2 Ongoing obligations of an endorsing CRA

10. ESMA expects that an endorsing CRA notifies ESMA if it becomes aware that one or more of the conditions initially assessed by ESMA are no longer fulfilled. As a good practice, the internal audit function should regularly review the control environment for endorsement.
11. In addition, an endorsing CRA should ensure that it meets the following requirements on an ongoing basis.

Requirements relating to Article 4(3)(b)

12. ESMA considers that compliance of the third-country CRA with the third-country legal and supervisory framework does not in and of itself prove that the third-country CRA is fulfilling requirements which are “as stringent as” the requirements set out in Articles 6 to 12 and Annex I of CRAR with the exception of Articles 6a, 6b, 8a, 8b, 8c, 8d and 11a, point (ba) of point 3 and points 3a and 3b of Section B as well as part III of Section D of Annex I of CRAR (hereinafter “the relevant endorsement provisions of CRAR”).
13. Instead, ESMA expects that the endorsing CRA has verified and is able to demonstrate that the third-country CRA has established internal requirements which are at least as stringent as the corresponding requirements in the relevant endorsement provisions of CRAR. ESMA, furthermore, expects that the endorsing CRA has verified and is able to demonstrate that the conduct of the third-country CRA fulfils the internal requirements set out by the third-country CRA on an ongoing basis.
14. Where the third-country CRA chooses to directly fulfil the requirements set out in the relevant endorsement provisions of CRAR, ESMA does not expect the endorsing CRA to demonstrate that the third-country CRA has established internal requirements which are as stringent as the relevant EU requirements. In this case, ESMA only expects that the endorsing CRA verifies and is able to demonstrate that the conduct of the third-country CRA fulfils the relevant EU requirements.
15. To be able to fulfil the requirements described above, ESMA expects that the endorsing CRA has put in place measures to:
 - (a) monitor the policies and procedures of the third-country CRA: Such measures should include an initial assessment of the relevant policies and procedures in the third-country CRA, which should be carried out to ensure that they meet the requirements in Article 4(3)(b) of CRAR. Any subsequent material changes to the relevant policies and procedures in the third-country CRA should also be reviewed and assessed.
 - (b) monitor the conduct of the third country CRA: such measures should ensure that the endorsing CRA is able to demonstrate to ESMA on an ongoing basis that the relevant policies and procedures of the third-country CRA are adhered to, for example through basic automated checks, periodic deep dive assessments of the compliance of a sample of endorsed credit ratings with

specific requirements or areas of requirements and/or review of documentation produced by the key control functions of the third-country CRA.

16. The endorsing CRA should ensure that the above-described measures are based on appropriate and effective organisational and administrative arrangements and clear decision-making procedures, which allocate roles and responsibilities.
17. Whenever the endorsing CRA finds that the conduct of the third-country CRA may not fulfil requirements which are as stringent as the relevant endorsement provisions of CRAR, ESMA expects that the endorsing CRA informs ESMA and takes appropriate steps. The steps should be proportionate and may include:
 - (a) requesting clarification from the third-country CRA;
 - (b) taking appropriate remedial action;
 - (c) suspending endorsement of new ratings which may be affected by the potential breach;
 - (d) withdrawing outstanding endorsed ratings which may be affected by the potential breach.

Requirements relating to Article 4(3)(c)-(d)

18. With regard to point (c) of Article 4(3) of CRAR, the endorsing CRA should make available to ESMA, on an ad-hoc or periodical basis, any information which ESMA may need in order to be able to assess and monitor the compliance of the third-country CRA with the requirements laid down in Article 4(3)(b).
19. If the endorsing CRA identifies any factors outside of its control which may create limitations to ESMA's ability to assess and monitor the compliance of the third-country CRA, for example resulting from third-country legislation, ESMA expects that the endorsing CRA informs ESMA without undue delay.
20. With regard to point (c)-(d) of Article 4(3) of CRAR, when requested, in order to supervise EU CRAs on an ongoing basis, ESMA expects that the endorsing CRA provides any relevant information relating to an endorsed credit rating or the conduct of the third-country CRA.

Requirements relating to Article 4(3)(e)

21. ESMA considers that the following should, inter alia, be considered objective reasons within the meaning of Article 4(3)(e):

- (a) when a rated entity or instrument is non-EU²⁸;
- (b) when an endorsed credit rating relating to an EU entity or instrument is dependent on the rating of a subsidiary or parent company of the rated entity which is non-EU;
- (c) when only a small part of a CRA's outstanding ratings in a narrowly defined asset class are EU entities or instruments and when analytical staff specialised in this asset class is based outside the EU. However, a CRA should continually ensure that it has specialised analytical staff based in the EU in proportion to the relevance of the asset class in the EU; and
- (d) when an event occurs that temporarily impacts the allocation of analytical capacity of a group of CRAs, such as in the following cases:
 - i. A CRA has only recently opened an EU office and the staff that have the experience to rate some EU entities or asset classes are not yet based in the EU.
 - ii. A corporate action such as a takeover or merger, if the rating activity no longer reflects the new corporate structure.
 - iii. Absence of key analytical staff which could not reasonably have been foreseen or planned for.

22. In order to rely on objective reasons referred to in paragraph 21(d), a CRA should be able to demonstrate to ESMA that it is taking the necessary steps to enable the gradual transfer of these ratings to the EU.

23. The endorsing CRA should notify ESMA when the objective reasons for elaborating endorsed credit ratings outside the EU, deviate from those indicated to ESMA. To be able to fulfil this requirement and to allow ESMA to assess the objective reason for individual ratings, ESMA expects that the endorsing CRA documents the objective reason for each endorsed credit rating and verifies periodically that the indicated objective reason for an outstanding endorsed credit rating remains valid.

²⁸ For the purposes of these guidelines, the country of an entity or financial instrument follows Articles 4-6 as well as Field 10 of Table 1 of Part 2 of Annex I of the Commission delegated Regulation 2015/2 of 30 September 2014 with regard to regulatory technical standards for the presentation of the information that CRAs make available to ESMA, available at: http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2015.002.01.0024.01.ENG

5.3 Requirements which ESMA considers at least as stringent as those set out in Articles 6-12 and Annex I of CRAR

24. ESMA considers that a requirement can be considered to be as stringent as a requirement set out in CRAR within the meaning of Article 4(3)(b) when it achieves the same objective and effects in practice. ESMA considers that an endorsing CRA which is unable to demonstrate to ESMA that the conduct of the credit rating activities by the third-country CRA resulting in the issuing of an endorsed credit rating fulfils requirements which are at least as stringent as those set out in the relevant endorsement provisions of CRAR infringes Article 4(3)(b) of CRAR, unless the reason for the infringement is outside the CRA's knowledge or control. However, this should not be understood as relieving an endorsing CRA from its overriding obligation to verify the compliance of the conduct of the third-country CRA as specified in Paragraphs 15-17 above.
25. The following is a non-exhaustive list of alternative internal requirements which ESMA considers to be at least as stringent as a requirement set out in one of the relevant endorsement provisions of CRAR. However, where no alternative internal requirement is provided in these guidelines, ESMA recommends that the endorsing CRA ensures that the third-country CRA directly fulfils the requirements set out in the relevant endorsement provisions of CRAR as per paragraph 14 above.
26. ESMA considers that an endorsing CRA has demonstrated to ESMA that the conduct of the credit rating activities by the third-country CRA resulting in the issuing of an endorsed credit rating fulfils requirements which are at least as stringent as those set out in:
 - a. Article 7(4) and Point 8 of Section C of Annex I of CRAR (**Rotation**), where the third-country CRA does not subject its staff to rotation of the length and frequency required under these provisions, but instead:
 - i. records the length of time an analysts, a lead analyst and a person approving credit ratings is assigned to a single issuer;
 - ii. ensures that analysts, lead analysts and persons approving credit ratings are subject to an appropriate rotation mechanism which provides for a gradual change in analytical teams and credit rating committees; and
 - iii. has in place dedicated and robust internal requirements relating to potential conflicts of interest between an analyst and a rated entity;
 - b. Article 7(4) and Point 8 of Section C of Annex I of CRAR in conjunction with Article 6(3) of CRAR, where the third-country CRA does not subject its staff to any rotation and the endorsing CRA has verified and is able to demonstrate to ESMA that the third-country CRA meets the conditions for the exemption set out in Article 6(3) of CRAR;
 - c. Article 8(7)(a) of CRAR (**Errors in methodologies**), where the endorsing CRA reports the information set out in these provisions to ESMA for a credit rating it has

endorsed, in the same manner it reports such information for credit ratings issued in the EU;

- d. Article 10(2a) of CRAR (**Inside information**), where the credit ratings to be endorsed, rating outlooks and information related thereto are treated according to that third-country regime's requirements for the handling of inside information up until the point of publication/disclosure and where the third-country CRA adheres to the requirements regarding protection of confidential information set out in Article 7(3) as well as Paragraph 3 of Section C of Annex I of CRAR;
- e. Article 10(3) and (5) of CRAR (**Rating disclosures**), where the relevant disclosures are made in accordance with the definitions set out in CRAR clearly and prominently but without the use of a distinguishing symbol or a colour code;
- f. Article 11(3) and point 2 of Part II of Section E of Annex I of CRAR as further specified in the Delegated Regulation on Fees²⁹ (**Reporting of information about fees**), where records are kept of the third-country CRA's pricing policies, procedures and fee schedules and deviations from these are recorded. ESMA will request these records and related information from CRAs on an ad hoc basis;
- g. Article 12 and Part III of Section E of Annex I of CRAR (**Transparency Report**), where the endorsing CRA includes information about the endorsed credit ratings in its own transparency report, ensuring that:
 - i. the description of the internal control mechanisms ensuring quality of a CRA's credit rating activities includes control mechanisms applicable to endorsed credit ratings;
 - ii. the outcome of the annual internal review of a CRA's independent compliance function takes into account the role of the endorsing CRA's compliance function with respect to endorsed ratings;
 - iii. the description of the policy for record-keeping and analyst rotation indicates whether such policies are global or only applied to EU ratings; and
 - iv. the financial information on the revenue of the endorsing CRA, including total turnover and the geographical allocation of that turnover to revenues generated in the Union and revenues worldwide clearly states whether revenues from endorsed ratings are taken into account;
- h. Paragraph 3(aa) of Section B of Annex I (**Cross-shareholdings**), where the endorsing CRA only endorses a new credit rating which is potentially affected by the situation set out in this provision when:

²⁹ The European Commission Delegated Regulation (2015/1) of 30 September 2014 supplementing CRAR with regard to regulatory technical standards for the periodic reporting on fees charged by credit rating agencies for the purpose of ongoing supervision by the European Securities and Markets Authority.

- i. this is clearly and prominently disclosed;
 - ii. the third-country CRA has verified that the shareholder or member of the CRA is not in a position to exercise significant influence on the business activities of the CRA³⁰;
 - iii. the third-country CRA has robust internal requirements to ensure that the shareholder or member is not able to exercise any influence on the credit rating; and
 - iv. the holding of capital or voting rights in the third-country CRA is no more than 20%;
- i. Point 3c of Section B of Annex I of CRAR (**Requirements relating to fees**), where the fees charged for credit ratings and ancillary services do not depend on the level of credit rating issued or on any other result or outcome of the work performed and where the fees charged for credit ratings and ancillary services are established in compliance with the relevant competition and antitrust rules in place in the third country;
 - j. Point 3 of Part I of Section D of Annex I of CRAR (**Pre-publication notification**), where the third-country CRA:
 - i. notifies a rated entity about a rating action in advance of publication;
 - ii. during the business hours of the rated entity; and
 - iii. provides the rated entity with a reasonable amount of time to provide feedback taking into account, inter alia, the CRA's other regulatory obligations;
 - k. Point 6 of Part I of Section D of Annex I of CRAR (**Initial assessments and preliminary ratings**), where the third-country CRA does not knowingly incentivise or facilitate rating shopping.

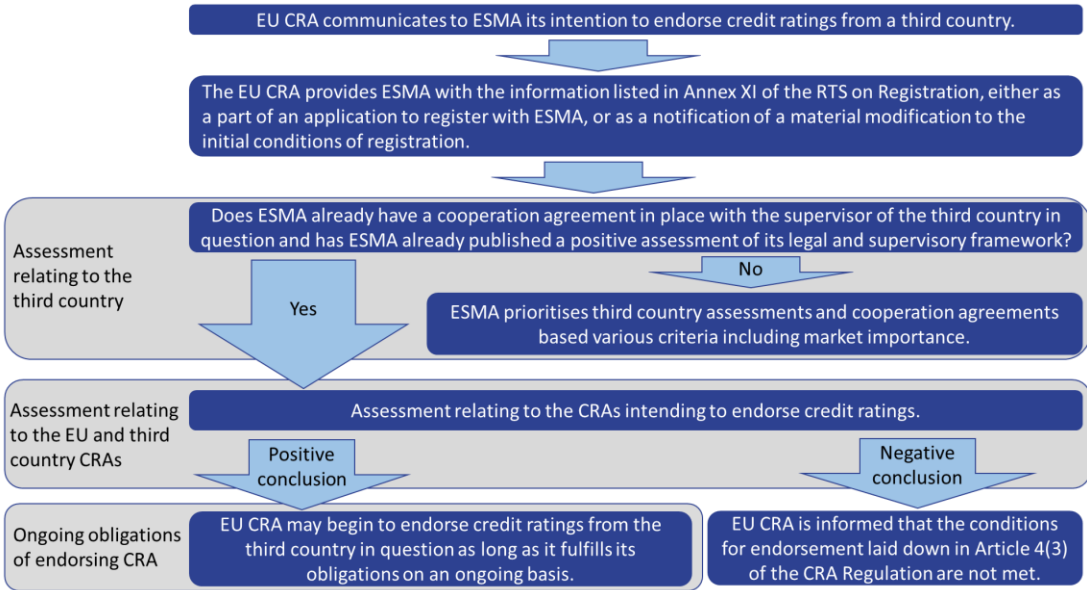
³⁰ As set out in International Accounting Standard no. 28: Investments in Associates and Joint Ventures, paragraphs 5-6.

Annex II: Methodological framework for assessing a third country supervisory and legal framework for the purpose of endorsement

1 Background: The process of approving endorsement from a third country

1. Where an EU CRA intends to endorse credit ratings issued in third countries, it must communicate to ESMA its intention to do so either in its application for registration or as material change to the initial conditions of registration. As set out in paragraph 9 of these guidelines, an EU CRA should not begin endorsing credit ratings, before ESMA has completed two separate assessments: (1) an assessment of the conditions relating to the legal and supervisory framework of the third country including the existing of a cooperation agreement between ESMA and the third-country supervisor (the third-country assessment) as and (2) an assessment of the conditions relating to the CRAs intending to endorse credit ratings. Subsequent to these assessments, an EU CRA which endorses credit ratings issued in a third country should ensure continued compliance with all the conditions set out in article 4(3) of CRAR.
2. The result of the third-country assessment is made publicly available on ESMA’s website. Once published, the third-country assessment can be relied upon by all EU CRAs intending to endorse credit ratings from that third country. The result of the second assessment is communicated directly to the applicant CRA.
3. The below figure summarises the process of approving endorsement from a third-country.

FIGURE 1. THE PROCESS OF APPROVING ENDORSEMENT FROM A THIRD COUNTRY



2.1 Assessment relating to the third-country legal and supervisory framework

4. ESMA's third-country assessment is carried out in accordance with the methodological framework set out in Section 2 to this Annex. It verifies that the following conditions for endorsement are met:
 - there is a supervisor in the third country which authorises or registers CRAs and subjects them to ongoing supervision. For this condition to be met, ESMA considers that there should be a legal and supervisory framework for supervision of CRAs in the third country providing a level of protection which is comparable to CRAR (Article 4(3)(f) and (h) of CRAR);
 - the regulatory regime in that third country prevents interference by the competent authorities and other public authorities of that third country with the content of credit ratings and methodologies (Article 4(3)(g) of CRAR); and
 - ESMA has established a cooperation agreement with the supervisor of the third country (Article 4(3)(h) of CRAR).

2.2 Assessment of certain conditions relating to the CRAs intending to endorse credit ratings

5. ESMA's assessment relating to the CRAs intending to endorse credit ratings verifies that the following conditions for endorsement are met:
 - the credit rating activities resulting in the issuing of the credit ratings to be endorsed will be undertaken in whole or in part by the EU CRA or a CRA belonging to the same group of CRAs (article 4(3)(a) of CRAR);
 - the EU CRA has put in place measures to monitor that the conduct of the credit rating activities by the third-country CRA is fulfilling requirements which are as stringent as the EU Regulation (Article 4(3)(b) of CRAR as explained further in paragraph 15 of these guidelines);
 - the EU CRA has provided an indication of the objective reasons for credit ratings to be elaborated in a third country (Article 4(3)(e) of CRAR as explained further in paragraphs 21-23 in these guidelines); and
 - the EU CRA can provide evidence that that the third-country CRA is authorised or registered in the third country where it is established (Article 4(3)(f) of CRAR).

2.3 Summary of the conditions for endorsement

6. The below table provides a summary of the conditions laid down in Article 4(3) which should be fulfilled for the endorsement regime to be operational. The table indicates which

of the conditions are assessed by ESMA before an EU CRA begins endorsing credit ratings.

7. The symbol “✓” indicates when a requirement is assessed. The exclamation mark “!” indicates that an endorsing CRA is expected to notify ESMA without undue delay if it becomes aware that the conditions initially assessed by ESMA are no longer met.

FIGURE 1: CONDITIONS FOR ENDORSEMENT

Relevant Level 1 provision	Conditions laid down in Article 4(3)	Assessment, which ESMA undertakes before a CRA starts endorsing, relating to...		Ongoing obligations of endorsing CRA
		...the third country	...the endorsing and third-country CRAs	
4(3)(a)	The credit rating activities resulting in the issuing of the credit ratings to be endorsed will be undertaken in whole or in part by the EU CRA or a CRA belonging to the same group of CRAs.		✓	!
4(3)(b)	The endorsing CRA has put in place measures to monitor that the conduct of the credit rating activities by the third-country CRA is fulfilling requirements which are as stringent as the EU Regulation.		✓	!
4(3)(b)	The endorsing CRA is able to demonstrate on an ongoing basis that the third-country CRA is fulfilling requirements which are at least as stringent as the relevant EU requirements.			✓
4(3)(c)	The endorsing CRA ensures on an ongoing basis that the ability of ESMA to assess and monitor the compliance of the third-country CRA with the requirements referred to in point (b) is not limited;			✓
4(3)(d)	The endorsing CRA makes available on request to ESMA all the information necessary to enable ESMA to supervise on an ongoing basis the compliance with the requirements of this Regulation.			✓
4(3)(e)	The endorsing CRA has documented an objective reason for elaborating every single endorsed rating in a third country.			✓
4(3)(e)	the EU CRA has provided ESMA with an indication of the objective reasons for credit ratings to be elaborated in a third country.		✓	!
4(3)(f)	The EU CRA can provide evidence that that the third-country CRA is authorised or registered in the third country where it is established.		✓	!
4(3)(f) and (h)	There is a supervisor in the third country which authorises or registers third-country CRAs and subjects them to supervision. For this condition to be met there should be a legal and supervisory framework for supervision of CRAs in the third-country which is comparable to the EU framework.	✓		!
4(3)(g)	The regulatory regime in the third country prevents interference by the competent authorities and other public authorities of that third country with the content of credit ratings and methodologies.	✓		!
4(3)(h)	An appropriate cooperation arrangement has been established between ESMA and the relevant supervisory authority of the CRA established in a third country.	✓		

2 Methodological framework for assessing a third-country supervisory and legal framework for the purposes of endorsement

1. For the purposes of this assessment, ESMA has grouped the requirements from CRAR into different sections depending on the objective each provision seeks to address. These sections are discussed in further detail below and are as follows:

2.1 Scope of the regulatory and supervisory framework

2.2 Corporate governance

2.3 Conflicts of interest management

2.4 Organisational requirements

2.4.1 General organisational requirements

2.4.2 Outsourcing

2.4.3 Confidentiality

2.4.4 Record Keeping

2.5 Quality of methodologies and quality of ratings

2.5.1 Reviewing credit ratings, methodologies, models and assumptions and information used in issuing ratings

2.5.2 Knowledge and experience of employees directly involved in credit rating activities

2.5.3 Quality of credit ratings and analysis of information used in assigning credit ratings

2.5.4 Quality of methodologies and changes to them

2.6 Disclosure

2.6.1 Presentation and disclosure of credit ratings

2.6.2 General and periodic disclosure about the CRA

2.7 supervision and enforcement

2.7.1 The methods that the third-country authority has in place to ensure that it is adequately staffed

2.7.2 Powers of the third country authority

2.7.3 Sanctions

2.1 Scope of the legal and supervisory framework

2. The purpose of assessing the legal and supervisory framework of a third country is to determine whether that framework achieves the same objectives in practice as the EU framework. If ESMA is not satisfied that a framework achieves these objectives, then a positive conclusion cannot be reached.
3. In this regard, the following elements need to be in place in order to meet the initial requirements for endorsement:
 - (a) CRAs are subject to some form of registration or authorisation process as well as ongoing supervision (Articles 4(3)(f) of CRAR);
 - (b) The above requirement as well as Article 4(3)(h) presuppose that there is some form of legally binding regulatory and supervisory framework for CRAs in place;
 - (c) the scope of the activities of a CRA that are subject to the third-country legal and supervisory framework includes the scope of activities that is included in the EU regime (Article 3(1)(a), (b) and (w) of CRAR);
 - (d) the relevant authority is prohibited from influencing the content of ratings and methodologies (Articles 4(3)(g) of CRAR).
4. In respect of the points above, point a) is further developed in subsection 2.7 below regarding what ESMA considers needs to be in place for ongoing supervision.
5. Of the other requirements set out in paragraph 2 above, it is point c) that needs further elaboration below. There needs to be legal clarity regarding what a CRA is, or the activities that it conducts are, and these need to broadly cover what CRAR covers. While CRAR provides a definition of a rating outlook in Article 3(1)(w), ESMA may accept that no such explicit definition is provided in a third-country legal framework. However, rating outlooks should be covered by the same safeguards that ensure the quality, independence, timely disclosure and confidentiality of credit ratings.
6. Where exemptions are permissible according to third-country laws and regulations, such exemptions need to be considered in order to verify that they do not hamper the compliance with the objectives of CRAR.
7. Looking at the requirements of CRAR, this means that the definition of a CRA or the activities that it conducts do not need to be identical, but they need to have requirements regarding independence, conflicts of interest, quality of methodologies, disclosure of ratings, confidentiality of information and record keeping which are comparable to CRAR.
8. ESMA will look at the legal definition of what a CRA is, what activities are covered and also at the nature of the exemptions that can be applied.
9. In looking at the definition of a CRA, ESMA will consider whether or not the definition means that individuals as opposed to legal entities could be considered as CRAs, as this could have implications for the recourse of those relying on those ratings. A definition of

CRAs, which is broader in scope than the EU definition, is acceptable for the purpose of endorsement.

10. ESMA points out that a third-country legal and supervisory framework may not require all CRAs to be registered or authorised with the relevant authority, but only those that want to enable their ratings to be used for what ESMA considers to be those circumstances covered by Article 4(1) of CRAR (referred to as “use for regulatory purposes” in this document) need to be registered or authorised.
11. ESMA highlights that Articles 4 of CRAR make specific reference to the use of credit ratings issued in a third country for regulatory purposes in the EU and require the CRA in question to be registered or authorised in that third country. In addition, ESMA highlights that it does not expect the concept of “use for regulatory purposes” in a third-country legal and supervisory framework to be the same. In cases where the third-country legal and supervisory framework is broad for the purpose of endorsement, ESMA is only focusing on those aspects of the third country framework that relate to the use of credit ratings for “regulatory purposes”.

Exemptions

12. In terms of assessing the exemptions that can be applied and how the authority in question exercises its discretion in respect of these exemptions, any exemptions need to be assessed for the following reasons.
13. It is acceptable that there are no exemptions set out in the third-country legal and supervisory framework because, the exemptions allowed under CRAR exist in order to facilitate competition, recognising that the nature, scale, and complexity of a CRA’s business and the nature and range of its credit ratings, may in certain circumstances warrant that the agency can be exempted from complying with some requirements.
14. Where exemptions are allowed, ESMA looks at what the nature of these exemptions are or can be, looking at whether it is ensured that users of ratings in the EU would benefit from equivalent protections in terms of CRA’s integrity, transparency, good governance and reliability of the credit rating activities.
15. ESMA must be satisfied that the exemptions do not prevent the achievement of this objective in practice, and there is legal clarity as to how the authority will exercise its discretion in respect of applying exemptions for attaining registered or authorisation status.

2.2 Corporate governance

16. Corporate governance is a core aspect of CRAR and as such sets out a large number of detailed and prescriptive requirements in Article 6 and Section A of Annex I of CRAR.
17. ESMA considers that the key objectives of CRAR’s requirements with respect to corporate governance are to ensure that senior management is responsible and legally accountable for ensuring:

- (a) that credit ratings activities are independent;
 - (b) that there is proper management of conflicts of interest; and
 - (c) compliance with the legal requirements of the regulatory framework.
18. ESMA points out that, as set out in recitals 28, 29 and 30 of CRA I, corporate governance arrangements are necessary to ensure that credit ratings are independent, objective, and of adequate quality.
19. ESMA considers that there, as a minimum, needs to be some form of requirement established by law in the third-country that a corporate governance structure is in place to ensure that senior management is accountable and ensures monitoring by someone who is independent 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 CRA of the following:
- (a) the development of credit rating policy and of the methodologies used by the CRA in its credit rating activities;
 - (b) effectiveness of the internal quality control system;
 - (c) effectiveness of measures and procedures instituted to ensure that any conflicts of interest are identified, eliminated or managed and disclosed; and
 - (d) compliance and governance processes.

2.3 Conflicts of interest management

20. ESMA deems that conflicts of interest management is a core requirement of CRAR in order to ensure that it meets the overall objective.
21. ESMA considers the objectives of the conflicts of interest management requirements of CRAR are to ensure:
- (a) objectivity, independence, integrity, and quality of the credit ratings;
 - (b) transparency about the credit ratings; and
 - (c) the protection of investors and financial markets.
22. CRAR sets out a number of detailed requirements that have to be met by CRAs in order to ensure that these objectives are achieved in Article 6, Article 7(2)-(5) and Sections A, B, and C of Annex I. In addition to those aspects of conflicts of interest covered in the corporate governance section above, ESMA considers that the third-country legal framework should, as a minimum, require a CRA to:
- (a) be organised in a manner that ensures that its business interests do not impair the independence and accuracy of its credit rating activities;

- (b) establish appropriate and effective organisational and administrative arrangements to prevent, identify, eliminate, or manage and disclose any conflicts of interest;
 - (c) identify, eliminate, or manage and disclose clearly and prominently any actual or potential conflicts of interest;
 - (d) ensure that the provision of ancillary services do not present conflicts of interest with its credit rating;
 - (e) design its reporting and communication channels so as to ensure independence of related persons from the other activities of the CRA carried out on a commercial basis;
 - (f) ensure that compensation and performance evaluation of the rating analysts and persons approving the credit ratings are not linked to the amount of revenue they generate;
 - (g) have requirements whereby those who know of illegal conduct by others report it to the compliance officer without negative consequences; and
 - (h) establish, maintain, enforce and document an effective internal control structure governing the implementation of policies and procedures to prevent and mitigate possible conflicts of interest and to ensure the independence of credit ratings, rating analysts and rating teams regarding shareholders, administrative and management bodies and sales and marketing activities.
27. In addition to the above, a CRA as well as individuals and entities, who are in a position to exercise significant influence on the business activities of a CRA are prohibited from providing consultancy or advisory services to a rated entity or a related third party. Furthermore, rating analysts are prohibited from engaging in transactions in financial instruments issued, guaranteed or otherwise supported by the rated entity.
23. ESMA believes that conflicts of interest management is fundamental to the ability of CRAR to achieve its objectives and does expect, that there are robust provisions reflected in the law that cover actual or potential conflicts of interest management and disclosure.
24. As such, ESMA considers that, in addition to those aspects of corporate governance set out in paragraphs 16 to 19, overall, the objectives of each individual conflict of interest management requirement described in paragraphs 20 to 27 above should be met through provisions reflected in the third-country legal and regulatory framework, together with proper supervision.

2.4 Organisational requirements

25. ESMA considers that the overall objective of the organisational requirements is to contribute to ensuring the objectivity, independence, integrity, and quality of the credit rating activities.

26. CRAR sets out a number of organisational requirements that CRAs need to have in place in order to be able to demonstrate its ability to meet these objectives and compliance with them.

27. These requirements can be divided as follows:

- I) General organisational requirements;
- II) Outsourcing;
- III) Confidentiality; and
- IV) Record keeping.

2.4.1 General organisational requirements

28. Article 6(2) and paragraphs (3)-(6), (8), (10) of Section A of Annex I of CRAR requires establish general organisational requirements. The local regulatory framework should at least require a CRA to:

- (a) establish adequate policies and procedures that ensure compliance of its obligations under the relevant legislation;
- (b) have sound administrative and accounting procedures, internal control mechanisms designed to secure compliance with decisions and procedures at all levels, effective procedures for risk assessment, effective control and safeguard arrangements for information processing systems;
- (c) implement and maintain decision making procedures and organisational structures that clearly and in a documented manner specify reporting lines and allocates functions and responsibilities;
- (d) establish and maintain a permanent and effective compliance function which operates independently;
- (e) employ appropriate systems, resources and procedures to ensure continuity and regularity in the performance of its credit rating activities; and
- (f) monitor and evaluate the adequacy and effectiveness of its systems, internal control mechanisms and arrangements established in accordance with the authorities' requirements and take appropriate measures to address any deficiencies.

29. ESMA considers that the above mentioned requirements are necessary to facilitate the CRA's ability to achieve the objectives set out in paragraph 25 above, although it does not expect the identical requirements to be hard wired into a third-country regulatory framework.

30. ESMA needs to take an in-depth look at what organisational requirements are in place as a package, and in addition consider the nature and extent of the supervisory and enforcement powers and practices that are in place, as discussed below.
31. Having assessed what is in place as a package, ESMA considers that the overall organisational requirements must objectively achieve the purposes discussed above in order to reach the initial condition for endorsement.
32. In this regard, ESMA may accept that there may not be an identical requirement set out in the law to have a permanent and effective compliance function which operates independently, but it does expect the objective of this requirement to be in place.

2.4.2 Outsourcing

33. Article 9 of CRAR prohibits outsourcing of important operational functions in such a way so as to impair materially the quality of the CRA's internal control and the ability of the authorities to supervise the credit ratings agency's compliance under CRAR.
34. In assessing this prohibition for endorsement purposes, it should be clear:
 - (a) if any outsourcing of important operational functions is allowed;
 - (b) if any restrictions in respect of outsourcing exist;
 - (c) whether or not the regulatory framework ensures that:
 - i. none of the outsourced functions impair the quality of the CRA's internal controls; and
 - ii. that the outsourcing does not impair the ability of the relevant authority to supervise the CRA's compliance with its regulatory obligations.
35. In respect of these requirements, ESMA considers that, where outsourcing is allowed in the third country, the third-country regulatory framework should set out conditions for outsourcing aimed at ensuring that the following objectives are achieved:
 - (a) none of the outsourced functions impair the quality of the CRA's internal controls, and
 - (b) the ability of the authority to supervise the CRA's compliance with its legal obligations is not impaired.
36. In addition, ESMA expects that if outsourcing is allowed:
 - (a) there needs to be legal clarity regarding what can be outsourced; and
 - (b) the legal responsibility for what is being outsourced shall remain with the CRA.

2.4.3 Confidentiality

37. Requirements relating to confidentiality are important because of the nature of the information that the CRA and its employees have access to. There is a need to ensure that confidential information is only used for purposes related to credit rating activities and is protected from fraud, theft or misuse.
38. CRAR imposes a number of confidentiality obligations on rating analysts, employees of the CRA as well individuals whose services are placed at the disposal or under the control of the CRA and who are directly involved in credit rating activities as well as individuals closely associated with them as set out in Article 7(3) and Annex I Section C paragraph 3 of CRAR. ESMA expects that at least the following requirements are established by law in the third-country:
 - (a) to take all reasonable measures to protect property and records in possession of the CRA from fraud, theft or misuse;
 - (b) to not disclose any information about credit ratings or future ones other than to the rated entity or its related third party;
 - (c) to keep information entrusted to the CRA confidential; and
 - (d) to not use or share confidential information for trading purposes or any other purpose other than credit rating activities.

2.4.4 Record Keeping

39. Effective record keeping enables a CRA to document the manner in which it meets its legal obligations, as well as allows its regulator to supervise that this is being done.
40. Article 6(2) and paragraphs (7)-(9) of Section B of Annex I of CRAR require CRAs to keep adequate records and, where appropriate, audit trails of their credit rating activities for at least five years and make them available upon request to the competent authority.
41. ESMA considers this requirement to be crucial but can accept that the period of time for which records need to be kept may differ from jurisdiction to jurisdiction, but whatever is in place has to be reasonable.

2.5 Quality of Methodologies and Quality of Ratings

42. In addition to the general organisational requirements referred to above, CRAR sets out a number of requirements aimed at ensuring the following objectives:
 - (a) that the methodologies, models and key rating assumptions that are used in credit rating activities are rigorous, continuous and thorough;
 - (b) the adequate quality, integrity and thoroughness of the credit rating activities;

- (c) the protection of the stability of financial markets and of investors (as set out in recital 7 of CRAR); and
 - (d) that ratings and methodologies are subject to validation as well as the adequate quality and thoroughness of ratings.
43. These requirements are set out in Article 6(2) – paragraph (9) of Section A of Annex I, Article 7(1), Articles 8(2), 8(3), 8(4), 8(5), 8(6), Article 10(2) and part I of Section D of Annex I of CRAR, and can be divided into the following areas:
- I) Reviewing credit ratings, methodologies, models and assumptions and information used in issuing ratings;
 - II) Knowledge and experience of employees directly involved in credit rating activities;
 - III) Quality of credit ratings and analysis of information used in assigning credit ratings; and
 - IV) Quality of methodologies and changes to them.

2.5.1 Reviewing credit ratings, methodologies, models and assumptions and information used in issuing ratings

44. CRAR sets out a number of requirements dealing with the review of credit ratings, methodologies, models and assumptions as well as the need to review the information used in issuing ratings in Article 8(2), Article 8(5), Article 8(6) and paragraph (9) of Section A of Annex I.
45. The local legal framework should at least ensure that CRAs:
- (a) have staff devoted to the periodical review of methodologies, models, key rating assumptions, independent from those that are responsible for the development and use of these methodologies, key rating assumptions and models;
 - (b) monitor its ratings and methodologies on an on-going basis; and
 - (c) review the affected credit ratings as soon as possible.
46. ESMA considers it important that methodologies are up-to-date and subject to a comprehensive review on a periodic basis.

2.5.2 Knowledge and experience of employees directly involved in credit rating activities

47. CRAR sets out requirements relating to the knowledge and experience of CRA's employees directly involved in credit rating activities in Article 7(1). Specifically, CRAs have to ensure that rating analysts, employees of the CRA, and any other natural person directly involved in credit rating activities have appropriate knowledge and experience for the duties assigned.

48. ESMA considers it important that those involved in credit rating activities have the necessary skills and knowledge to carry out their respective responsibilities, and that this is an area that needs to be covered in the relevant third-country framework.

2.5.3 Quality of credit ratings and analysis of information used in assigning credit ratings

49. CRAR sets out a number of requirements dealing with the quality of ratings and the information that credit rating analysts have to use when assigning ratings, as well as ensuring that the information is up to date and accurate.

50. These requirements are set out in Articles 8(2), 8(5), 10(2), and part I of Section D of Annex of CRAR. ESMA considers, the that the following requirements should at least be reflected in the regulatory framework:

(a) 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;

(b) to adopt all necessary measures so that the information they use in assigning a credit rating is of sufficient quality and from reliable sources; and

(c) to refrain from issuing a credit rating or withdraw an existing rating if they do not have sufficient quality information to base their ratings on.

51. ESMA considers these requirements are important for the purpose of achieving the objective of ensuring that the ratings being issued are robust, well founded and based on reliable information and overall are of adequate quality.

2.5.4 Quality of methodologies and changes to them

52. CRAR sets out a number of requirements relating to the quality of methodologies and what needs to be done when methodologies, models or key rating assumptions used in credit rating activities are changed, as set out in Article 8(3) and 8(6) (a)-(c) of CRAR. ESMA considers that at least the following should be in place in regulatory framework of the third country:

(a) use rating methodologies that are rigorous, systematic, continuous and subject to validation based on historical experience, including back-testing;

(b) apply the changes in methodologies and models consistently to existing ratings; and

(c) immediately disclose the likely scope of credit ratings to be affected by using the same means of communication as was used for the distributions of the affected credit ratings.

2.6 Disclosure

53. The information that has to be disclosed either to the public or the supervisor in respect of credit ratings and the CRA and its activities forms another set of core requirements.
54. For the purpose of endorsement, ESMA has subdivided CRAR's disclosure requirements as follows:
 - I) Presentation and disclosure of credit ratings.
 - II) General and periodic disclosure about the CRA.

2.6.1 Presentation and disclosure of credit ratings

55. In light of the number of presentation and disclosure of ratings requirements, ESMA has further categorised these requirements into:
 - (a) General provisions on the presentation and disclosure of any credit ratings; and
 - (b) Additional requirements in respect of the presentation and disclosure of credit ratings for structured finance products.

General provisions on the presentation and disclosure of any credit ratings

56. CRAR sets out a number of detailed requirements relating to the disclosure and presentation of ratings. ESMA considers that the objectives of these requirements aim at ensuring that ratings are disclosed in a timely manner and in a non-selective basis, and that adequate information is provided to the users of credit ratings in order to allow them to conduct their own due diligence when assessing whether or not to rely on those credit ratings.
57. Article 10(1), (4), (5), (6) Article 11(2), and paragraph (5) of Section D of Annex I of CRAR sets out certain requirement of which at least the following should be in place in the third-country legal framework, CRAs are required to:
 - (a) disclose any credit rating on a non-selective basis and in a timely manner;
 - (b) refrain from using the name of the competent authority in such a way that would indicate endorsement or approval by that authority of the credit rating or any credit rating activities of the CRA;
 - (c) disclose its policies and procedures regarding unsolicited credit ratings and ensure that unsolicited credit ratings are identified as such; and
 - (d) when announcing a credit rating, to explain in their press releases or reports the key elements underlying the credit rating.
58. In addition, according to Article 8(2), 8(2a), 10(2)-(2a) and paragraphs (1), (2), (4) of Section D of Annex I of CRAR, CRAs should ensure that a range of information is

indicated in the credit ratings or rating outlooks. At least the following should be established by law in the third-country:

- (a) all substantially material sources used to prepare the credit rating, with an indication of whether the credit rating has been disclosed to that rated entity or its related third party and amended following that disclosure;
- (b) the principal methodology or methodology version that was used in determining the rating, with a reference to its comprehensive description; and
- (c) any attributes and limitations of a credit rating, and in particular to what extent the CRA has examined the quality of information used in the rating process and whether it is satisfied with the quality of information it bases its rating on.

2.6.2 General disclosure about the CRA

59. In addition to the requirements on disclosure and presentation of credit ratings, CRAR imposes a number of prescriptive disclosure requirements on CRAs in relation to their organisation and their activities, including the methodologies they use for determining and publishing credit ratings.
60. ESMA considers that the objectives of the general disclosure requirements of CRAR are aimed at ensuring transparency about credit rating activities, at making information available to the public to allow it to perform an assessment on whether to rely on certain credit ratings as well as at providing information to competent authorities for the purpose of on-going supervision.
61. According to Article 11(1) and Part I of Section E of Annex I of CRAR, a CRA is required to generally disclose to the public a range of information. For the purpose of this assessment, ESMA expects at least the following to be in place:
- (a) the fact that it is registered;
 - (b) a list of ancillary services;
 - (c) the policy of the CRA concerning the publication of credit ratings and other related communications;
 - (d) the methodologies, and descriptions of models and key rating assumptions as well as their material changes; and
 - (e) where relevant, its code of conduct.
62. Furthermore, ESMA expects the third-country legal and supervisory framework to impose some form of disclosure requirement regarding revenue generation by the CRA and that the third-country supervisor has the power to request all the information listed above, concerning, among others, the compensation arrangements, fees and the pricing policy.

2.7 Supervision and enforcement

63. Article 4(3)(f) of CRAR include as preconditions for endorsement that the CRA established in the third country is authorised or registered, and is subject to supervision in that third country. In addition, the coordination arrangements that need to be in place in accordance with Articles 4(3)(h) have to include provisions relating to the “coordination of supervisory activities...”. Both requirements presuppose the existence of a supervisor undertaking supervisory activities on an ongoing basis.
64. The following provides a fixed set of criteria for assessing a third-country supervisory regime. In assessing the nature of a third-country supervisory framework, ESMA divided the requirements into the following areas:
- I) the methods that the authority has in place to ensure that it is adequately staffed;
 - II) the powers of the relevant authority; and
 - III) the nature of the penalties that can be imposed.
65. ESMA points out that it does not make any judgments regarding the approach that the third country regulator adopts in relation to on-going supervision, for example, whether a risk-based approach is a good or bad thing, but is overall looking to get comfort that the supervision that will or is being done can be or is in practice effective.

2.7.1 The methods that the third-country authority has in place to ensure that it is adequately staffed

66. The nature of supervision and enforcement that takes place in respect of monitoring and supervising the CRAs’ adherence to their obligations and taking action where they do not, is heavily dependent upon the number of staff that the relevant authority charged with the legal responsibility of supervising these entities has in place.
67. Article 22(2) of CRAR requires that competent authorities in the EU be adequately staffed, with regard to capacity and expertise, in order to be able to apply CRAR. ESMA does not expect to find a similar legal provision but ESMA does expect that there will be an adequate number of staff.
68. Without the necessary staff there cannot be “ongoing supervision”, as such, ESMA has sought to understand how the regulator in question either already does, or will, in the future be organising itself, and how many staff it has or will have.

2.7.2 The powers of the relevant authority

69. Articles 23b-23d of CRAR sets out the details of the powers ESMA has order to be able to discharge its legal duties under CRAR.
70. For the purposes of this assessment, ESMA expects at least the third-country authority to have the power to:

- (a) access to any document in any form and to receive or take a copy thereof;
 - (b) demand information from any person and if necessary to summon and question a person with a view to obtaining information.
71. carry out on-site inspections In addition, as set out in Article 24 of CRAR, the third-country authority has to be able to take the following measures following an infringement by a CRA:
- (a) to withdraw the CRA's registration or authorisation;
 - (b) to prohibit the CRA from temporarily issuing credit ratings;
 - (c) to suspend the use of credit ratings issued by the CRA for regulatory purposes;
 - (d) to take appropriate measures to ensure that the CRA continues to comply with its legal requirements; and
 - (e) to issue public notices.

2.7.3 Sanctions

72. Article 36 of CRAR sets out that the penalties that can be imposed need to be: “effective, proportionate and dissuasive” – but leaves it to each authority to determine what these should be.
73. ESMA expects that the relevant third-country framework has legal provisions setting out what the penalties that can be imposed for breaches of the relevant requirements are, but does not expect these penalties to be published.