

**Regulatory Implementation  
of the Statement of Principles Regarding the  
Activities of Credit Rating Agencies**

**Final Report**



**IOSCO**

**TECHNICAL COMMITTEE  
OF THE  
INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS**

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## Chapter 1 Executive Summary

This Final Report of the Technical Committee (TC) of the International Organization of Securities Commissions (IOSCO) addresses several of the recent regulatory initiatives that impact or will shortly impact credit rating agencies (CRAs) that are active in multiple jurisdictions. In particular, the paper reviewed CRA supervisory initiatives in Australia, the European Union (EU), Japan, Mexico, and the United States (US) in order to evaluate whether, and if so how, these regulatory programs implemented the four principles set forth in the 2003 IOSCO paper *Statement of Principles Regarding the Activities of Credit Rating Agencies* (IOSCO CRA Principles)<sup>1</sup>.

The four principles address:

- 1) quality and integrity in the rating process;
- 2) independence and conflicts of interest;
- 3) transparency and timeliness of ratings disclosure; and
- 4) confidential information.

The Technical Committee Standing Committee on Credit Rating Agencies (TCSC6) undertook the evaluation work that underlies this paper. TCSC6 is a newly formed permanent standing committee of the TC that is continuing the work of the Task Force on Credit Rating Agencies created by the TC in 2003 (CRA Task Force).

TCSC6's evaluation reveals that although the structure and specific provisions of CRA regulatory programs may differ, the objectives of the four IOSCO CRA Principles are embedded into each of the programs. Indeed, the principles appear to be the building blocks upon which CRA regulatory programs have been constructed, as illustrated in the following examples.

The first principle – quality and integrity in the rating process – is given effect in the regulatory programs through, for example, explicit requirements on CRAs to adopt, implement and enforce measures to ensure that credit ratings are based on a thorough analysis of all available and relevant information and that the information they use in developing credit ratings is of sufficient quality and from reliable sources. The regulatory programs reviewed also give effect to the first principle through provisions that implicitly mandate measures designed to promote quality ratings by providing authority to the supervisor to deny or revoke the registration of, or to impose remedial measures on, a CRA that does not have adequate financial and managerial resources to consistently produce credit ratings with integrity.

The second principle – independence and conflicts of interest – is given effect in the regulatory programs through, for example, provisions that require a CRA to implement

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<sup>1</sup> *IOSCO Statement Of Principles Regarding The Activities Of Credit Rating Agencies*, Statement of the Technical Committee of IOSCO September 2003 available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD151.pdf>.

procedures designed to identify and eliminate conflicts of interest inherent in its business activities. Another provision that is common to the jurisdictions reviewed, requires a CRA to manage and publicly disclose to the market the conflicts of interest inherent in its business activities. Several jurisdictions' regulatory programs also identify certain conflicts that a CRA is prohibited from having under any circumstances. For example, CRA analysts generally are prohibited from participating in determining credit ratings for securities that they directly own.

The third principle – transparency and timeliness of ratings disclosure – is given effect in the regulatory programs through, for example, provisions that require a CRA to publicly disclose to the market information about the methodologies it uses to determine credit ratings. Another common provision across the jurisdictions is the requirement to disclose statistics and other information about the performance of a CRA's credit ratings.

The fourth principle – confidential information – is given effect in the regulatory programs through, for example, provisions that require CRAs to protect confidential information obtained from entities being rated so that the information cannot be used for inappropriate purposes (e.g., insider trading). Jurisdictions also commonly have provisions that require CRAs to implement processes to ensure that ratings decisions are not disclosed selectively but instead are broadly disseminated to the public (whether for free or through subscription).

The TC notes that the CRA supervisory initiatives in the jurisdictions addressed in this consultative paper are in various stages of implementation. For example, the initiatives in Australia, Japan and the EU will become effective to varying degrees during 2010. The US CRA supervisory program became effective in June 2007, and the first set of CRAs registered pursuant to that program became subject to its full requirements in September 2007. However, the US has engaged in two subsequent rounds of rulemaking (largely in response to CRAs' roles in the credit crisis). Similarly the Mexican regulatory program for CRAs has been augmented through subsequent grants of authority and rulemaking since the initial grant of supervisory authority in 1993.

As this activity demonstrates, the transition from conceiving a CRA supervisory program to effectively applying its requirements in practice involves an ongoing process of re-evaluation as practical considerations emerge. For example, some of the subsequent rulemaking in the US was informed by examinations of the CRAs that occurred once they became subject to the new supervisory program.

The actual exercise of supervisory authority over CRAs, including through examinations and monitoring, provides the best vantage point from which to evaluate the effectiveness of CRA requirements. In this regard, TCSC6 has a mandate to provide a forum for CRA supervisors to share their observations on how well their local requirements give effect to the IOSCO CRA Principles in practice. This forum will be helpful to regulators in enhancing international supervisory cooperation in the implementation of their respective jurisdictions' programs, as well as in addressing potential conflicts that may arise from the differing regulatory requirements imposed by different jurisdictions upon globally operating CRAs.

Finally, the TC notes that the regulatory implementation of the IOSCO CRA Principles should not be viewed as the sole means of addressing the issue of potential overreliance on credit ratings or the impact of their use by market participants and regulators.<sup>2</sup>

TCSC6 also intends to continue its work on reviewing how the various CRA regulatory initiatives impact CRAs that are active in more than one jurisdiction. TCSC6 has engaged with CRAs of varying sizes and business models to gain an understanding of how differing requirements across jurisdictions may impact their operations or subject them to conflicting legal requirements. The findings of this ongoing consultative effort will be conveyed to the TC on a continuing basis so that local authorities can take them under consideration as they evaluate and develop their respective CRA supervisory programs and enhance international supervisory cooperation as necessary.

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<sup>2</sup> See, e.g., *The Role of Credit Rating Agencies in Structured Finance Markets – Final Report*, May 2008, available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD270.pdf>; *Report of the Task Force on the Subprime Crisis—Final Report, Report of the Technical Committee of IOSCO*, May 2008, available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD273.pdf>.

## Chapter 2 Background

### A. The Work of IOSCO Relating to CRAs

In 2003, the TC formed the CRA Task Force to study issues related to the activities of CRAs. Shortly after its creation, the CRA Task Force issued the IOSCO CRA Principles. The paper outlines a set of principles that regulators, CRAs and other market participants might follow as a way to better guard the integrity of the rating process and help ensure that investors are provided with ratings that are timely and of high quality.

The IOSCO CRA Principles articulate four objectives that rating agencies, regulators, issuers and other market participants should strive to achieve in order to improve investor protection and the fairness, efficiency and transparency of the securities markets as well as to reduce systemic risk.

These four objectives are:

- **Quality and integrity in the rating process** – CRAs should endeavor to issue opinions that help reduce the asymmetry of information among borrowers, lenders and other market participants;
- **Independence and conflicts of interest** – CRA rating decisions should be independent and free from political or economic pressures and from conflicts of interest arising due to the CRA's ownership structure, business or financial activities, or the financial interests of the CRA employees. CRAs should, as far as possible, avoid activities, procedures or relationships that may compromise or appear to compromise the independence and objectivity of credit rating operations;
- **Transparency and timeliness of ratings disclosure** – CRAs should make disclosure and transparency an objective of their ratings activities; and
- **Confidential information** – CRAs should maintain in confidence all non-public information communicated to them by any issuer, or its agents, under terms of a confidentiality agreement or otherwise under a mutual understanding that the information is shared confidentially.

In the paper articulating the four IOSCO CRA Principles, the TC stated that the manner in which these principles are given effect will depend upon local market circumstances and each jurisdiction's legal system. The TC further stated that in some cases the principles may be best implemented through internal mechanisms at CRAs and promoted by borrowers, lenders and other market participants. As a result, the TC noted that the mechanisms for implementing the principles may take the form of any combination of—

- Government regulation;
- Regulation imposed by non-government statutory regulators;
- Industry codes; and

- Internal rating agency policies and procedures.

Following the publication of the IOSCO CRA Principles, some commenters, including a number of CRAs, suggested that it would be helpful to develop a more specific and detailed code of conduct giving guidance on how the principles could be implemented in practice. In response, the CRA Task Force drafted the *Code of Conduct Fundamentals for Credit Rating Agencies* (IOSCO CRA Code)<sup>3</sup>, which the TC approved and published in 2004.

The IOSCO CRA Code was directed to CRAs and designed to serve as a model upon which CRAs could base their own codes of conduct as a way of implementing the IOSCO CRA Principles. Like the IOSCO CRA Principles, the IOSCO CRA Code was designed for CRAs of all sizes and business models operating around the world to help them guard against conflicts of interest, ensure that their rating methodologies are used consistently by their employees, provide investors with sufficient information to allow them to judge the quality of a CRA's ratings, and generally help ensure the integrity of the rating process.

In light of the role of CRAs in the credit crisis, IOSCO published an updated version of the IOSCO CRA Code in May 2008<sup>4</sup> to address issues arising in relation to the activities of CRAs in the structured finance market. The amendments aimed to improve the quality and integrity of the rating process, disclosure of ratings methodologies and historic performance data, and to prevent conflicts of interests.

In March 2009, the TC published its *Review of Implementation of the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies*.<sup>5</sup> The final report reflected the comments received from 16 credit rating agencies<sup>6</sup> to a consultative version of the review, published in February 2007.<sup>7</sup> The purpose of both the consultation and final report was to determine the extent to which credit rating agencies had incorporated the IOSCO CRA Code (including as amended in 2008) into their own codes of conduct.<sup>8</sup> Among the 32 CRAs reviewed for the consultative report, a number were found to have substantially implemented the IOSCO CRA Code. This group included the three largest CRAs. A somewhat larger group of CRAs had partially implemented the IOSCO CRA Code, while a relatively large group of CRAs (which mostly included smaller CRAs) had only minimal or non-existent implementation of the IOSCO CRA Code.

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<sup>3</sup> *Code of Conduct Fundamentals for Credit Rating Agencies*, Report of the Technical Committee of IOSCO December 2004 available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD180.pdf>.

<sup>4</sup> *Code of Conduct Fundamentals for Credit Rating Agencies*, Report of the Technical Committee of IOSCO May 2008 <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD271.pdf>.

<sup>5</sup> Available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD286.pdf>.

<sup>6</sup> Available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD249.pdf>.

<sup>7</sup> Available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD233.pdf>.

<sup>8</sup> With regard to both the consultation and final report, the CRA Task Force looked only at codes of conduct that were available to the public, and did not seek further information from the CRAs themselves. In particular, the CRA Task Force assessed (1) the degree to which CRAs have adopted codes of conduct that reflect the provisions of the IOSCO CRA Code, and (2) whether any trends exist with regard to whether CRAs consistently choose to “explain” (rather than comply with) specific provisions of the IOSCO CRA Code.

In May 2009, the TC converted the CRA Task Force into TCSC6, a permanent standing committee on CRAs, with a mandate to:

- 1) regularly discuss, evaluate and consider regulatory and policy initiatives vis-à-vis credit rating agency activities and oversight in an effort to seek cross border regulatory consensus through such means as the IOSCO CRA Code; and
- 2) facilitate regular dialogue between securities regulators and the credit rating industry.

## **B. The Implementation of CRA Regulation**

As a result of the credit crisis, a strong consensus emerged that further regulatory intervention was needed with respect to CRAs. Specifically, a consensus emerged that the IOSCO CRA Code, as an industry code that promoted CRAs to implement internal controls and processes designed to give effect to the IOSCO CRA Principles, should be supplemented with regulation of CRAs by national competent authorities. This consensus was encapsulated in the Group of Twenty (G20) *Declaration on Strengthening the Financial System* on 2 April 2009<sup>9</sup> (G20 Declaration), which stated, among other things, that all CRAs whose ratings are used for regulatory purposes should be subject to a regulatory oversight regime that includes registration and is consistent with the IOSCO CRA Code. The G20 Declaration further stated that IOSCO should coordinate full compliance.

In the US, initiatives to establish government regulation of CRAs began before the emergence of the credit crisis. These efforts culminated with the enactment of legislation in September 2006 governing the conduct of credit rating agencies whose ratings are used for regulatory purposes in the US.<sup>10</sup> The Credit Rating Agency Reform Act of 2006 established a registration and oversight program for CRAs through self-executing provisions and rulemaking, examination, and enforcement authority provided to the US Securities and Exchange Commission (SEC). In June 2007, the SEC adopted final rules to fully implement the registration and oversight program.<sup>11</sup>

Under the US regulatory program, CRAs must be registered with the SEC as “nationally recognized statistical rating organizations” (NRSROs) if their ratings are to be used for regulatory purposes in the US. The first seven CRAs, including the three largest CRAs, were granted registration as NRSROs in September 2007; subsequently, an additional three CRAs have been granted registration as NRSROs. Since June 2007, the SEC engaged in two subsequent rounds of rulemaking to enhance CRA supervision in light of the issues raised by the role of credit ratings in the credit crisis. These efforts culminated in final rules in February and December of 2009.<sup>12</sup> Additional rule proposals are pending.<sup>13</sup> In addition, the

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<sup>9</sup> Available at [http://g20.org/Documents/Fin\\_Deps\\_Fin\\_Reg\\_Annex\\_020409\\_-\\_1615\\_final.pdf](http://g20.org/Documents/Fin_Deps_Fin_Reg_Annex_020409_-_1615_final.pdf).

<sup>10</sup> Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291 (2006).

<sup>11</sup> 17 CFR 240.17g-1 through 17 CFR 240.17g-6.

<sup>12</sup> Amendments to Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 59342 (February 2, 2009), 74 FR 6485 (February 9, 2009); Amendments to Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 61050 (November 23, 2009), 74 FR 63832 (December 4, 2009).

<sup>13</sup> Proposed Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 61051 (November 23, 2009), 74 FR 63866 (December 4, 2009).



Dodd–Frank Wall Street Reform and Consumer Protection Act, enacted and signed into law in July 2010, made significant changes to the U.S. regulatory program which are not reflected in this report. These changes, however, do not materially impact the conclusions regarding the U.S. implementation of the IOSCO CRA Principles as discussed throughout this report.

In November 2009, the EU published a regulation (the EU Regulation) in its Official Journal requiring the registration and oversight of CRAs.<sup>14</sup> The regulation became effective on December 7, 2009. The EU Regulation requires that all CRAs established in the EU seek authorization from the relevant national authorities and, among other things, provides that only credit ratings issued by CRAs subject to the new regulations can be used by entities based in the EU for regulatory purposes.

In June 2009, the Japanese Diet passed legislation introducing a regulatory framework for CRAs, which was followed by the December 2009 release of Cabinet Orders and Cabinet Office Ordinances laying out the details of the terms and conditions of this framework.<sup>15</sup> The framework, which becomes effective in April 2010, requires CRAs to be registered with the Financial Services Agency of Japan (JFSA) and imposes additional obligations on broker-dealers, effective in October 2010, to provide detailed explanations to customers upon using ratings issued by unregistered entities.

In November 2008, the Australian Government announced its decision to require CRAs to be licensed.<sup>16</sup> This followed a review, announced in May 2008, by the Australian Securities and Investments Commission (ASIC) and the Australian Department of the Treasury. Since CRAs give “financial advice,” defined under the Australian Corporations Act to include opinions or reports that could reasonably be regarded as intended to influence a person in making a decision in relation to a financial product, CRAs are covered by the existing Australian licensing regime for all financial services providers. As a result, on January 1, 2010, ASIC revoked previously existing licensing relief for the three largest CRAs operating in Australia, and beginning on that date, CRAs operating in Australia have been required to hold an Australian Financial Services (AFS) license.

In Mexico, CRAs have been regulated and supervised by the National Banking and Securities Commission (CNBV) since July of 1993.<sup>17</sup> Authorization of CRAs has been required since the December 1999 enactment of the Regulation for CRAs,<sup>18</sup> which included, among other things, requirements to obtain authorization to operate as a CRA, requirements to maintain internal controls for the rating process, and qualification requirements for analysts. In 2005, the Mexican Congress amended the Securities Market Law in order to empower the CNBV to enact conduct rules for CRAs.<sup>19</sup> The rules adopted that same year by the CNBV incorporated

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<sup>14</sup> Regulation no. 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies.

<sup>15</sup> See <http://www.fsa.go.jp/news/21/20091222-4.html> (Japanese text only).

<sup>16</sup> See *Improved Australian Controls for Credit Rating Agencies and Research Houses*, Minister for Superannuation & Corporate Law Media Release No. 77, 13 November 2008, available at <http://www.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2008/077.htm&pageID=003&min=ns&Year=&DocType=>

<sup>17</sup> Amendment to the Securities Market Law, July 23, 1993, Article 41.

<sup>18</sup> Regulation for Securities Rating Institutions, December 9, 1999.

<sup>19</sup> Amendment to the Regulation for Securities Rating Institutions, December 15, 2005.

the principles set forth in the IOSCO CRA Code. Currently, the CNBV is working on a proposal to modify the Securities Market Law in order to enhance its powers to regulate, supervise and sanction misbehavior. In addition, a proposal to improve the Regulation for CRAs was sent to CRAs in November of 2009, opening a consultation period which was to finish by the end of January 2010.<sup>20</sup>

Finally, several other IOSCO member jurisdictions, including Hong Kong,<sup>21</sup> are in the process of developing regulations for CRAs.

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<sup>20</sup> The proposal contains, among other things, provisions relating to improving ratings of structured products; requirements to enhance transparency and disclosure of press releases; an obligation to file an annual report with the CNBV; and the improvement of internal controls, conflicts of interest mitigation requirements, and analyst rotation policies.

<sup>21</sup> In addition to engaging in the process of developing an oversight program for CRAs, the Hong Kong Monetary Authority has in place, with respect to banks in Hong Kong, policy provisions with regard to recognizing CRA as “external credit assessment institution” (ECAI) for Basel II purposes.

## Chapter 3 Scope and purpose of report

In light of the initiatives for government oversight of CRAs emerging in different jurisdictions, in September 2009, the TC approved a project specification for TCSC6, which, among other things, mandated TCSC6 to evaluate, in light of the IOSCO CRA Principles, several of the recent regulatory initiatives that impact or will shortly impact credit rating agencies whose ratings are used for regulatory purposes in multiple jurisdictions. The evaluation was to focus on whether, and if so how, these regulatory programs implement the IOSCO Principles. This report was developed in response to that mandate.

As previously stated above, the TC – when publishing the IOSCO CRA Principles – noted that the mechanisms for implementing the principles may take the form of any combination of, among other things, government regulation, industry codes, and internal CRA policies and procedures. The IOSCO CRA Code has served as an industry code and promoted the establishment of internal CRA policies and procedures to give effect to the IOSCO CRA Principles. The new government regulation in place or being implemented can – as noted by the TC – also provide a mechanism for implementing the principles in combination with the IOSCO CRA Code and the CRAs’ internal policies and procedures. The goal of this report is to describe how provisions in the various emerging CRA government regulations are designed to implement and promote the objectives in the four IOSCO CRA Principles.

For that purpose, TCSC6 conducted a survey in the form of a questionnaire to assess how laws and regulations established or being implemented (CRA regulatory programs) in the jurisdictions of member regulators promoted the objectives of the four IOSCO CRA Principles. The questionnaire requested information regarding whether the member regulator’s jurisdiction defined the term *credit rating agency*; the usage of credit ratings and/or references to credit rating agencies in the laws and regulations of the member regulator; how the member regulator’s CRA regulatory program promotes each of the four IOSCO CRA Principles; and the member regulator’s sanctioning authority for CRA violations of requirements in the jurisdiction’s CRA regulatory program.

The questionnaire was sent to all TCSC6 country members. In total, seven responses were received, respectively from the following authorities:

- Australian Securities and Investments Commission (ASIC);
- Brazilian Comissao de Valores Mobiliarios (CVM);
- Committee of European Securities Regulators (CESR), on behalf of its members, regarding the EU Regulation;
- Japanese Financial Services Agency (JFSA);
- Mexican National Banking and Securities Commission (CNBV);
- Swiss Financial Market Supervisory Authority (FINMA); and
- US Securities and Exchange Commission (SEC).

This report is based on the responses received from member authorities in response to the questionnaire circulated. The report focuses on jurisdictions that have implemented or are far along<sup>22</sup> in implementing CRA-specific regulatory programs.<sup>23</sup> The report does not seek to set

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<sup>22</sup> It should be noted that, while Switzerland has not implemented a CRA-specific regulatory program, it does have provisions with respect to CRAs in the context of the Basel II capital adequacy standards for banks. In this regard, the Swiss Financial Market Supervisory Authority must recognize a CRA as an

forth principles for government regulation of CRAs. Furthermore, the report is intended to identify and describe regulations that implement and promote the objectives of the principles without providing any qualitative assessment of the effectiveness of the regulations.

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ECAI before Swiss banks may use its credit ratings for computing their capital ratios under Basel II. In addition, while Brazil has not implemented a CRA-specific regulatory program, it is in the process of analyzing the local activities of CRAs as part of a review of whether CRA-specific regulation is appropriate. If Brazil determines to move forward with CRA-specific regulation, it would proceed under current authority to regulate securities analysts.

<sup>23</sup> Members of the Canadian Securities Administrators are also developing a regulatory regime for credit rating organizations which is intended to address each of the IOSCO CRA Principles. The proposed regime was initially published for comment in the summer of 2010, and would have required that “designated rating organizations” either comply with the IOSCO Code, or explain how they deviate from the Code and how their practices nevertheless meet the underlying principles of the Code. In addition, certain practices were to be considered mandatory, and certain conflict relationships were strictly prohibited. A revised version of the proposal will likely be republished for comment in the spring of 2011.

The Canadian Securities Administrators intend to bring the regime into force in the fall of 2011.

## Chapter 4 Components of CRA Regulatory Programs

### A. Definition of *Credit Rating Agency*

CRA's are active in the jurisdictions of all the respondents to the questionnaire. For example, CRA's may have a physical presence through an operating company organized under local corporation laws. In some cases, CRA's conduct activities in a jurisdiction through a branch or office of a company organized in another jurisdiction. Moreover, even if a CRA is not physically present in a jurisdiction, it may rate companies (and the debt they issue) located in that jurisdiction. Furthermore, investors and other market participants located in the jurisdiction may use credit ratings of CRA's located outside the jurisdiction to make investment and other credit-based decisions.

Finally, all the jurisdictions reported that credit ratings are used in local laws and regulations, most notably for the following general purposes:

- (a) determining capital requirements (the most common use reported);
- (b) identifying or classifying assets (typically in terms of eligible investments or permissible asset concentrations);
- (c) determining disclosure requirements; and
- (d) determining prospectus eligibility.<sup>24</sup>

The question – given that CRA's are active in the jurisdictions and their ratings are used in local laws and regulations – is how CRA's are identified as such for purposes of imposing registration and supervision requirements. In other words, what type of activity will trigger the requirement to be registered as a CRA and adhere to local laws and regulations governing the activities of CRA's?

The EU CRA regulatory program has two relevant definitions that build on each other: “credit rating” and “credit rating agency.” A “credit rating” is defined as “an opinion regarding the creditworthiness of an entity, a debt or financial obligation, debt security, preferred share or other financial instrument, or an issuer of such debt or financial obligation, debt security, preferred share or other financial instrument, issued using an established and defined ranking system of rating categories.”<sup>25</sup> A “credit rating agency” is defined as a “legal person whose occupation includes the issuing of credit ratings on a professional basis.”<sup>26</sup>

Similarly, the US CRA regulatory program has definitions of “credit rating” and “credit rating agency” that build on each other. However, because registration is voluntary, the US CRA regulatory program has a third relevant definition – “nationally recognized statistical rating organization” – that distinguishes regulated credit rating agencies from unregulated credit rating agencies. Under the US CRA regulatory program, a “credit rating” is defined as an “assessment of the creditworthiness of an obligor as an entity or with respect to specific

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<sup>24</sup> The questionnaire responses were consistent with the findings of the Joint Forum report *Stocktaking on the use of credit ratings* published in June 2009 (available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD291.pdf>), to which readers should refer for a detailed survey of the legislative and regulatory use of credit ratings in various jurisdictions.

<sup>25</sup> EU Regulation, Article 3.1 lett. a).

<sup>26</sup> EU Regulation, Article 3.1 lett. b).

securities or money market instruments.” A “credit rating agency” is defined as a person that, among other things, is “engaged in the business of issuing credit ratings on the Internet or through another readily accessible means, for free or a reasonable fee.” A “nationally recognized statistical rating organization” is defined as, among other things, a “credit rating agency” that has “been in business as a credit rating agency for at least the 3 consecutive years preceding the date of its application for registration” with the SEC and is registered with the SEC.

The definitions of “credit rating” and “credit rating agency” also build on each other under Japan’s CRA regulatory program. A “credit rating” is defined as “a grade indicating the result of an assessment regarding the credit status (creditworthiness) of financial instruments or legal persons using symbols or figures,”<sup>27</sup> while a “credit rating agency” is defined as, among other things, “a person whose occupation includes determining credit ratings and either providing them to someone or making them available to the public on a professional basis and who is registered with the JFSA.”<sup>28</sup>

Australia – while not having a definition of “credit rating agency” – includes a definition of “credit rating” in its AFS license for CRAs. AFS licenses granted to CRAs define “credit rating” as “a statement, opinion or research dealing with: (a) the creditworthiness of a body; or (b) the ability of an issuer of a financial product to meet its obligations under the financial product.”

In Mexico, although there is no definition of “credit rating,” credit rating agencies are defined in the Securities Market Law as entities that provide professional services for the study, analysis, opinion, evaluation and assessment of the creditworthiness of securities.<sup>29</sup>

## **B. Registration and Supervision**

Having established the type of activity that causes an entity to be a *credit rating agency*, the next question is whether a CRA must register with a local authority if it is active in that jurisdiction. An additional question applies for CRAs that have affiliates located in other jurisdictions: is the CRA required to register in a given jurisdiction if an affiliate is active within that jurisdiction (for example, if the affiliate rates companies located within the jurisdiction or if investors located in the jurisdiction use the affiliate’s ratings)? If registration is required, another follow-up question addresses the implications of being registered; in particular, is the CRA subject to requirements specific to CRAs and to examination by the competent authority?

Under the EU CRA regulatory program, a CRA that is a legal person established in an EU country must register with the home Member State competent authority. This is the case regardless of whether the CRA’s ratings are used for regulatory purposes. Only the activities of the CRA undertaken in the EU will be covered by the registration. Furthermore, because registration is required for a CRA’s ratings to be used for regulatory purposes in the EU, credit ratings issued by foreign affiliates would not qualify for regulatory use in the EU simply because the local affiliate was registered as a CRA in the EU.

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<sup>27</sup> Financial Instruments and Exchange Act, Article 2(34).

<sup>28</sup> Financial Instruments and Exchange Act, Articles 2(36) and 66-27.

<sup>29</sup> Securities Market Law, Article 334.

However, the EU CRA regulatory program does have a mechanism through which credit ratings issued by foreign affiliates could be used for regulatory purposes in the EU. Specifically, the EU registered affiliate would need to “endorse” the credit ratings of its foreign affiliates. Under the “endorsement” procedure, the EU registered affiliate may endorse ratings issued by a foreign CRA belonging to the same group if, among other things, the EU registered affiliate can demonstrate on an on-going basis to its home Member State competent authority that the conduct of credit rating activities by the foreign affiliate whose ratings it wants to endorse fulfils requirements that are at least “as stringent as” the EU CRA regulatory program and there is an appropriate cooperation agreement between the EU supervisor and the foreign supervisor.<sup>30</sup>

There is a second “certification” process for CRAs established in a third country that have no affiliates in the EU and are not systemically important for the financial stability or integrity of the financial markets of one or more Member States.<sup>31</sup> Such a CRA’s credit ratings can be used for regulatory purposes in the EU, if, among other things: (1) the European Commission determines that the third-country CRA is subject to a legal and supervisory framework that is equivalent to that established by the EU Regulation; and (2) a cooperation arrangement exists between the home supervisor and relevant EU competent authorities.<sup>32</sup> CRAs established in the EU are, by virtue of being a CRA, subject to the EU CRA regulatory program and to examination by local competent authorities.

In the US, CRAs are not required to register simply because they engage in the activity of issuing credit ratings. However, in order for a CRA’s credit ratings to be used for regulatory purposes, it must apply for and be granted registration with the SEC as an NRSRO. An NRSRO can include foreign affiliates in its registration. By including these affiliates, they become part of the NRSRO. Upon registration, the NRSRO (which, if applicable, includes its foreign affiliates) becomes subject to the requirements governing the activities of CRAs in the US CRA regulatory program and to examination by the SEC.

Australia’s CRA regulatory program requires all CRAs operating in Australia to be licensed as providers of financial services regardless of whether their credit ratings are used for regulatory purposes. In the past, CRAs operating in Australia were exempted from this licensing requirement on the condition that they complied with the IOSCO CRA Code. In addition to the general obligations for licensed entities under Australian laws and regulations (which includes examination authority), ASIC imposes specially tailored conditions on AFS licenses granted to CRAs. These conditions include compliance with the IOSCO CRA Code (on a ‘comply or explain’ basis until June 30, 2010 and on a mandatory basis after that date) and the requirement to lodge with ASIC (annually or upon request) an IOSCO CRA Code Annual Compliance Report.<sup>33</sup>

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<sup>30</sup> EU Regulation, Article 4.3.

<sup>31</sup> A systemically important CRA could not use this process to have its credit ratings qualify for regulatory purposes in the EU. Instead, it would need to establish and register an affiliate in the EU and have that affiliate endorse the credit ratings of affiliates outside the EU.

<sup>32</sup> EU Regulation, Article 5.

<sup>33</sup> See *ASIC outlines improvements to regulation of credit rating agencies in Australia*, November 12, 2009, available at <http://www.asic.gov.au/asic/asic.nsf/byheadline/09-224MR-ASIC-outlines+-improvements-to-regulation-of-credit-rating-agencies-in-Australia?openDocument>.

Japan's CRA regulatory program will require a CRA, including one located outside Japan, to be registered with the JFSA in order for its credit ratings to be used for regulatory purposes in Japan. In addition, broker-dealers that use credit ratings in soliciting customers will be required to provide an extensive explanation to the customers if such credit ratings are provided by entities not registered with the JFSA.<sup>34</sup> Upon registration, a CRA becomes subject to all the requirements governing the activities of CRAs in Japan's CRA regulatory program and subject to examination by the Securities and Exchange Surveillance Commission under the JFSA, except in certain cases where exemptions apply. Specifically, credit ratings that are not brought to the Japanese market remain outside the scope of Japan's CRA regulatory program. In addition, for credit ratings issued by foreign CRAs and related to the Japanese market, certain regulatory requirements will be exempted, upon approval by the JFSA Commissioner, if the foreign CRA is taking alternative measures to achieve corresponding regulatory objectives and the CRA's direct regulatory supervisor is overseeing the proper functioning of such measures.<sup>35</sup>

Under the Mexican regulatory framework, a CRA must be constituted as a legal person under the Securities Markets Law and the Mexican Companies' Law and must be authorized by the CNBV. The CNBV requires CRAs to develop and implement their own codes of conduct, encouraging them to fully adhere to the applicable international standards. Moreover, the CNBV has powers to set the minimum requirements to be included in those codes of conduct. The CNBV is responsible for carrying out of the supervision of credit rating agencies and is empowered to conduct inspection visits and require from them any applicable information.<sup>36</sup>

In Mexico CNBV authorization is required for anyone engaging in the activity of issuing credit ratings for securities, regardless of whether those ratings are used for regulatory purposes. However, several Mexican financial regulations, for example the capital rule, only permit the use of ratings issued by CRAs that have the authorities' recognition.<sup>37</sup>

### **C. Enforcement Authority**

The final component of the CRA regulatory programs is the ability to sanction CRAs and their employees for violating requirements governing the activities of CRAs.<sup>38</sup> In other words, does the local competent authority have the ability to initiate or take actions against a CRA or its employees for violating provisions of the jurisdiction's CRA regulatory program?

The EU CRA regulatory program includes a number of supervisory measures that the home competent authorities (and, in some cases, other competent authorities) may take in response to violations of requirements governing the activities of CRAs. These measures include:

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<sup>34</sup> Financial Instruments and Exchange Act, Article 38(iii).

<sup>35</sup> Cabinet Office Ordinance on Financial Instruments Business, etc., Article 306(6).

<sup>36</sup> Securities Market Law, Articles 335, 336 and 350.

<sup>37</sup> Capital Requirements for Banking Institutions, III.3.1.

<sup>38</sup> As noted above, Switzerland does not have a CRA-specific regulatory program. However, if FINMA ascertains that the requirements underlying the ECAI recognition of a CRA are no longer met, it is authorized to take appropriate measures, including, in the worst case, withdrawing recognition. In the case of recognition withdrawal, the CRA's credit ratings would no longer be able to be used by banks for regulatory capital adequacy purposes. *See* FINMA-Circ. 08/26 Mn 44.



withdrawing a CRA's registration; temporarily prohibiting the issuance of credit ratings with effect throughout the EU; and disqualifying the CRA's credit ratings from being used for regulatory purposes. In addition, competent authorities can refer a CRA for criminal prosecution for general offenses.<sup>39</sup>

The US CRA regulatory program provides the SEC with authority to take a variety of actions against an NRSRO for violating provisions of the US CRA regulatory program. These actions include: censuring; placing limitations on the activities, functions or operations of an NRSRO; suspending for a period not exceeding 12 months; or revoking the registration of an NRSRO.<sup>40</sup> The SEC also has authority to assess money penalties against an NRSRO.<sup>41</sup> CRAs can also be referred for criminal prosecution for general offenses. In addition, pending US legislation would enhance the SEC's sanctioning authority for NRSROs.

Australian CRAs are subject to the penalties applicable to all AFS licensees. Pursuant to Australian law, ASIC may, after a hearing, suspend or revoke an AFS license under certain specified circumstances.<sup>42</sup> In addition, ASIC may prohibit a person (e.g., a CRA or a representative of a CRA) from providing any financial service permanently or for a specified period (i.e., make a banning order) under certain specified circumstances.<sup>43</sup> CRAs who fail to ensure they have a reasonable basis for their ratings may also be subject to sanctions for engaging in misleading or deceptive conduct, or making false or misleading statements, in relation to financial services and products.<sup>44</sup>

In Japan, administrative sanctions that may be taken against CRAs include orders to improve business operations, suspension of all or part of a business operation for a period not exceeding six months, withdrawal of registration, and orders to dismiss executives.<sup>45</sup> CRAs can also be referred for criminal prosecution for general offenses.

In Mexico, the CNBV may take actions against CRAs, including, among other things, rejecting an application for authorization to operate as a CRA;<sup>46</sup> removing or suspending members of the CRA's board of directors, its managers, or its employees;<sup>47</sup> assessing monetary penalties against a CRA when, for example, the CRA does not publish its ratings according to the specified regulatory requirements;<sup>48</sup> withdrawing the CRA's authorization to

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<sup>39</sup> EU Regulation, Articles 24 and 25.

<sup>40</sup> Exchange Act Section 15E(d).

<sup>41</sup> Exchange Act Section 21B(a).

<sup>42</sup> Corporations Act 2001 (Cth) ss915B and 915C.

<sup>43</sup> Corporations Act 2001 (Cth) s920A.

<sup>44</sup> Corporations Act 2001 (Cth) ss1041E and 1041H; Australian Securities and Investment Commission 2001 (Cth) Act ss12DA-12DB.

<sup>45</sup> Financial Instruments and Exchange Act, Articles 66-41 and 66-42.

<sup>46</sup> Securities Market Law, Article 335.

<sup>47</sup> Securities Market Law, Article 393; I.

<sup>48</sup> Securities Market Law, Article 392, I, z.

perform its activities;<sup>49</sup> and initiating criminal prosecution for violations of the CRA's confidentiality duties.<sup>50</sup>

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<sup>49</sup> Securities Market Law, Article 340.

<sup>50</sup> Securities Market Law, Article 380.

## Chapter 5 The Various Ways CRA Regulatory Programs Promote the Objectives of the IOSCO CRA Principles

### A. The First IOSCO CRA Principle

*Quality and integrity in the rating process – CRAs should endeavor to issue opinions that help reduce the asymmetry of information among borrowers, lenders and other market participants.*

The first IOSCO CRA Principle includes five subsections that provide further explanation of the objective of the principle. The subsections address the adoption and implementation of procedures and methodologies for developing and validating ratings; the monitoring and, as appropriate, updating of ratings; the maintenance of internal records to support ratings; the maintenance of sufficient resources to carry out high-quality credit assessments; and the professionalism, competency, and integrity of analysts employed by CRAs.<sup>51</sup>

The objective of the first principle is the issuance of credit ratings that provide users of credit ratings with assessments of relative creditworthiness that are the product of informed analysis and which improve market transparency. In other words, a credit rating should assist market participants in analyzing the degree of credit risk inherent in the rated obligor or debt instrument (and certainly not mislead them in performing such analysis). At the same time, the principle does not suggest that this objective can only be achieved using certain specified methodologies or techniques to determine credit ratings, and it should be noted that the CRA regulatory programs of the EU, US and Japan have provisions that prohibit the competent authorities from regulating the substance of credit ratings or credit rating methodologies. Instead, the objective focuses on controls and processes designed to ensure that whatever methodology a CRA employs to determine credit ratings (e.g., a qualitative assessment of relevant factors, a quantitative model using relevant inputs, or a combination of both) is employed in a systematic and consistent manner by competent analysts and that the results can be reviewed to assess whether the methodology produces ratings that do enhance the ability of market participants to assess relative creditworthiness.<sup>52</sup>

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<sup>51</sup> The subsections of the first IOSCO CRA Principle are:

1.1. *CRAs should adopt and implement written procedures and methodologies to ensure that the opinions they issue are based on a fair and thorough analysis of all relevant information available to the CRA, and that CRA analysts perform their duties with integrity. CRA rating methodologies should be rigorous, systematic, and CRA ratings should be subject to some form of validation based on historical experience.*

1.2. *CRAs should monitor on an ongoing basis and regularly update an analysis and rating once a rating is issued whenever new information becomes available that causes the rating agency to revise or terminate its opinion.*

1.3. *CRAs should maintain internal records to support their ratings.*

1.4. *CRAs should have sufficient resources to carry out high-quality credit assessments. They should have sufficient personnel to properly assess the entities they rate, seek out information they need in order to make an assessment, and analyze all the information relevant to their decision-making processes.*

1.5. *Analysts employed by ratings agencies should use the methodologies established by the CRA and be professional, competent, and of high integrity.*

<sup>52</sup> In Switzerland, a CRA granted ECAI status must have a ratings practice and individual ratings that satisfy an “objectivity principle” as set forth in the Section 91 of the Basel II accord and codified in the

The EU CRA regulatory program contains a number of provisions designed to promote the objective of the first IOSCO CRA Principle. For example, it has provisions that track to a certain degree the language of the first subsection in that they require a CRA to adopt, implement and enforce measures to ensure that credit ratings are based on a thorough analysis of all available and relevant information and that the information it uses in developing credit ratings is of sufficient quality and from reliable sources.<sup>53</sup> Similarly, a further provision requires that ratings be rigorous, systematic, continuous and subject to validation based on historical experience, including back testing.<sup>54</sup>

The EU regulatory program also requires a CRA to monitor credit ratings and review its credit ratings and methodologies on an ongoing (at least annual) basis, in particular where material changes occur that could impact a credit rating. It also requires a CRA to monitor the impact of changes in macroeconomic or financial market conditions on its credit ratings.<sup>55</sup> There also are provisions that address in detail the steps a CRA must take when its methodologies, models, or key rating assumptions used in credit rating activities are changed.<sup>56</sup>

The EU CRA regulatory program also has provisions that require CRAs to maintain internal records to support their ratings. Specifically, it requires CRAs to arrange for the keeping of adequate records and, where appropriate, audit trails of credit rating activities. This includes, among other things, a record for each credit rating decision taken including the identity of the credit rating analysts, the identity of the persons who approved the credit rating, whether the credit rating was solicited or unsolicited, and the date on which the credit rating action was taken.<sup>57</sup> It also specifies the amount of time all of these records must be kept and requires

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Swiss Capital Adequacy Ordinance as well as in FINMA's circular on credit rating agencies. *See* Swiss Capital Adequacy Ordinance, Art. 52 Par. 1 Let. a CAO; FINMA-Circ. 08/26 Mn 10. Pursuant to these requirements, a CRA must apply its credit rating methodologies strictly and systematically and be able to prove that it does so. A CRA must be able to demonstrate the quality of its ratings and have been in the market for at least one year. In addition, the FINMA circular requires that credit ratings have to be reviewed periodically in a timely manner. *See* FINMA-Circ. 08/26 Mn 10ff.

<sup>53</sup> EU Regulation, Article 8.2.

<sup>54</sup> EU Regulation, Article 8.3.

<sup>55</sup> EU Regulation, Article 8.5. Specifically, these requirements include immediate disclosure of the likely scope of credit ratings to be affected, the placement of affected credit ratings under observation and a review of those ratings as soon as possible (but no later than six months) after the change, and, "if, following the review, the overall combined effect of the changes affects those credit ratings," the re-rating of all credit ratings based on the changed methodologies, models or key rating assumptions.

<sup>56</sup> EU Regulation, Article 8.6.

<sup>57</sup> EU Regulation, Annex I, Section B, Items 7, 8, and 9. Other recordkeeping requirements in the EU Regulation include account records relating to fees received from any rated entity or related third party or any user of ratings; account records for each subscriber to credit ratings or related services; records documenting the CRA's established procedures and methodologies to determine credit ratings; the internal records and files, including non-public information and work papers, used to form the basis of any credit rating decision taken; credit analysis reports, credit assessment reports and private credit rating reports and internal records, including non-public information and work papers, used to form the basis of the opinions expressed in such reports; records of the procedures and measures implemented by the CRA to comply with the EU Regulation; and copies of internal and external communications, including electronic communications, received and sent by the CRA and its employees, that relate to credit rating activities.

certain records to be made available upon request to authorities of a Member State.<sup>58</sup>

The EU CRA regulatory program also has provisions designed to require CRAs to have sufficient resources to carry out high-quality credit assessments. These provisions require a CRA to allocate a sufficient number of employees with appropriate knowledge and experience to its credit rating activities and to ensure that adequate human and financial resources are allocated to the issuing, monitoring and updating of credit ratings.<sup>59</sup> There also are provisions that set forth requirements for a CRA's senior management and its administrative or supervisory board.<sup>60</sup> In addition, it has provisions that require a CRA to have appropriate systems, resources and procedures to ensure continuity and regularity in the performance of its credit rating activities.<sup>61</sup>

It also requires a CRA to ensure that any persons – whether rating analysts or other employees – directly involved in credit rating activities have appropriate knowledge and experience.<sup>62</sup>

The US CRA regulatory program also has a number of provisions designed to promote the objective of the first IOSCO CRA Principle. The stated purpose of the legislation granting the SEC the authority to implement registration, recordkeeping, financial reporting and oversight rules with respect to CRAs that register as NRSROs is “To improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency, and competition in the credit rating agency industry.”<sup>63</sup> To that end, the US CRA regulatory program mandates that the SEC deny a CRA's application for registration as an NRSRO if it finds that the applicant does not have adequate financial and managerial resources to consistently produce credit ratings with integrity and materially comply with its disclosed procedures and methodologies.<sup>64</sup> After registration, the legislation provides the SEC with authority to take action with respect to an NRSRO that could include, among other measures, limiting its activities, suspending its registration, or revoking its registration if the NRSRO fails to maintain adequate financial and managerial resources to consistently produce credit ratings with integrity.<sup>65</sup> Thus, the US CRA regulatory program confers broad authority on the SEC to take action against an NRSRO if it fails to maintain the integrity of its credit rating process.

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<sup>58</sup> EU Regulation, Annex I, Section B, Items 7, 8, and 9.

<sup>59</sup> EU Regulation, Recital 31.

<sup>60</sup> EU Regulation, Annex I, Section A.2. Specifically, the EU Regulation requires the senior management to “be of good repute and sufficiently skilled and experienced” and “ensure the sound and prudent management of the credit rating agency.” With respect to the board, the EU Regulation mandates that at least one third, but no less than two, of its members be independent members who are not involved in credit rating activities. In addition, it requires that the majority of members of the board, including its independent members, have “sufficient expertise in financial services.” In addition, for CRAs that issue credit ratings of structured finance instruments, the EU Regulation requires that at least one independent member and one other member of the board have “in-depth knowledge and experience at a senior level of the markets in structured finance instruments.”

<sup>61</sup> EU Regulation, Annex I, Section A, Item 8.

<sup>62</sup> EU Regulation, Article 7.1.

<sup>63</sup> Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291.

<sup>64</sup> Exchange Act Section 15E(a)(2)(C)(ii)

<sup>65</sup> Exchange Act Section 15E(d)

In addition, the SEC's Form NRSRO – which applicants for registration as NRSROs are required to complete and registered NRSROs are required to update and disclose to the public – contains a number of provisions designed to promote the objective of the first IOSCO CRA Principle. These provisions are intended to provide users of credit ratings with information that allows them to assess for themselves whether the NRSRO employs methodologies for determining credit ratings in a systematic and consistent manner by competent analysts and that enhance the ability of market participants to assess relative creditworthiness. For example, an NRSRO is required to publicly disclose on Form NRSRO information regarding the procedures and methodologies it uses to determine credit ratings. The instructions to Form NRSRO require a description that is sufficiently detailed to provide users of credit ratings with an understanding of the processes the CRA uses to determine credit ratings. Those instructions also identify a number of areas that must be addressed in the description to the extent they are applicable, including the CRA's procedures for monitoring, reviewing, and updating credit ratings.<sup>66</sup> Furthermore, NRSROs are required to disclose information about the performance of their credit ratings. This information includes performance statistics for each class of credit ratings for which the NRSRO is registered over 1, 3 and 10 year time periods and the histories of current ratings. In addition, an NRSRO is required to publicly disclose certain information about its credit analysts, including their qualifications.<sup>67</sup>

The US CRA regulatory program also has provisions that require an NRSRO to furnish the SEC five, or in some cases six, financial reports annually.<sup>68</sup> The required financial disclosure is designed to assist the SEC, among other things, in monitoring the financial resources of the NRSROs, thus promoting the objective of ensuring that CRAs maintain sufficient resources to carry out high-quality credit assessments and ensuring the integrity of the ratings process. The reports also require an NRSRO to report the number of ratings actions (upgrades, downgrades, placements on watch, withdrawals) taken in each class of credit rating for which it is registered. This will permit the SEC to perform trend analysis on the number of ratings

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<sup>66</sup> Form NRSRO, Exhibit 2. Specifically, the instructions require disclosure regarding monitoring, reviewing, and updating ratings must include how frequently credit ratings are reviewed, whether different models or criteria are used for ratings surveillance than for determining initial ratings, whether changes made to models and criteria for determining initial ratings are applied retroactively to existing ratings, and whether changes made to models and criteria for performing ratings surveillance are incorporated into the models and criteria for determining initial ratings.

<sup>67</sup> Form NRSRO, Exhibit 8. This information includes the total number of credit analysts; the total number of credit analyst supervisors; a general description of the minimum required qualifications of the credit analysts, including education level and work experience; and a general description of the minimum required qualifications of the credit analyst supervisors, including education level and work experience

<sup>68</sup> Exchange Act Rule 17g-3(a). The rule requires audited financial statements of the NRSRO (or of its parent if the NRSRO is a separately identifiable division or department of the parent) and if applicable, unaudited consolidated financial statements of the parent of the NRSRO that include the NRSRO; an unaudited financial report providing information concerning revenue of the NRSRO from, as applicable, determining and maintaining credit ratings, subscribers, granting licenses or rights to publish credit ratings, and all other sources; an unaudited financial report providing the total aggregate and median annual compensation of the credit analysts of the NRSRO for the fiscal year; an unaudited financial report listing the 20 largest issuers and subscribers that used credit rating services provided by the NRSRO by amount of net revenue attributable to the issuer or subscriber during the fiscal year; and an unaudited report of the number of credit ratings actions (upgrades, downgrades, placements on credit watch, and withdrawals) taken during the fiscal year in each class of credit ratings for which the NRSRO is registered.

actions taken in each class of credit rating and focus examination resources when the number of rating actions in a class is an outlier to review whether the cause relates to the integrity of the rating process. Moreover, the US regulatory program contains provisions that prohibit an NRSRO from engaging in certain unfair, coercive, or abusive practices.<sup>69</sup> For example, an NRSRO cannot alter its rating process in order to issue a higher or lower credit rating to punish or favor a client.

The US CRA regulatory program also requires an NRSRO to make and retain certain records relating to its business and to retain certain other records made in the normal course of business operations. These include, among other things, records documenting the established procedures and methodologies used by the NRSRO to determine credit ratings, as well as certain records with respect to each current credit rating.<sup>70</sup> The SEC's regulations also require an NRSRO to maintain internal records, including nonpublic information and work papers, used to form the basis of a credit rating issued by the NRSRO.<sup>71</sup>

Finally, a new provision in the US CRA regulatory program adopted by the SEC in September 2009 is designed to reduce the asymmetry of information by providing a mechanism for NRSROs to issue unsolicited credit ratings for structured finance products. Specifically, an NRSRO hired by an issuer, sponsor, or underwriter of a structured finance security or money market instrument (or arranger) to rate such products will be required to alert other NRSROs that an arranger has initiated the rating process and to promptly inform the other NRSROs where the information being provided by the arranger to the hired NRSRO may be obtained.<sup>72</sup> The goal is increase the number of credit ratings determined for a structured finance product, including ratings from NRSROs that are not paid by the issuer to determine the credit rating.

The Australian CRA regulatory program contains a number of provisions designed to promote the objectives of the first IOSCO CRA Principle. For example, the conditions of a CRA's AFS license obligate a CRA to (among other things) periodically monitor and update ratings, have independently assessed training courses for credit analysts, have in place

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<sup>69</sup> Exchange Act Rule 17g-6. Specifically, an NRSRO is prohibited from conditioning or threatening to condition the issuance of a credit rating on the purchase of any other services or products, of the NRSRO or any associated person; issuing, offering or threatening to issue, modifying, or offering or threatening to modify a credit rating that is not determined in accordance with the NRSRO's established procedures and methodologies for determining or monitoring credit ratings, based on whether the rated person or an affiliate purchases or will purchase the credit rating or any other service or product of the NRSRO or any associated person; and issuing or threatening to take a negative ratings action with respect to securities or money market instruments issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction, unless all or a portion of the assets within such pool or part of such transaction also are rated by the NRSRO, where such practice is engaged in by the NRSRO for an anticompetitive purpose.

<sup>70</sup> Exchange Act Rule 17g-2. The records required for each current credit rating are (1) the identity of any credit analyst(s) that participated in determining the credit rating; (2) the identity of the person(s) that approved the credit rating before it was issued; (3) if a quantitative model was a substantial component in the process of determining the credit rating of a security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction, a record of the rationale for any material difference between the credit rating implied by the model and the final credit rating issued; and (4) whether the credit rating was solicited or unsolicited.

<sup>71</sup> Exchange Act Rule 17g-2.

<sup>72</sup> Exchange Act Rule 17g-5.

adequate arrangements to ensure compliance with financial services laws, and comply with the IOSCO CRA Code requirements relating to the quality and integrity of ratings.<sup>73</sup> By, in effect, codifying the IOSCO CRA Code into law, the Australian regulatory program requires CRAs to adhere to the IOSCO CRA Code provisions designed to give effect to the first IOSCO CRA Principle.<sup>74</sup>

In addition to CRA-specific obligations, AFS licensees are subject to general statutory obligations which promote the objectives of the first IOSCO Principle. A licensee must, for example, do all things necessary to ensure that its financial services (including advice) are provided efficiently, honestly and fairly,<sup>75</sup> take steps to ensure that it complies with the financial services laws,<sup>76</sup> maintain the competence to provide those financial services,<sup>77</sup> and ensure that its representatives are adequately trained and competent to provide their services.<sup>78</sup> In practice, these obligations require that credit ratings, like all financial product advice, should be prepared by skilled and experienced representatives and be based on reasonable grounds. These principles are consistent with the existing obligations of CRAs under general law in Australia to ensure that they act with due care, diligence and competence when preparing their ratings.

Australian licensed CRAs are also subject to an obligation to report to ASIC significant breaches of any of their obligations listed in certain sections of the Corporations Act 2001 (Cth), making them statutorily obliged to inform ASIC of any significant failures to comply with the requirements.<sup>79</sup> CRAs that issue ratings without reasonable grounds may be subject to sanctions under Australian law for engaging in misleading or deceptive conduct, or making false or misleading statements, in relation to financial services and products.<sup>80</sup>

Japan's CRA regulatory program also contains a number of provisions designed to promote the objectives of the first IOSCO CRA Principle. For example, in order to obtain registration, a prospective CRA must ensure that it has taken adequate measures to establish and implement policies for quality control in the process of determining credit ratings. Specifically, the CRA's credit rating determination policies must be rigorous and systematic and require comprehensive judgments based on all the collected information and materials pertaining to the entity or financial instruments to be rated.<sup>81</sup> Once registered, a CRA is also required to develop functions to ensure that the validity and effectiveness of its credit rating

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<sup>73</sup> Corporations Act 2001 (Cth) s912A(1)(b). *See also ASIC outlines improvements to regulation of credit rating agencies in Australia*, November 12, 2009, available at <http://www.asic.gov.au/asic/asic.nsf/byheadline/09-224MR-ASIC-outlines+-improvements-to-regulation-of-credit-rating-agencies-in-Australia?openDocument>.

<sup>74</sup> *See* IOSCO CRA Code measures 1.1 through 1.16.

<sup>75</sup> Corporations Act 2001 (Cth) s912A(1)(a).

<sup>76</sup> Corporations Act 2001 (Cth) s912A(1)(c) & (ca).

<sup>77</sup> Corporations Act 2001 (Cth) s912A(1)(e).

<sup>78</sup> Corporations Act 2001 (Cth) s912A(1)(f).

<sup>79</sup> Corporations Act 2001 (Cth) s912D(1).

<sup>80</sup> *See* Corporations Act 2001 (Cth) ss1041E and 1041H; Australian Securities and Investments Commission Act 2001 (Cth) ss12DA and 12DB.

<sup>81</sup> Cabinet Office Ordinance on Financial Instruments Business, etc., Articles 313(2)(i) and 313(2)(ii).



determination policies are appropriately checked from an independent standpoint.<sup>82</sup> Furthermore, the CRA is subject to obligations that require it to maintain fairness and integrity at all times and to conduct its credit rating business at its own discretion and responsibility.<sup>83</sup> Additional provisions address measures for reviewing and updating outstanding credit ratings in an appropriate and sustained manner.<sup>84</sup>

Similar to other jurisdictions, a CRA is also required to maintain internal records to support its ratings in Japan.<sup>85</sup> Such records must include not only fundamental information such as the credit rating determined, the date of the determination, and the information required for credit rating provision, but also the names of the rating analysts and the rating committee members, materials submitted to the committee, and other records, including the grounds for the rating decision.<sup>86</sup> These records must be kept for a period of five years from the date of their preparation.<sup>87</sup>

Finally, Japan's CRA regulatory program requires a CRA to take measures to secure sufficient personnel with the expertise and skills for the proper and smooth conduct of its credit rating business.<sup>88</sup> Additionally, the CRA must have policies preventing the determination of credit ratings in cases where such personnel cannot be sufficiently secured or in cases where the quality of the information used in the determination of credit ratings cannot be ensured.<sup>89</sup>

In Mexico, the authorization requirements for CRAs include several provisions that promote the objectives of the first IOSCO CRA Principle. For example, CRAs are required to file their internal manuals, which must include hiring policies, descriptions of their rating processes (including methodologies) and their applicable internal controls.<sup>90</sup> In addition, Mexican regulations require that analysts and managers involved in the rating process possess the necessary technical knowledge and financial expertise. Furthermore, analysts and managers must not have been convicted of certain felonies.<sup>91</sup> The Securities Market Law also requires CRAs to maintain the records supporting their credit ratings for a period of 5 years.<sup>92</sup> Recent proposals in Mexico would require analysts and managers to assess the quality of the information involved in the rating process and refrain from determining ratings in the absence of sufficient quality information.

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<sup>82</sup> Cabinet Office Ordinance on Financial Instruments Business, etc., Article 306(1)(vi)(d).

<sup>83</sup> Cabinet Office Ordinance on Financial Instruments Business, etc., Article 306(1)(i).

<sup>84</sup> Cabinet Office Ordinance on Financial Instruments Business, etc., Article 306(1)(vi)(g).

<sup>85</sup> Financial Instruments and Exchange Act, Article 66-37.

<sup>86</sup> Cabinet Office Ordinance on Financial Instruments Business, etc., Article 315(1).

<sup>87</sup> Cabinet Office Ordinance on Financial Instruments Business, etc., Article 315(2).

<sup>88</sup> Cabinet Office Ordinance on Financial Instruments Business, etc., Article 306(1)(vi)(a).

<sup>89</sup> Cabinet Office Ordinance on Financial Instruments Business, etc., Article 306(1)(vi)(c).

<sup>90</sup> Regulation for Securities Rating Institutions, Third Disposition.

<sup>91</sup> Regulation for Securities Rating Institutions, Fifth Disposition.

<sup>92</sup> Securities Market Law, Article, 341.

## B. The Second IOSCO CRA Principle

*Independence and conflicts of interest – CRA rating decisions should be independent and free from political or economic pressures and from conflicts of interest arising due to the CRA’s ownership structure, business or financial activities, or the financial interests of the CRA employees. CRAs should, as far as possible avoid activities, procedures or relationships that may compromise or appear to compromise the independence and objectivity of credit rating operations.*

The second IOSCO CRA Principle includes six subsections that provide further explanation of the objective of the principle. The subsections address written internal mechanisms to identify and eliminate, or manage and disclose, actual or potential conflicts of interest; avoiding allowing the existence of or potential for a business relationship with the issuer or a third party to affect a rating; prohibitions on CRA and CRA staff securities or derivatives trading presenting conflicts of interest; arranging reporting lines, compensation, and evaluations to eliminate or effectively manage actual and potential conflicts of interest; limiting the determination of a credit rating to factors relevant to the credit assessment; and disclosing the nature of compensation arrangements with issuers.<sup>93</sup> The objective of the principle is the issuance of credit ratings that are not influenced by factors unrelated to the creditworthiness of the rated obligor or issuer.<sup>94</sup>

The EU regulatory program has a number of provisions designed to promote the objective of the second IOSCO CRA Principle by requiring CRAs to identify and eliminate, or manage

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<sup>93</sup> The subsections of the second IOSCO CRA Principle are:

2.1. *CRAs should adopt written internal procedures and mechanisms to (1) identify, and (2) eliminate, or manage and disclose, as appropriate, any actual or potential conflicts of interest that may influence the opinions and analyses CRAs make or the judgment and analyses of the individuals the CRAs employ who have an influence on ratings decisions. CRAs are encouraged to disclose such conflict avoidance and management measures.*

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

2.3. *CRAs and CRA staff should not engage in any securities or derivatives trading presenting inherent conflicts of interest with the CRAs ratings activities.*

2.4. *Reporting lines for CRA staff and their compensation arrangements should be structured to eliminate or effectively manage actual and potential conflicts of interest. A CRA analyst should not be compensated or evaluated on the basis of the amount of revenue that a CRA derives from issuers that the analyst rates or with which the analyst regularly interacts.*

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

2.6. *CRAs should disclose the nature of the compensation arrangement that exists with an issuer that the CRA rates.*

<sup>94</sup> Basel II eligibility criteria for ECAIs, as codified in Swiss law, address the objectives of the second IOSCO CRA Principle. Specifically, they require that a Swiss CRA’s rating processes must be independent. See Art. 52 Par. 1 Let. b CAO. They prohibit any connection between CRAs and public corporations, companies or issuers of structured products for whom ratings are provided as well as companies that use their ratings and require that Chinese Walls be implemented where necessary. Swiss regulations state that CRAs must have an internal control, that no pressure on credit ratings must be exerted on either political or economic matters and that CRAs should detect, prevent and disclose conflicts of interest, in particular for members of their leading bodies when they detect them. See FINMA-Circ. 08/26 Mn 14ff.

and disclose, actual or potential conflicts of interest. For example, it requires a CRA to establish appropriate and effective organizational and administrative arrangements to prevent, identify, eliminate or manage and disclose conflicts of interest. It requires a CRA to arrange for records to be kept of all significant threats to the independence of credit rating activities, as well as safeguards applied to mitigate those threats.<sup>95</sup> A CRA is also required to identify, eliminate or manage and disclose, clearly and prominently, any actual or potential conflicts of interest that may influence the analyses and judgments of its rating analysts, employees, or any other person whose services are placed at the disposal or under the control of the CRA and who are directly involved in the issuing of credit rating and persons approving credit ratings.<sup>96</sup>

The EU CRA regulatory program also has provisions designed to require CRAs to avoid allowing a business relationship with the issuer or a third party to have any affect on a rating. For example, it requires a CRA to take all necessary steps to ensure that the issuance of a credit rating is not affected by any existing or potential conflict of interest or business relationship involving the CRA, its personnel, or any person directly or indirectly linked to it by control.<sup>97</sup> Moreover, a CRA shall not provide consultancy or advisory services to the rated entity or a related third party regarding the corporate or legal structure, assets, liabilities or activities of the rated entity or related third party<sup>98</sup>.

The EU CRA regulatory program also has provisions designed to prevent CRAs or CRA staff from engaging in trading presenting conflicts of interest with rating activities. The regulation prohibits rating analysts, employees of the CRA, 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 from buying or selling, or engaging 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.<sup>99</sup>

The EU CRA regulatory program has provisions designed to address reporting lines, compensation, and evaluations to eliminate or effectively manage actual and potential conflicts of interest. For example, compensation and performance evaluation of rating analysts and persons approving credit ratings must not be contingent on the amount of revenue that the credit rating agency derives from the rated entities or related third parties.<sup>100</sup> CRAs are also required to design their reporting and communication channels in order to ensure the independence of their personnel from any other activities of the CRA carried out on a commercial basis.<sup>101</sup> CRAs shall ensure that a minimum number of members of their administrative or supervisory board are independent members who are not involved in credit

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<sup>95</sup> EU Regulation, Annex I, Section A.7. In addition, Sections A and B of Annex I of the EU Regulation include detailed organizational and operational requirements to promote independence and avoid conflicts of interest.

<sup>96</sup> EU Regulation, Annex I, Section B.1.

<sup>97</sup> EU Regulation, Article 6.1

<sup>98</sup> EU Regulation, Annex I, Section B, Item 4.

<sup>99</sup> EU Regulation, Annex I, Section C, Item 1.

<sup>100</sup> EU Regulation, Article 7.5.

<sup>101</sup> EU Regulation, Annex I, Section B, item 6.

rating activities and whose compensation shall be arranged so as to ensure the independence of their judgment. The independent members of the administrative or supervisory board are entrusted with specific monitoring tasks.<sup>102</sup>

In addition, the EU Regulation has provisions designed to ensure that the determination of a credit rating should be influenced only by factors relevant to the credit assessment by requiring credit ratings to be well-founded and solidly substantiated, in order to avoid rating compromises.<sup>103</sup> Finally, it has provisions designed to address disclosing the nature of compensation arrangements with issuers by requiring a CRA to disclose the general nature of its compensation arrangements.<sup>104</sup>

The US CRA regulatory program promotes the second IOSCO CRA Principle by requiring an NRSRO to establish, maintain, and enforce policies and procedures reasonably designed, taking into consideration the nature of its business, to address and manage conflicts of interest.<sup>105</sup> The program also has a provision that sets forth nine categories of conflicts of interest an NRSRO is prohibited from having unless it discloses them and has implemented procedures to address and manage them.<sup>106</sup> For example, one of the identified conflicts is being paid by issuers to rate their securities. Consequently, an NRSRO that determined and published a credit rating paid for by an issuer would be in violation of this provision unless it discloses that the conflict is inherent in its business activities and has implemented procedures reasonably designed to address the conflict. Another provision prohibits seven specific types of conflicts outright.<sup>107</sup> For example, a credit analyst is prohibited from participating in determining a credit rating for a security the analyst owns. An NRSRO would be in violation if it published a credit rating under this circumstance even if it disclosed the conflict and had procedures to manage it. Furthermore, as noted above, an NRSRO must publicly disclose on Form NRSRO any conflicts of interest inherent in its business operations along with a copy of the written policies and procedures it establishes, maintains, and enforces to address and manage conflicts of interest.<sup>108</sup> This allows users of credit ratings to review the quality of the NRSRO's procedures for managing conflicts in the context of the actual conflicts that arise from its business activities.

In addition, the financial reports that an NRSRO must submit annually to the SEC, as discussed above, assist the SEC, among other things, in reviewing the potential that conflicts of interest could unduly influence an NRSRO in determining credit ratings.<sup>109</sup> For example, the reports require the NRSRO to identify the twenty largest clients of the NRSRO in terms of net revenue earned by the NRSRO. This assists SEC examiners in focusing their reviews of the NRSRO's activities on services – including determining credit ratings – provided to large clients. Finally, an NRSRO is required to publicly disclose certain information

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<sup>102</sup> EU Regulation, Annex I, Section A, Item 2.

<sup>103</sup> EU Regulation, Recital 24.

<sup>104</sup> EU Regulation, Annex I, Section E, Item 4.

<sup>105</sup> Exchange Act Section 15E(h)(1) (15 U.S.C. 78o-7(h)(1)).

<sup>106</sup> Exchange Act Rule 17g-5.

<sup>107</sup> *Id.*

<sup>108</sup> Form NRSRO, Exhibits 6 and 7.

<sup>109</sup> Exchange Act Rule 17g-3.

regarding its organizational structure, including management structure and senior management reporting lines, which also assists the SEC in monitoring the potential for conflicts of interest.<sup>110</sup>

In Australia, as discussed above, AFS licensees are subject to general statutory obligations, including the requirement to have adequate arrangements for the management of conflicts of interest.<sup>111</sup> A CRA is required to have in place arrangements (i.e., internal measures, processes and procedures) to avoid, control and disclose (as appropriate) conflicts of interest, as well as to document these policies and procedures, implement and monitor them, and keep records of their compliance with these obligations.<sup>112</sup> As noted above, the AFS license conditions for CRAs include, among other things, obligations to comply with the IOSCO CRA Code, including the requirements relating to independence and conflicts of interest.<sup>113</sup>

Japan's CRA regulatory program has a number of provisions designed to require a CRA to identify and eliminate, or manage and disclose, actual or potential conflicts of interest. A CRA is required to specify acts that create conflicts of interest or potential conflicts of interest with regard to the credit rating business (specified acts) and ensure that such acts do not undermine the interests of investors.<sup>114</sup> Furthermore, the CRA must disclose its specified acts and its measures for preventing conflicts of interest in connection with such acts.<sup>115</sup>

Japan's CRA regulatory program also has provisions designed to prevent undermining investor protection when determining credit ratings related to a stakeholder who may have potential conflicts of interest with a CRA. For example, in cases where a ratings stakeholder holds more than 5% of voting shares issued by the CRA or where the CRA receives a large amount of consideration from a ratings stakeholder for services other than credit rating services, the CRA must ensure that its determination of credit ratings does not have the effect of undermining investor protection.<sup>116</sup>

In addition, Japan's CRA regulatory program also prohibits securities or derivatives trading when there are conflicts of interest with a CRA's rating activities. Specifically, a CRA must prevent persons involved in processes pertaining to the determination of credit ratings from selling or purchasing securities in which they have potential conflicts of interest.<sup>117</sup> Furthermore, Japan's CRA regulations include provisions designed to ensure that the determination of credit ratings is influenced only by factors relevant to the credit assessment by requiring measures to prevent associated or other services from unduly affecting credit

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<sup>110</sup> Form NRSRO, Exhibit 4.

<sup>111</sup> Corporations Act 2001 (Cth) s912A(1)(aa). ASIC Regulatory Guide 181 *Licensing: managing conflicts of interest* (RG 181) sets out ASIC's expectations for compliance with s912A(1)(aa) and discusses mechanisms for complying.

<sup>112</sup> ASIC Regulatory Guide 181 *Licensing: managing conflicts of interest* (RG 181) sets out ASIC's expectations for compliance with s912A(1)(aa) and discusses mechanisms for complying.

<sup>113</sup> See IOSCO CRA Code measures 2.1 through 2.17.

<sup>114</sup> Cabinet Office Ordinance on Financial Instruments Business, etc., Article 306(1)(vii)(a).

<sup>115</sup> Cabinet Office Ordinance on Financial Instruments Business, etc., Article 318(iii)(e).

<sup>116</sup> Cabinet Office Ordinance on Financial Instruments Business, etc., Article 306(1)(vii)(a).

<sup>117</sup> Cabinet Office Ordinance on Financial Instruments Business, etc., Article 306(1)(vii)(a).

rating actions.<sup>118</sup>

The CRA regulatory program in Japan also addresses compensation arrangements. For example, a CRA is required to take measures to establish policies for determining the compensation of its executives and employees and to ensure that such policies do not impede the fair and appropriate execution of the credit rating business. These policies must ensure that the compliance officer's compensation is not affected by the performance of the credit rating business and the amount of compensation for persons involved in processes pertaining to the determination of credit ratings is not affected by the fees obtained by the CRA for such credit rating services.<sup>119</sup> Furthermore, the regulations require disclosure of the general compensation system between the CRA and its ratings stakeholders.<sup>120</sup>

In Mexico, several rules deal with independence and conflicts of interest within CRAs. For example, managers and directors are precluded from acquiring and maintaining stock issued by financial entities to which the CRA provides rating services.<sup>121</sup> In addition, CRAs are forbidden from offering rating services to issuers when managers, directors, or persons involved in the rating process have conflicts of interest with respect to the securities submitted to be rated.<sup>122</sup> Additional regulations also prohibit analysts from participating in the rating process if they have recently been employed by or have another significant business relationship with the rated entity. CRAs are required to adopt written internal procedures and mechanisms to identify, eliminate or manage, and disclose, as appropriate, any actual or potential conflicts of interest that may influence the rating process. CRAs are obliged to disclose their procedures for conflict of interest management as well as any actual or potential conflicts in a manner sufficiently clear and complete for it to be understood by investors. Finally, CRAs must not compensate or evaluate analysts on the basis of the amount of revenue they bring to the CRA. To this end, disclosure regarding compensation agreements is mandatory.<sup>123</sup>

### **C. The Third IOSCO CRA Principle**

*Transparency and timeliness of ratings disclosure – CRAs should make disclosure and transparency an objective of their ratings activities.*

The third IOSCO CRA Principle includes five subsections that provide further explanation of the objective of the principle. The subsections address the timely distribution of publicly issued ratings decisions, the non-selective disclosure of publicly issued ratings decisions as well as discontinuations of ratings, the disclosure of sufficient information about procedures and methodologies to allow outside parties to understand how a rating was arrived at by a CRA, the disclosure of information about historical default rates within a CRA's rating categories, and the disclosure of whether a rating was unsolicited.<sup>124</sup> In short, the objective of

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<sup>118</sup> Cabinet Office Ordinance on Financial Instruments Business, etc., Article 306(1)(vii)(b).

<sup>119</sup> Cabinet Office Ordinance on Financial Instruments Business, etc., Article 306(1)(x).

<sup>120</sup> Cabinet Office Ordinance on Financial Instruments Business, etc., Article 318(ii)(c).

<sup>121</sup> Securities Market Law, Article 337.

<sup>122</sup> Securities Market Law, Article 338.

<sup>123</sup> Regulation for Securities Rating Institutions, Annex 1, II, A-K.

<sup>124</sup> The subsections of the third IOSCO Principle are:

the principle is the disclosure of sufficient information to allow users of credit ratings to understand the methodologies by which a CRA determines credit ratings and what the ratings mean in terms of assessing relative creditworthiness.<sup>125</sup>

The EU regulatory program contains provisions promoting the third IOSCO CRA Principle. For example, it has provisions that address the timely and non-selective distribution of publicly issued ratings decisions as well as discontinuations of ratings, by requiring a CRA to disclose any credit rating, or any decision to discontinue a credit rating, on a non-selective basis and in a timely manner. It further requires that the information disclosed in connection with a decision to discontinue a credit rating include the full reasons for that decision. In each case, these requirements apply to credit ratings that are distributed by subscription as well as those paid for by issuers or obligors.<sup>126</sup>

The EU regulatory program also has provisions designed to address the disclosure of sufficient information about procedures and methodologies to allow outside parties to understand how a rating was arrived at, by requiring a CRA to disclose to the public the methodologies, models and key rating assumptions it uses in its credit rating activities.<sup>127</sup> It also requires a CRA to ensure that, at a minimum, the meaning of each rating category, the definition of default or recovery and any appropriate risk warning, including a sensitivity analysis of the relevant key rating assumptions, such as mathematical or correlation assumptions accompanied by worst-case scenario credit ratings as well as best-case scenario credit ratings, are explained.<sup>128</sup>

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3.1. CRAs should distribute in a timely manner their ratings decisions regarding publicly issued fixed-income securities or issuers of publicly traded fixed-income securities.

3.2. CRAs should disclose to the public, on a non-selective basis, any rating regarding publicly issued fixed income securities as well as any subsequent decisions to discontinue such a rating if the rating is based in whole or in part on material non-public information.

3.3. CRAs should publish sufficient information about their procedures and methodologies so that outside parties can understand how a rating was arrived at by the CRA. This information should include (but not be limited to) the meaning of each rating category and the definition of default and the time horizon the CRA used when making a rating decision.

3.4. CRAs should publish sufficient information about the historical default rates of CRA rating categories and whether the default rates of these categories have changed over time, so that interested parties can understand the historical performance of each category and if and how ratings categories have changed.

3.5. CRAs should disclose if a rating is unsolicited.

<sup>125</sup> The Swiss Capital Adequacy Ordinance and FINMA's circular on CRAs are designed to address the objectives of the third IOSCO CRA Principle. Pursuant to the former, CRAs must provide access to their ratings. See Art. 52 Par. 1 Let. c CAO. The details of this requirement are provided in the circular, which stipulates that CRAs must provide access to their credit ratings to any interested parties on equal conditions and to accommodate both for the issuer pays and investors pays business models; the circular specifies that access through a subscription is considered as equal conditions. Pursuant to the circular, in order to obtain ECAI recognition, a CRA must publicly disclose the main features of its methodologies. See FINMA-Circ 08/26 Mn 20.

<sup>126</sup> EU Regulation, Article 10.1 and Annex I, Section D.

<sup>127</sup> EU Regulation, Article 8.1 and Annex I, Section E (point 5).

<sup>128</sup> EU Regulation, Annex I, Section D.I (point 2(c)).

The EU regulatory program also has provisions designed to address the disclosure of information about historical default rates of CRA rating categories, as well. For example, a CRA is required to make available in a central repository established by CESR, using a standard form provided by CESR, certain historical performance information. This information, which CESR is required to make accessible to the public, includes ratings transition frequency and information about credit ratings issued in the past and on their changes. In addition, CESR is required to publish summary information on the main developments observed from this disclosure on an annual basis.<sup>129</sup> The EU Regulation also requires a CRA to disclose, every six months, data about the historical default rates of its rating categories, distinguishing between the main geographical areas of the issuers and whether the default rates of these categories have changed over time.<sup>130</sup>

Finally, the EU CRA regulatory program has provisions designed to address the disclosure of whether a rating is unsolicited, by requiring that when a CRA issues an unsolicited rating it state prominently in the credit rating whether or not the rated entity or related third party participated in the credit rating process, as well as whether the credit rating agency had access to the accounts and other relevant internal documents of the rated entity or a related third party.<sup>131</sup> In addition, the regulation mandates that a CRA disclose generally its policies and procedures regarding unsolicited ratings.<sup>132</sup>

The US CRA regulatory program promotes the third IOSCO CRA Principle by requiring NRSROs to update and disclose information on Form NRSRO, including information about how ratings are determined. Specifically, an NRSRO must disclose its methodologies for determining as well as for monitoring credit ratings.<sup>133</sup> NRSROs must also define on Form NRSRO the credit rating categories, notches, grades, and rankings it assigns.<sup>134</sup>

Form NRSRO also addresses the publication of CRAs' historical default rates by rating category along with the definition of default and the time horizon used. Specifically, it requires an NRSRO to disclose its ratings performance statistics – specifically, default and transition statistics over 1, 3, and 10 year time periods - for each class of credit ratings for which the NRSRO is registered. It also requires an NRSRO to explain these performance measurement statistics, including the inputs, time horizons, and metrics used to determine the statistics.<sup>135</sup>

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<sup>129</sup> EU Regulation, Article 11.2.

<sup>130</sup> EU Regulation, Annex I, Section E.II.1.

<sup>131</sup> EU Regulation, Article 10.5.

<sup>132</sup> EU Regulation, Article 10.4.

<sup>133</sup> Exchange Act Rule 17g-1; Form NRSRO, Exhibit 2. An NRSRO must disclose for initial credit ratings whether and, if so, how information about verification performed on assets underlying or referenced by a structured finance product is relied on in determining the rating and whether and, if so, how assessments of the quality of originators of assets underlying or referenced by a structured finance product factor into the determination of credit ratings. In addition, an NRSRO must include, in disclosure regarding the monitoring of credit ratings, how frequently credit ratings are reviewed, whether different models are used for surveillance, and whether changes to initial rating or surveillance models are applied retroactively to existing ratings

<sup>134</sup> Exchange Act Rule 17g-1; Form NRSRO, Exhibit 1.

<sup>135</sup> Exchange Act Rule 17g-1; Form NRSRO, Exhibit 1.



In addition to requiring the disclosure of historical default rate statistics on Form NRSRO, the SEC's regulations require an NRSRO to make and keep publicly available on its website ratings action information for a randomly selected 10% of the ratings in each class of ratings for which it is registered and for which it has issued 500 or more ratings paid for by the issuer, underwriter, or sponsor of the security being rated. The disclosure of these ratings actions, which must take place no later than six months after they are taken, is intended to provide investors, other users of credit ratings, and other market participants and observers the raw data with which to compare the credit ratings performance of NRSROs by showing how different NRSROs initially rated an obligor or security and, subsequently, adjusted those ratings, including the timing of the adjustments.<sup>136</sup> An amendment to the SEC's regulations adopted in September 2009 but not yet in effect will further allow investors, other users of credit ratings, and other market participants to compare the credit ratings performance of NRSROs. Pursuant to this new requirement, an NRSRO will be required to make and keep publicly available on its website ratings action information for any credit rating initially determined by the nationally recognized statistical rating organization on or after June 26, 2007. This requirement will apply to all NRSROs regardless of the rating action information related to the credit ratings were paid for by the obligor being rated or by the issuer, underwriter, or sponsor of the security being rated or not, with a twelve month delay for the release of ratings actions taken on issuer-paid ratings and a twenty-four month delay for all other ratings.<sup>137</sup>

In Australia, as discussed above, AFS licensees are subject to general statutory obligations. In addition, as of January 2010, a CRA's AFS license requires a CRA to adhere to the IOSCO CRA Code including, among other things, provisions relating to transparency and timeliness of ratings disclosure.<sup>138</sup> In addition, CRAs are required to provide an annual report of compliance with the IOSCO CRA Code.<sup>139</sup>

Japan's CRA regulatory program has provisions designed to promote the objectives of the third IOSCO CRA Principle by requiring a CRA to publish rating policies on a timely basis and to disclose explanatory documents periodically. The policies required to be published include policies and methods pertaining to the determination of credit ratings ("credit rating determination policies") as well as for making ratings publicly available or providing them to someone ("credit rating provision policies").<sup>140</sup> The latter set of requirements stipulates that a CRA must ensure that its credit ratings are made available to the public without delay.<sup>141</sup>

In addition, a CRA's credit ratings provision policies must detail what information is used in the ratings determination process, such as an outline of the key information, an outline of the measures taken to ensure the quality of the key information and the source of the key

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<sup>136</sup> Exchange Act Rule 17g-2.

<sup>137</sup> Exchange Act Rule 17g-2.

<sup>138</sup> See IOSCO CRA Code measures 3.1 through 3.10.

<sup>139</sup> See ASIC outlines improvements to regulation of credit rating agencies in Australia, November 12, 2009, available at <http://www.asic.gov.au/asic/asic.nsf/byheadline/09-224MR-ASIC-outlines+-improvements-to-regulation-of-credit-rating-agencies-in-Australia?openDocument>.

<sup>140</sup> Cabinet Office Ordinance on Financial Instruments Business, etc., Article 313(1).

<sup>141</sup> Cabinet Office Ordinance on Financial Instruments Business, etc., Articles 313(3)(i) and 313(3)(ii).

information.<sup>142</sup> Furthermore, a CRA is required to make an explanatory document available to the public showing statistics and other information related to changes in the credit status of a legal person or financial instrument as well as information related to the history of the determined credit ratings.<sup>143</sup>

Finally, Japan's CRA regulatory program also addresses the disclosure of unsolicited ratings. In cases where credit ratings have been determined without being solicited by rating stakeholders, a CRA must disclose that fact as well as whether unpublished information regarding the rating stakeholders was acquired in the rating process.<sup>144</sup>

In Mexico, the requirements for CRA authorization include having policies and means for issuing ratings, including modifications to ratings.<sup>145</sup> Furthermore, CRAs must disclose to the public the rating actions regarding registered securities in the manner established by the CNBV in secondary regulations. CRAs must post on their website, free of charge and on a non-selective basis, information such as: credit ratings, including the meaning of each rating category and the definition of "default" or "recovery;" the time horizon being used; any subsequent decision to discontinue ratings; and, when feasible, historical default data. Additionally, a CRA must publish sufficient information about its procedures, methodologies and assumptions to allow outside parties to understand how a rating was determined by the CRA.<sup>146</sup>

Finally, the Mexican CRA regulatory program stipulates that when feasible and appropriate, prior to issuing or revising a rating, CRAs are obliged to inform issuers about the critical information and main considerations taken into consideration for the determination of the rating. CRAs are required to give the issuer the opportunity to clarify any possible factual misperceptions or to bring to the CRA's attention any other matters that it believes the CRA should be made aware of in order to produce an accurate rating. CRAs are obliged to duly evaluate any clarification given by the issuer. In certain circumstances CRAs are not required to inform the issuer prior to the issuance of a rating; however, under those circumstances they are obligated to inform the issuer as soon as practical thereafter and to explain the reasons for the delay.<sup>147</sup>

#### **D. The Fourth IOSCO CRA Principle**

*Confidential information – CRAs should maintain in confidence all nonpublic information communicated to them by any issuer, or its agents, under terms of a confidentiality agreement or otherwise under a mutual understanding that the information is shared confidentially.*

The fourth IOSCO CRA Principle has two subsections that provide further explanation of the objective of the principle. The first addresses the adoption of procedures and mechanisms to

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<sup>142</sup> Cabinet Office Ordinance on Financial Instruments Business, etc., Article 313(3)(iii)(j).

<sup>143</sup> Cabinet Office Ordinance on Financial Instruments Business, etc., Article 318(ii)(b).

<sup>144</sup> Cabinet Office Ordinance on Financial Instruments Business, etc., Article 313(3)(iii)(g).

<sup>145</sup> Securities Market Law, Article 335, IV.

<sup>146</sup> Regulation for Securities Rating Institutions, Annex 1, III.

<sup>147</sup> Regulation for Securities Rating Institutions, Annex 1, III.

protect non-public information provided by issuers, while the second addresses the restriction of the use of such non-public information to purposes related to rating activities or otherwise as agreed upon by the issuer.<sup>148</sup>

The EU CRA regulatory program contains requirements that are designed to promote the objectives of the fourth IOSCO CRA Principle. For example, it mandates that CRAs ensure that specified persons, defined as rating analysts, employees or other persons whose services are placed at the disposal or under the control of the CRA and are directly involved in credit rating activities, and persons closely associated with them, do not share confidential information entrusted to the CRA 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. It further provides that CRAs must ensure that such persons do not use or share confidential information for the purpose of trading financial or for any other purpose except for the conduct of credit rating activities.<sup>149</sup>

In addition, the EU CRA regulatory program requires a CRA to arrange for adequate records and, where appropriate, audit trails of its credit rating activities to be kept. The regulation requires that such records include internal records and files, including non-public information and work papers, used to form the basis of any credit rating decision taken as well as credit analysis reports, credit assessment reports and private credit rating reports and internal records used to form the basis of the opinions expressed in such reports.<sup>150</sup> It further details that CRAs must ensure that relevant employees should not use or share such confidential information for any purpose other than the conduct of credit rating activities.<sup>151</sup>

The US CRA regulatory program has provisions that are designed to promote the objectives of the fourth IOSCO CRA principle. For example, it has provisions that require an NRSRO to have procedures to address the handling of material non-public information received during the rating process and the trading of securities while in possession of material non-public information, as well as to avoid the selective disclosure of a pending ratings decision. Specifically, an NRSRO's written policies and procedures must include policies and procedures reasonably designed to prevent the inappropriate dissemination within and outside the NRSRO of material nonpublic information obtained in connection with the performance of credit rating services. These policies and procedures must also be designed to prevent a person within the NRSRO from purchasing, selling, or otherwise benefiting from any transaction in securities or money market instruments when the person is aware of material non-public information obtained in connection with the performance of credit rating services

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<sup>148</sup> The subsections of the fourth IOSCO CRA Principle are:

4.1. *CRAs should adopt procedures and mechanisms to protect the non-public nature of information shared with them by issuers under the terms of a confidentiality agreement or otherwise under a mutual understanding that the information is shared confidentially.*

4.2. *CRAs should use non-public information only for purposes related to their rating activities or otherwise in accordance with their confidentiality agreements with the issuer.*

<sup>149</sup> EU Regulation, Annex I, Section C.3c,d.

<sup>150</sup> EU Regulation, Annex I, Section B.7e,f.

<sup>151</sup> EU Regulation, Annex I, Section C.3d.

that affects the securities or money market instruments. In addition, the NRSRO's policies and procedures must be designed to prohibit the inappropriate dissemination within and outside the NRSRO of a pending credit rating action before issuing the credit rating on the Internet or through another readily accessible means.<sup>152</sup>

As discussed above, a new provision in the US CRA regulatory program provides a mechanism for NRSROs to issue unsolicited credit ratings for structured finance by requiring an NRSRO hired by an issuer, sponsor, or underwriter of a structured finance arranger to rate such products to alert other NRSROs that an arranger has initiated the rating process and to promptly inform the other NRSROs where the information being provided by the arranger to the hired NRSRO may be obtained.<sup>153</sup> This provision also includes a requirement that in order to access the information provided by arrangers to the hired NRSRO, a non-hired NRSRO must annually execute and furnish to the SEC a certification stating that it will keep the information obtained confidential and treat it as material nonpublic information subject to the NRSRO's written policies and procedures. In addition, the NRSRO must certify that it will determine and maintain credit ratings for at least 10% of the issued securities and money market instruments for which it accesses such information.<sup>154</sup> This threshold is designed to protect issuer information by ensuring that non-hired NRSROs are accessing that information solely for the purpose of determining credit ratings.

In Australia, both general and CRA-specific law and regulations address the treatment of confidential information. As noted above, AFS licensees must comply with licensing requirements. For CRAs, these license conditions include compliance with the IOSCO CRA Code, which sets forth measures CRAs should adopt to address the treatment of confidential information.<sup>155</sup> In addition, Australian law has comprehensive insider trading provisions which may apply if a CRA acts on confidential information or provides confidential information to a third party or group of people who act on the information.<sup>156</sup>

Japan's CRA regulatory program also contains requirements that are designed to promote the objectives of the fourth IOSCO CRA Principle. For example, CRAs are required to appropriately manage and maintain the confidentiality of information learned during the

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<sup>152</sup> Exchange Act Rule 17g-4.

<sup>153</sup> Exchange Act Rule 17g-5.

<sup>154</sup> Exchange Act Rule 17g-5.

<sup>155</sup> See IOSCO CRA Code measures 3.11 through 3.18.

<sup>156</sup> Corporations Act 2001 (Cth) s1043A(1). Specifically, where:

(a) a person (insider) possesses information which has the characteristics of 'inside information', i.e. the information is not generally available but, if it were generally available, a reasonable person would expect it to have a material effect on the price or value of particular financial products; and

(b) the person knows (or ought reasonably to know) that the information is inside information,

then the insider must not (directly or indirectly) communicate the information (or cause the information to be communicated) to another person if the insider knows (or ought reasonably to know) that the other person would or would be likely to:

(i) apply for, acquire or dispose of relevant financial products, or enter into an agreement to apply for, acquire or dispose of relevant financial products; or

(ii) procure another person to apply for, acquire or dispose of relevant financial products, or enter into an agreement to apply for, acquire or dispose of relevant financial products.

course of the credit rating business. Specifically, a CRA must take measures to prevent the leakage of secrets by specifying the scope of secrets and those who have access to them in the course of their duties and by establishing methods for managing those secrets. Furthermore, the Japanese CRA regulatory program requires a CRA to take measures to ensure that information and secrets learned during the course of the credit rating business are not used for any purposes other than those deemed necessary for conducting the credit rating business fairly and appropriately.<sup>157</sup>

In Mexico, CRAs are obliged to adopt procedures and mechanisms to protect non-public information obtained from issuers under the terms of a confidentiality agreement or otherwise under a mutual understanding that the information is shared confidentially. CRAs are required to restrict the use of such information to purposes related to their rating activities. Furthermore, a CRA's employees must take all reasonable steps to protect all information belonging to or in possession of the CRA from fraud, theft or misuse. Finally, employees should not disclose selectively any non-public information about credit ratings or possible future rating actions until such information is made public.<sup>158</sup>

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<sup>157</sup> Cabinet Office Ordinance on Financial Instruments Business, etc., Article 306(1)(xii).

<sup>158</sup> Regulation for Securities Rating Institutions, Annex 1, II, A.

## Chapter 6 Conclusion

TCSC6's evaluation of CRA regulatory programs across different jurisdictions reveals that while the structure and specific provisions of those programs may differ, the objectives of the four IOSCO CRA Principles – quality and integrity of the ratings process; management of conflicts; transparency; and treatment of confidential information – are embedded into each of the programs, albeit in varying degrees of implementation. As the evaluation of these regulatory initiatives – currently in various stages of implementation across the jurisdictions – illustrates, the transition from conceiving a CRA supervisory program to effectively applying its requirements in practice involves an ongoing process of re-evaluation as practical considerations emerge.

Despite the differences among the jurisdictions, however, in each jurisdiction reviewed, the IOSCO CRA Principles appear to be the building blocks upon which CRA regulatory programs have been constructed. Going forward, TCSC6 anticipates that the IOSCO CRA Principles will continue as the building blocks against which the various regulatory programs will be evaluated and on which international cooperation for ongoing supervision will be directed. In this regard, TCSC6 will continue to provide a valuable forum for CRA supervisors to share experiences among themselves and with the industry.

As supervisors gain experience in implementing their regulatory programs, it will be important for them to monitor the effectiveness of those programs and any regulatory conflicts that may exist for CRAs that are active across borders. IOSCO should take account of the lessons learned by member jurisdictions and, in those jurisdictions in which the implementation process is exposing conflicts with other regimes, regulators and policymakers should seek timely and reasonable accommodations so long as the IOSCO principles are not compromised.

Finally, an important component of regulation of CRAs active on a cross-border basis is the development of regulatory and supervisory cooperation arrangements. TCSC6 notes that the IOSCO Task Force on Supervisory Cooperation (Supervisory Task Force) was mandated by the TC to develop a report that will propose a set of principles to guide IOSCO members in developing cooperative supervisory arrangements amongst themselves. Part of the work of the Supervisory Task Force includes a consideration of mechanisms for enhancing cross-border cooperation among those regulators that have (or are planning to have) powers to inspect and oversee CRAs. We also anticipate that the report will be accompanied by an annotated sample Memorandum of Understanding (MOU), which IOSCO members will be able to modify as appropriate to cover different types of market participants and to use as a template for their own bilateral supervisory arrangements. TCSC6 will continue to monitor the work of the Supervisory Task Force and, once its work is complete, consider follow-up work as appropriate.