

# **Credit Rating Agencies: Internal Controls Designed to Ensure the Integrity of the Credit Rating Process and Procedures to Manage Conflicts of Interest**

## **Consultation Report**



# **IOSCO**

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

<b>CR380/2012</b>	<b>May 2012</b>
-------------------	-----------------

This paper is for public consultation purposes only. It has not been approved for any other purpose by the IOSCO Technical Committee or any of its members.

Copies of publications are available from:

The International Organization of Securities Commissions website [www.iosco.org](http://www.iosco.org)

*© International Organization of Securities Commissions 2012. All rights reserved. Brief excerpts may be reproduced or translated provided the source is stated.*

## Foreword

The International Organization of Securities Commissions' (IOSCO) Technical Committee (TC) has published this Consultation Report, *Credit Rating Agencies: Internal Controls Designed to Ensure the Integrity of the Credit Rating Process and Procedures to Manage Conflicts of Interest*, prepared by IOSCO Standing Committee 6 on Credit Rating Agencies (SC6). This Consultation Report describes certain internal controls and procedures that credit rating agencies (CRAs) use to promote the integrity of the credit rating process and address conflicts of interest, respectively, with the aim of promoting a better understanding of these practices. The TC seeks the views of stakeholders, and particularly CRAs, on the questions posed in this Consultation Report to refine and enhance the descriptions and assist in further analysis by SC6 of the internal controls and procedures used by CRAs.

## How to Submit Comments

Comments may be submitted by one of the three following methods **on or before 9 July 2012**. To help us process and review your comments more efficiently, please use only one method.

**Important:** All comments will be made available publicly, unless anonymity is specifically requested. Comments will be converted to PDF format and posted on the IOSCO website. Personal identifying information will not be edited from submissions.

### 1. Email

- Send comments to [CRA@iosco.org](mailto:CRA@iosco.org)
- The subject line of your message must indicate *Credit Rating Agencies: Internal Controls Designed to Ensure the Integrity of the Credit Rating Process and Procedures to Manage Conflicts of Interest*.
- If you attach a document, indicate the software used (e.g., WordPerfect, Microsoft WORD, ASCII text, etc) to create the attachment.
- Do not submit attachments as HTML, PDF, GIFG, TIFF, PIF, ZIP or EXE files.

### 2. Facsimile Transmission

Send by facsimile transmission using the following fax number: + 34 (91) 555 93 68.

### 3. Paper

Send 3 copies of your paper comment letter to:

**Mr. Tim Pinkowski**  
General Secretariat  
International Organization of Securities Commissions (IOSCO)  
Calle Oquendo 12  
28006 Madrid  
Spain

Your comment letter should indicate prominently that it is a “*Public Comment on Credit Rating Agencies: Internal Controls Designed to Ensure the Integrity of the Credit Rating Process and Procedures to Manage Conflicts of Interest.*”

## Contents

Chapter 1	Executive Summary .....	1
Chapter 2	Background .....	3
2.1	Previous work of IOSCO on CRAs .....	3
2.2	The current project on internal controls and conflict procedures.....	4
2.3	Scope and purpose of the Consultation Report .....	5
Chapter 3	Quality and integrity of the rating process .....	6
3.1	Quality of the rating process .....	6
3.1.1	Control functions within the CRA .....	7
3.1.2	Preparatory phase – gathering and using information.....	8
3.1.3	Assessment phase – use and consistency of methodologies .....	11
3.1.4	Decision phase – rating committee structure and voting process .....	13
3.1.5	Dissemination phase – release of rating actions .....	16
3.2	Structural support to ensure the quality of the rating process .....	18
3.2.1	Resources adequacy .....	18
3.2.1.a	Resources adequacy – review function for new products .....	19
3.2.1.b	Resources Adequacy - periodic reviews of methodologies .....	20
3.2.1.c	Resources adequacy – structured finance initial ratings and surveillance .....	22
3.2.2	Continuity in the rating process and avoidance of bias.....	23
3.3	Monitoring and Updating.....	24
3.3.1	Regular ratings reviews.....	24
3.3.2	Ad hoc ratings reviews.....	25
3.3.3	Timely updates of ratings.....	26
3.3.4	Comprehensive monitoring.....	26
3.3.5	Disclosure of discontinued ratings .....	27
3.4	Integrity of the Rating Process.....	27
3.4.1	Firms’ compliance culture .....	28
3.4.2	The role of compliance .....	29
3.4.3	Reporting of questionable behaviour .....	30
3.4.4	Staff ethics and integrity .....	32
3.4.5	No “guarantee” of ratings .....	32
3.4.6	Recordkeeping .....	33
Chapter 4	Management of Conflicts of Interest Discussion .....	34
4.1	Managing Firm-Level Conflicts.....	34
4.1.1	Rating committees and reporting lines.....	35
4.1.2	Corporate and business structures.....	36
4.1.3	Recordkeeping .....	37
4.1.4	Disclosure .....	37
4.2	Managing Employee -Level Conflicts .....	38
4.2.1	Compensation setting structures .....	39
4.2.2	Analyst selection .....	40
4.2.3	Outside employment and other business relationships .....	41
4.2.4	Designing securities .....	42
4.2.5	Trading securities and owning investments .....	42
4.2.6	Gifts.....	43

## Chapter 1 Executive Summary

This Consultation Report results from a review by SC6 that focused on internal controls established by CRAs to promote the integrity of the credit rating process and on procedures established by CRAs to manage conflicts of interest. The review was motivated by the role of CRAs in the 2008 financial crisis, which raised concerns about the quality of credit ratings and credit rating methodologies, the timeliness of adjustments to credit ratings, and, more generally, the integrity of the credit rating process.<sup>1</sup> The 2008 financial crisis also raised concerns about how conflicts of interest are being managed by credit rating agencies.<sup>2</sup>

For example, IOSCO noted in 2008 that the performance of CRAs in rating structured finance products raised questions about whether “credit ratings were based on incorrect information and faulty or dated models” and that “[m]any observers cite the conflicts of interest inherent in the credit rating industry as a source of concern.”<sup>3</sup> In addition, the staff of the U.S. Securities and Exchange Commission examined the activities of Fitch Ratings, Ltd. (“Fitch”), Moody’s Investor Services (“Moody’s”), and Standard & Poor’s Rating Services (“S&P”) in rating subprime residential mortgage-backed securities (“RMBS”) and collateralized debt obligations (“CDOs”) linked to subprime RMBS. The staff made a number of observations, including that:

- There was a substantial increase in the total number and complexity of RMBS and CDO deals being rated and some of the rating agencies appear to have struggled with the growth;
- Policies and procedures for rating RMBS and CDOs could be better documented;
- The rating agencies did not always document significant steps in the rating process – including the rationale for deviations from their models and for rating committee actions and decisions – and they did not always document significant participants in the ratings process;
- The surveillance processes used by the rating agencies appear to have been less robust than the processes used for initial ratings;
- There were issues with the management of conflicts of interest; and
- The rating agencies’ internal audit processes varied significantly.<sup>4</sup>

---

<sup>1</sup> See, e.g., *The Role of Credit Rating Agencies in Structured Finance Markets*, TC (May 2008), available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD270.pdf> (IOSCO CRA Structured Finance Report); *Summary Report of Issues Identified in the Commission Staff’s Examinations of Select Credit Rating Agencies*, U.S. Securities and Exchange Commission (July 2008), available at <http://www.sec.gov/news/studies/2008/craexamination070808.pdf> (U.S. SEC 2008 Staff CRA Exam Report).

<sup>2</sup> See U.S. SEC 2008 Staff CRA Exam Report.

<sup>3</sup> See IOSCO CRA Structured Finance Report.

<sup>4</sup> See U.S. SEC 2008 Staff CRA Exam Report.

Despite the concerns and observations noted above, CRAs continue to play an important role in most modern capital markets.<sup>5</sup> Issuers and corporate borrowers rely on the opinions of CRAs to raise capital.<sup>6</sup> Lenders and investors use credit ratings in assessing the likely risks they face when lending money to or investing in securities of a particular entity.<sup>7</sup> Institutional investors and fiduciary investors, likewise, use credit ratings to help them allocate investments in a diversified risk portfolio.<sup>8</sup> Finally, laws and regulations use credit ratings to distinguish creditworthiness.<sup>9</sup>

This Consultation Report describes certain internal controls and procedures that CRAs state they have established to promote the integrity of the credit rating process and address conflicts of interest, respectively. Consultation from stakeholders, including further consultation from CRAs, is sought to better understand these internal controls and procedures.

### **Request for Responses**

The TC is seeking the views of as wide a range of stakeholders as possible in response to the questions posed in this document. The TC seeks responses with as much supporting information and explanation as stakeholders consider appropriate. Responses are requested by 9 July 2012. These responses will be considered by SC6 in the preparation of a final report.

---

<sup>5</sup> See IOSCO CRA Structured Finance Report.

<sup>6</sup> See *Report on the Activities of Credit Rating Agencies*, TC (September 2003), available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD153.pdf> (Report on the Activities of CRAs).

<sup>7</sup> *Id.*

<sup>8</sup> *Id.*

<sup>9</sup> See *Stocktaking on the use of credit ratings*, Joint Forum (June 2009), available at <http://www.bis.org/publ/joint22.pdf>. The Financial Stability Board has promulgated a principle calling on standard setters and authorities to assess references to credit ratings in standards, laws and regulations and, wherever possible, to remove them or replace them by suitable alternative standards of creditworthiness. See *Principles for Reducing Reliance on CRA Ratings*, Financial Stability Board (October 2010).

## Chapter 2 Background

### 2.1 Previous work of IOSCO on CRAs

In September 2003, following the publication of the Report on the Activities of CRAs, the TC published a set of principles with respect to CRAs.<sup>10</sup> The IOSCO CRA Principles are intended to be a useful tool for CRAs, regulators, and others wishing to improve how CRAs operate and how credit ratings are used by market participants.<sup>11</sup> The IOSCO CRA Principles address four key objectives that are designed to promote informed, independent analyses and opinions by CRAs.<sup>12</sup> This, in turn, is designed to promote the three core objectives of securities regulations identified by IOSCO: improving investor protection; ensuring that securities markets are fair, efficient and transparent; and reducing systemic risk.<sup>13</sup>

The four objectives of the IOSCO CRA Principles are:

- **Quality and integrity in the rating process** – CRAs should endeavour 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.

Following the publication of the IOSCO CRA Principles, the TC published a code of conduct for CRAs.<sup>14</sup> The IOSCO CRA Code provides guidance to CRAs on how the IOSCO CRA Principles could be implemented to: help guard against conflicts of interest; ensure credit rating methodologies are used consistently by employees; provide investors with sufficient information

---

<sup>10</sup> *IOSCO Statement of Principles Regarding the Activities of Credit Rating Agencies*, TC (September 2003) available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD151.pdf> (IOSCO CRA Principles).

<sup>11</sup> *Id.*

<sup>12</sup> *Id.*

<sup>13</sup> *See Objectives and Principles of Securities Regulation*, IOSCO (May 2003), available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD154.pdf>.

<sup>14</sup> *See Code of Conduct Fundamentals for Credit Rating Agencies*, TC (December 2004), available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD271.pdf> (IOSCO CRA Code).



to judge the quality of the CRA's credit ratings; and generally ensure the integrity of the credit rating process. The IOSCO CRA Code was designed to be relevant to all CRAs irrespective of their size, their business model, and the market in which they operate.

In the wake of the 2008 financial crisis, the IOSCO Chairman's Task Force on Credit Rating Agencies (CRA Task Force), the predecessor of SC6, undertook a study of the role of CRAs in the structured finance market.<sup>15</sup> The findings of the study were released in the IOSCO CRA Structured Finance Report. The report included several recommendations to revise the IOSCO CRA Code, which were adopted concurrently with the publication of the report.<sup>16</sup> The revisions were designed to address the concerns that emerged from the study, including questions regarding the quality of information that CRAs relied on, suggestions that CRAs were too slow to review existing ratings and make downgrades as appropriate, and the possible conflict of interest arising from CRAs advising issuers on how to design structured finance products. Based on the recommendations, an updated IOSCO CRA Code was published in May 2008.<sup>17</sup>

In 2009, the CRA Task Force completed a review of the level of CRA implementation of the IOSCO CRA Code and, in particular, the 2008 revisions.<sup>18</sup> The results of the review showed that, among the CRAs reviewed, a number were found to have substantially implemented the IOSCO CRA Code, including the three largest CRAs – Fitch, Moody's, and S&P.<sup>19</sup> In addition, a large majority of the remaining CRAs had implemented the 2004 IOSCO CRA Code provisions but had not yet implemented the provisions added through the 2008 revisions. Only a handful of the CRAs reviewed were found to have not implemented the IOSCO CRA Code in any meaningful way.

In 2010 the TC published a report containing the results of an evaluation by SC6 of how regional and national authorities were implementing CRA regulations.<sup>20</sup> Among other things, the report concluded that, while the structure and specific provisions of regulatory programs may differ, the objectives of the four IOSCO CRA Principles are embedded into each of the programs reviewed.

## 2.2 The current project on internal controls and conflict procedures

In June 2010, the TC approved two related project specifications for SC6 entitled *CRA Internal Controls as a Means to Ensure the Integrity of the Ratings Process* (internal controls project) and *Credit Rating Agency Management of Conflicts of Interest* (conflicts project). The primary goal

---

<sup>15</sup> See IOSCO CRA Structured Finance Report.

<sup>16</sup> *Id.*

<sup>17</sup> <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD271.pdf>

<sup>18</sup> See *A Review of Implementation Of The Iosco Code Of Conduct Fundamentals For Credit Rating Agencies*, TC (March 2009), available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD286.pdf>. This report followed a Consultation Report published in 2007 that contained findings of a review of CRA implementation of the IOSCO CRA Code prior to it being revised in 2008. See *Review Of Implementation Of The Iosco Fundamentals Of A Code Of Conduct For Credit Rating Agencies*, TC (February 2007), available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD233.pdf>.

<sup>19</sup> *Id.*

<sup>20</sup> See *Regulatory Implementation of the Statement of Principles Regarding the Activities of Credit Rating Agencies*, TC (February 2011), available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD346.pdf>. Also, <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD319.pdf>

of the internal controls project is to obtain a comprehensive and practical understanding of CRAs' internal controls over the credit rating process that are designed to promote the quality of the credit ratings produced by CRAs. The primary goal of the conflicts project is to obtain a comprehensive and practical understanding of the current practices of CRAs designed to manage the conflicts of interest they face in connection with the determination and issuance of credit ratings. A second goal of both projects is to identify practices CRAs have implemented to give effect to the IOSCO CRA Principles and the IOSCO CRA Code.

In order to perform the work described in the mandates, SC6 surveyed nine CRAs for the internal controls project and ten CRAs for the conflicts project.<sup>21</sup> The surveyed CRAs are active in SC6 member jurisdictions, and encompass a range of differing sizes, business models, and rating activities. Additionally, a number of the surveyed CRAs gave presentations on these topics to SC6 during its regular meetings.

For the internal controls project, the CRAs were provided with a questionnaire designed to elicit information regarding their practices for ensuring the integrity of their processes for determining credit ratings. The CRAs were asked to describe the internal controls they have established that are designed to ensure the integrity of their credit rating processes and whether and how the internal controls address the IOSCO CRA Code provisions under Section 1 (*Quality and Integrity of the Rating Process*) and its three subsections: Section 1.A (*Quality of the Rating Process*), Section 1.B (*Monitoring and Updating*), and Section 1.C (*Integrity of the Rating Process*). For the conflicts project, CRAs were provided with a questionnaire designed to elicit information regarding the procedures they have established to manage the conflicts of interest inherent in their business models. The CRAs were asked to describe the procedures and whether and how they address the IOSCO CRA Code provisions under Section 2 (*CRA Independence and Avoidance of Conflicts of Interest*) and its three subsections: Section 2.A (*General*), Section 2.B (*CRA Procedures and Policies*), and Section 2.C (*CRA Analyst and Employee Independence*). The surveyed firms also were asked to detail their procedures for making and keeping records of matters that would be relevant to an assessment by regulators of the independence of a CRA's credit rating activities, including whether those activities have been compromised by conflicts of interest.

The findings in this Consultation Report are based on the firms' responses to these questionnaires. Chapter 3 describes internal controls the CRAs have established to promote the integrity of the credit rating process. Chapter 4 describes procedures the CRAs have established to manage conflicts of interest. To respect the confidentiality of individual firm information, the CRAs that participated are not identified by name.

### **2.3 Scope and purpose of the Consultation Report**

This Consultation Report is intended to describe the practices of CRAs that are designed to give effect to the IOSCO CRA Code provisions under Section 1 (*Quality and Integrity of the Rating Process*) and Section 2 (*CRA Independence and Avoidance of Conflicts of Interest*). The reviews of the level of implementation of the IOSCO CRA Code completed in 2009, pursuant to the

---

<sup>21</sup> A number of CRAs answered both surveys.

scope of the mandate for those reviews, only considered publicly available CRA codes of conduct and did not seek further information from the CRAs on the internal controls and procedures they have established to give effect to their code provisions. This Consultation Report seeks to go one step further and describe the operational practices of the CRAs that are designed to give effect to the relevant provisions of the IOSCO CRA Code.

The Consultation Report is not intended to prescribe specific types of internal controls or procedures, nor make judgments about whether a particular internal control or procedure gives effect to a specific provision of the IOSCO CRA Code. It also is not intended to serve as an evaluation of CRAs' compliance with their internal controls and procedures or an evaluation of the effectiveness of their internal controls and procedures. In addition, the report is not designed to assess how the internal controls and procedures work in practice. Finally, the findings in this report are subject to the limitations of the information received from the CRAs and were not independently verified by SC6 members.

Given the large amount of information provided by CRAs and the differing approaches the CRAs took in responding to the questionnaires sent by SC6, some degree of judgement and interpretation is necessary. As such, the Consultation Report can provide only a broad description of the CRAs' internal controls to promote the integrity of the credit rating process and procedures to manage conflicts of interest.

## **Chapter 3 Quality and integrity of the rating process**

### **3.1 Quality of the rating process**

CRAs use different quantitative and qualitative models and methodologies to determine credit ratings. However, they generally follow the same steps to produce a credit rating. As described by the TC in 2003, the rating process has four main steps.<sup>22</sup> First, there is a preparatory phase during which an analyst is assigned to gather information about the issuer of the security being rated (issuer) and the characteristics of the security or obligation being rated (obligation), or, if an entity is being rated itself, information about the entity (obligor). Second, there is an assessment phase during which the analyst applies the models and methodologies to that information in order to develop a recommendation for a rating committee on the credit rating that should be published by the CRA. Third, there is a decision phase during which a rating committee will consider the analyst's recommendation and related information, deliberate on the recommendation, and, if sufficient members agree, settle on a final credit rating to be published by the CRA. Fourth, there is a dissemination phase, at which point the assigned credit rating will be publicly announced if it is to be made available to the public or privately disseminated by the CRA.

The IOSCO CRA Code has provisions designed to enhance the quality of this rating process. This Chapter describes the CRAs' internal controls that seek to give effect to the provisions of the IOSCO CRA Code. The subsections are in the chronological order of the steps of the rating

---

<sup>22</sup> See Report on the Activities of CRAs.

process.<sup>23</sup> Consequently, the provisions of the IOSCO CRA Code cited in the discussion below may not be in numerical order and may overlap in some instances.

### **3.1.1 Control functions within the CRA**

Some CRAs, including the largest CRAs, have established control functions within their organizational structures that are designed to promote the integrity of the rating process. For example, several CRAs have a chief credit officer, which is a senior level position. The responsibilities of the chief credit officer may include independently reviewing rating methodologies and analyzing and validating models used in the credit rating process. At one CRA, the chief credit officer is in charge of a credit policy team that has supervision over the rating process and the development, vetting, and review of rating methodologies. Among other things, this team is responsible for: (1) conducting research on ratings performance; (2) reviewing and approving methodologies and models; and (3) overseeing credit policy committees that formulate high-level rating policies and practices for each of the rating groups within the CRA. The credit policy team is separate from the rating groups that are principally responsible for rating obligors and obligations. The firm stated that the independence of this function is designed so that decisions taken on methodological issues or questions relating to how credit ratings have performed over time are “independent of any non-credit business objective.” The rating performance studies conducted by the credit policy team test whether the CRA’s rating system and the methodologies that underpin that system are performing in accordance with expectations. The chief credit officer also chairs a credit policy committee that sets overall standards for the credit rating process. The committee is made up of the chief credit officers of each of the CRA’s main rating groups (corporate finance, financial institutions, public and infrastructure finance, and structured finance), the managers of each of these rating groups, and other senior officers. The credit policy committee has three standing committees that review analytical and procedural issues in each of the main rating groups (one standing committee responsible for corporate finance and financial institutions, one standing committee responsible for public and infrastructure finance, and one standing committee responsible for structured finance).

Another CRA has established criteria and quality control functions. The functions are each independent of the CRA’s business lines. The criteria function is responsible for overseeing and approving the development of analytical methodologies and assumptions and changes to analytical methodologies and assumptions across products, sectors, and geographic regions. The quality control function is responsible for reviewing the CRA’s adherence to analytical policies and procedures as well as overseeing ratings processes, conducting reviews of the quality and performance of credit ratings, and identifying areas for improvement. In this regard, the quality control personnel evaluate credit rating files for substantive analytical issues, including the adherence to analytical procedures and methodologies, the proper application of criteria, the quality of rating committee decisions, and the adequacy of file documentation. The quality

---

<sup>23</sup> To protect the confidentiality of the surveyed CRAs, in reporting their practices in the following sections, the generic term “rating committee” will be used to describe a committee of any form that performs the functions typically conducted by a rating committee regardless of the name or designation assigned to it by the CRA.

control function also conducts sector reviews, rating committee assessments, and targeted post event reviews.

While small CRAs may not establish independent functions made up of groups of employees, one CRA has a head of methodology who is in charge of the firm's analysts and is accountable for all the ratings issued by the CRA. The head "does not perform regular ratings, but coordinates the rating process of the agency." The head monitors all stages of a rating process to make sure that analysts adhere to the firms' rating methodologies, policies and procedures. His role also includes overseeing that rating analysts are suitably qualified to perform the rating assignments.

In addition, some CRAs have established internal compliance and internal audit functions. Generally, the compliance functions are responsible for monitoring adherence to global regulatory requirements and providing training and guidance on compliance related policies and guidelines of the CRA. At one CRA, the internal audit function conducts global audits of each rating group annually. The audits focus on the rating processes and internal controls over the rating process.

*Q1* Are there any other key control functions within CRAs that are not described above? If so, describe them.

*Q2* Are there other key responsibilities of the control functions identified above that are not included in the description above? If so, describe them.

*Q3* The ability to establish independent control functions within a CRA's organization may depend on the resources available to a CRA. Is it practical for smaller CRAs to establish independent control functions? If not, explain why. In addition, if it is not practical, describe other measures small CRAs can take that are a reasonable substitute to having independent control functions.

### **3.1.2 Preparatory phase – gathering and using information**

CRAs were asked to describe the internal controls they employ with respect to the information gathering process and the use of that information. Specifically, they were asked to describe whether and how their internal controls:

- Ensure that the opinions the firm disseminates are based on a thorough analysis of all information known to the CRA that is relevant to its analysis according to the CRA's published rating methodology (Code 1.1);
- Ensure that the CRA's ratings reflect all information known, and believed to be relevant, to the CRA, consistent with its published methodology (Code 1.4);
- Allow the CRA to determine whether its personnel are likely to have access to sufficient information to make a rating assessment (Code 1.7); and

- Ensure that the information they use in assigning a rating is of sufficient quality to support a credible rating (Code 1.7).

CRA's use a range of information in determining credit ratings. For example, CRA's may use information obtained from issuers and obligors, information obtained from third parties, and public information. One CRA states that it also uses "confidential proprietary information" of the CRA and its affiliates. Another CRA stated that, while publicly available information is used in the rating process, the "most relevant information" is provided by the issuer or the obligor. In this regard, the issuer or obligor is required to provide the CRA with up-to-date financial statements, projections of cash flows, historical operating indicators, and other corporate data. Additionally, this CRA conducts due diligence visits to the premises of the issuer or obligor during which analysts have the opportunity to confirm certain information and collect additional information.

In terms of communicating to analysts the information that should be gathered, one CRA indicated that it requires each practice area to create and maintain a list of the types of information generally considered relevant to the credit ratings issued by that practice area. Similarly, a second CRA has internal policies for each major rating group that "provide guidance to assist them in determining the sufficiency of information received as part of the rating process." A third CRA cited training policies designed to provide guidance on the sufficiency of information. This firm explained that it "conducts mandatory training for all new analysts in their first year of employment, and every three years for existing analysts, on ensuring the robustness of data used to determine a credit rating." A fourth CRA noted that its methodologies "indicate, in general, the information necessary for the analysis, as well as the procedures to obtain it." A fifth CRA uses checklists to identify necessary information. Another CRA uses standardized questionnaires to gather information from issuers and obligors.

Several CRA's make it the responsibility of the lead analyst to gather the relevant and necessary information to determine the credit rating. For example, one CRA requires the lead analyst to gather the information needed for the credit analysis "in a thorough and comprehensive way." This includes having "frank discussions" with the issuer or obligor about its credit strengths and weaknesses, and trends in its industry. The lead analyst also is responsible for pursuing relevant lines of inquiry.

CRA's may have policies and procedures regarding the presentation of information to a rating committee. One CRA explained that its policies require that the lead analyst to prepare and distribute to rating committee members a package of information that includes a memorandum and any other information to be considered by the rating committee, such as supporting materials and analysis (*e.g.*, models, portions of offering materials, written presentation materials provided by the issuer, financial analysis, peer group comparisons, other ratings issued by the CRA, ratings assigned by competitors, and market implied ratings). If practical, this information should be provided in advance of each rating committee meeting. The CRA added that the rating committee memorandum generally includes the lead analyst's written credit analysis of the issuer or obligation being considered and his or her recommendation regarding the credit rating. Another CRA explained that presentations by analysts typically include a rating recommendation and rationale, a discussion of key analytical considerations, the principal methodologies and

criteria applied, a draft press release and/or rating report, financial metrics, comparisons with similar ratings, peer ratings, financial forecasts, stress analysis and pro forma metrics, and key information from the issuer or obligor, market information relevant to the issuer or obligor, and background information on the rating and relevant industry.

While the lead analyst may be responsible for gathering the necessary information, several CRAs make it the ultimate responsibility of the rating committee to assess whether the gathered information is sufficient to support the determination of a credit rating and whether that information has been adequately analyzed. For example, one CRA stated that its policies require that the rating committee chair ensure, among other things, “that the rating committee reviews all relevant information and materials and appropriately applies [the CRA’s] criteria.” Another CRA indicated that its most senior credit analyst supervisors, who typically serve as rating committee chairs, are responsible in that capacity for ensuring that the CRA’s policies, procedures, and methodologies are followed. According to this CRA, the credit analyst supervisors are required to ensure that “rating committee presentations are of high quality and are based upon information and documentation reasonably believed to be reliable.”

If the information is insufficient, the CRAs will not continue with the rating process. For example, one CRA noted that it only assigns ratings when there is “sufficient information available to support the analysis and monitor the rating on an ongoing basis.” The CRA stated that it “refrains from assigning credit ratings and will discontinue an outstanding rating in any situation where there was a lack of reliable data (including in respect of the assets underlying a structured product)...or where the quality of information is not satisfactory or raises serious questions as to whether a credible credit rating can be provided.” Another CRA explained that its head of analysis whose responsibilities include checking that credit rating analyses are prepared in accordance with the criteria stipulated in the specific methodology as well as its rating committee may question the responsible analysts about the information used and have veto power over the assignment of a rating in the event that they believe that the firm’s information requirements were not sufficiently met.

A third CRA explained that prior to starting the rating process an analyst is required to report to the manager of the relevant rating department or division on whether or not the information used in the process of assigning credit ratings is of sufficient quality to proceed with the rating process. The manager is then responsible for determining whether to commence the process of assigning a credit rating. If the manager has doubts as to whether or not the information is of sufficient quality, the manager is required to convene a committee to discuss whether or not to proceed with the rating. In addition, once a rating committee is formed, the committee chair also examines whether or not the information is of sufficient quality. If the rating committee chair determines that the information is not of sufficient quality, the rating committee does not proceed. Similarly another CRA noted that if rating committee members have concerns about the completeness or accuracy of information that is relevant to the credit assessment and could affect the rating outcome, the rating committee is adjourned and the lead analyst is asked to collect and analyze additional information. This additional information gathering process could involve, among other things, requesting that the issuer or obligor provide additional information or verify data previously provided. The CRA explained that, once the additional information has been obtained and analyzed, the rating committee is reconvened. However, if the lead analyst or

rating committee believes the information is still insufficient, the CRA will decline to assign a credit rating or withdraw an outstanding credit rating, as applicable.

### ***Questions for Comment***

- Q4* Are there any other key internal controls established by CRAs with respect to information gathering and use of information that are not described above? If so, describe them.
- Q5* Some CRAs use checklists and/or standardized questionnaires to identify the types of information considered relevant to the given credit rating methodology to guide analysts and rating committee members as to the relevant information that must be gathered and considered to determine a credit rating under the methodology. Checklists and standardized questions are useful tools; however, there is potential risk that they may limit analysts and rating committee members from gathering and considering other relevant information not specifically identified in the checklists or standardized questionnaires. Accordingly, what controls or other steps are taken by CRAs to ensure that checklists or standardized questionnaires do not limit analysts and rating committee members from gathering and considering other information not specifically identified in the checklist or questionnaire?
- Q6* In addition to information from issuers and obligors, what other types of information are used in the rating process? For example, what types of confidential proprietary information of the CRA (as opposed to the issuer or obligor) is used in the rating process? How does the information used in the rating process differ across different classes of credit ratings (*e.g.*, corporate issuers, structured finance products, governmental issuers)?
- Q7* While CRAs are not auditors, taking reasonable steps to verify information used in the rating process can enhance the integrity of the process. What types of information used during the rating process do CRAs seek to verify? What types of information would it be practical and feasible for CRAs to verify? Does the degree of verification depend on the class of credit rating?
- Q8* When data are the input for models or score cards, what steps are taken to ensure they are up-to-date?

### **3.1.3 Assessment phase – use and consistency of methodologies**

CRAs were asked to describe the internal controls they employ in connection with the use of their rating methodologies. Specifically, they were asked to describe whether and how their internal controls:

- Ensure that they use rating methodologies that are rigorous, systematic, and, where possible, result in ratings that can be subjected to some form of objective validation based on historical experience (Code 1.2);



- Ensure that in assessing an issuer’s creditworthiness, analysts involved in the preparation or review of any rating action use methodologies established by the CRA (Code 1.3); and
- Ensure that analysts apply a given methodology in a consistent manner, as determined by the CRA. (Code 1.3)

Several CRAs make it the responsibility of the lead analyst and, ultimately, the rating committee chair to select the appropriate models and methodologies to use in determining a given credit rating. In this regard, one CRA explained that chief credit officers from the firm’s credit policy team help analysts “understand how [the firm’s] established methodologies should be applied.” It noted that although updates to a methodology must be approved and published before they became eligible to serve as the governing methodology in reaching a rating decision, “this principle must not prevent a rating committee from using its overall best judgment in assigning or updating a [credit rating]. Accordingly, the rating committee may exercise its judgment and decide to include (or decide not to include) some components of an imminent methodology change in its deliberations and decision-making.” Another CRA stated that analysts are “accompanied by senior managers in order to standardize processes and avoid misunderstanding of the methodology.” It explained that the process as a whole is monitored by a senior officer who does not participate in credit analysis or influence credit ratings but is available to provide clarifications on specific procedures. The role of this senior officer is to “homogenize the analytical procedures and the consistency of the conclusions and fundamentals.” The analyst and this senior manager meet in a “pre-committee” before the rating committee convenes in order to review whether the analyst is using an inappropriate methodology or data interpretation and to “give consistency to the findings.”

CRAs also may use “after-the-fact” reviews to test whether analysts and rating committees are using the correct models and methodologies. For example, one CRA noted that its internal compliance group has procedures to test whether the analysts involved in the preparation or review of any rating action comply with the relevant methodologies. A second CRA stated that internal audit function reviews the firm’s rating activities. The CRA stressed the “global remit” of the internal audit function, noting that, among other things, the firm conducted global audits of each rating group on an annual basis, focusing on the processes and internal controls over the rating process. This firm also noted that its rating groups are organized globally along major lines of business and stated that this approach contributes to rating quality and integrity by facilitating consistency in analytical approach, as appropriate, across jurisdictions. It also conducts rating performance studies to determine if the CRA’s rating system and the methodologies that underpin that system are performing in accordance with expectations.

***Question for comment***

- Q9* Are there any other key internal controls established by CRAs with respect to the use and consistency of methodologies that are not described above? If so, describe them.
- Q10* How are the “after-the-fact” reviews that test whether analysts and rating committees are using correct models and methodologies conducted? What do they entail?

### 3.1.4 Decision phase – rating committee structure and voting process

CRAAs were asked to describe the internal procedures and mechanisms they employ in connection with their rating committee processes. Specifically, firms were asked to describe whether and how their internal procedures and mechanisms:

- Ensure that credit ratings are assigned by the CRA and not by any individual analyst employed by the CRA (Code 1.4); and
- Ensure that the CRA uses people who, individually or collectively (particularly where rating committees are used) have appropriate knowledge and experience in developing a rating opinion for the type of credit being applied. (Code 1.4)

Each of the CRAAs surveyed reported that it used rating committees to ensure that its credit ratings were assigned by the CRA and not by an individual analyst. The composition of those committees as well as the policies governing the rating committee decision-making process, however, varied among the surveyed CRAAs.

Several CRAAs identified education and experience qualifications as a prerequisite to serving on a rating committee. For example, one CRA noted that an analyst who votes in a rating committee must be approved by his or her manager to vote in a rating committee and generally must have been employed as an analyst for at least one year. Another CRA's guidelines provide that – in addition to meeting education standards – analysts are expected to provide input into the rating decision of the committee based on their specialized knowledge and experience.

In addition, some CRAAs emphasized that they seek to staff rating committees with individuals that have a range of perspectives. For example, one CRA explained that committee participants are selected with a view toward bringing together individuals who are familiar with the issuer or obligor, individuals who are knowledgeable about the industry or asset class, and “individuals with fresh perspectives on the credit in question.” Moreover, the chair of the rating committee is expected to encourage broad-based participation from all members, regardless of seniority, and the expression of dissenting or controversial views. Once a full discussion has taken place, voting begins with the lead analyst and back-up analyst and, thereafter, voting by other members generally in rank order from junior to senior, with the chair voting last so that the senior members (including the chair) do not influence the votes of the junior members. If no single outcome has the support of the majority, the rating committee is reconvened and another analyst (who is at least managing director or above) is brought in to serve on the reconvened committee.

Similarly, another CRA explained that while all of its rating committees include a chair and a lead analyst, the composition of individual committees varies. The CRA stated that rating committee members potentially could include one or more analysts from the same rating group (including analysts from the same region and/or other regions), analysts from another rating group “who may bring a useful perspective to bear on the analysis,” senior-level analysts, specialist analysts (*e.g.*, accounting specialists), and/or “support analysts.” Members of the rating committee are encouraged to express dissenting or controversial views and to discuss differences openly. The CRA stated that discussion in a rating committee should continue “as

long as necessary so that the relevant points, including differences of opinion, are thoroughly discussed, assumptions are tested, and a fully reasoned opinion is articulated that is supported by a majority vote of the rating committee.” A third CRA stated that it may consult external specialized professionals such as accounting experts, and lawyers, among others, in order to qualify its credit opinion “[w]henever deemed necessary.”

In terms of forming the committee, one CRA requires the lead analyst to report to the responsible manager of the rating department or division as to whether or not a sufficient number of staff possessing professional expertise and skills in handling the relevant credit ratings can be secured. Based on these reports, the manager determines whether the process of assigning credit ratings can be commenced. If the manager has doubts as to whether or not a sufficient number of staff possessing professional expertise and skills in handling the relevant credit ratings can be secured, the manager must convene a special committee to decide whether or not to proceed with the rating process. Once a rating committee is formed, the committee chairman also is required to examine whether or not a sufficient number of staff possessing professional expertise and skills in handling the relevant credit ratings can be secured. If it is determined that a sufficient number cannot be secured, the rating committee may not proceed with determining a rating or, if the process has already started, must cease that process.

Another CRA explained that its head of analysis whose role includes conducting quality control checks on the rating process is responsible for ensuring that that a committee has the most appropriate composition in terms of the experience and qualifications of its members, taking into account “the peculiarities and characteristics of the asset/issuer evaluated” and confirming that committee members have “time availability and the tools needed to take part.” The CRA noted that while the rating process may involve only two analysts (a main analyst and an assistant analyst), ratings are assigned, without exception, after its standing rating committee analyzes the information and votes. The resulting rating reports are designed to “reflect the information deemed relevant” by the rating committee. The CRA noted that the standing rating committee operates with a minimum of five members and takes decisions based only upon a majority vote, adding, “[h]owever, if there are any major disagreements in the vote, the vote is generally done over.”

One CRA has separate requirements for corporate and structured finance ratings committees. For corporate ratings, the firm’s most senior credit analyst supervisors typically serve as rating committee chairs and are responsible for ensuring that the CRA’s policies, procedures, and methodologies are followed. Specifically, they are responsible for ensuring, among other things, that all proposed ratings and rating actions are reviewed by a properly constituted rating committee, which includes soliciting participation by other groups, as necessary. The CRA noted that rating committee voters are selected from a pre-approved list. In addition to the chair and the lead analyst, committee membership is generally comprised of analysts with at least 5 years experience. The firm features different rating committee compositions for different situations. A rating committee with a quorum of three voters may perform “limited straight forward rating actions,” while a quorum of five voters is necessary for a rating committee to perform more complicated actions.

For structured finance ratings, the CRA noted that it may convene preliminary rating committees at any time during the rating process to determine credit enhancement levels for a proposed transaction, assign provisional ratings, or resolve a substantive issue prior to continuing with a transaction's credit analysis. Structured finance rating committees may operate exclusively through e-mail when dealing with "minor events;" however, a unanimous vote is needed for the committee to take action through e-mail, and a full rating committee is necessary for assigning rating actions on newly issued securities and for taking rating actions such as upgrades or downgrades on existing securities. Structured finance rating committees must have at least four voters, with a minimum of one of the firm's most senior credit analyst supervisors, two voters from a pre-approved list, and one voter who does not report to the head of the product group under which the transaction under consideration falls. Rating decisions are made based on a majority vote. For both corporate and structured finance rating committees, other analysts and staff members may attend as non-voting participants provided that they do have not any conflicts of interest.

Several CRAs discussed their knowledge prerequisites and training policies for rating committee participants. One CRA stated that its professional development and training program "contributes to the quality of [the CRA's] rating analysis" by providing training designed to, among other things, help analysts maintain and enhance their knowledge of matters relevant to credit risk analysis and the rating process and familiarize them with credit-related issues, and emerging trends in the market. This CRA noted that it "seeks to employ [analysts] who have the requisite skills, are appropriately qualified for their positions, demonstrate good judgment, and adhere to high standards of integrity. [The firm] recruits individuals with diverse educational backgrounds and work experience to serve as [analysts] for different industry sectors and asset classes so that, individually and/or collectively, they possess the appropriate knowledge and experience to analyze the particular type of credit presented in each circumstance." Another CRA stated that it seeks to hire individuals who are appropriately qualified to conduct credit rating activities and cited its education policy, which "sets forth ongoing education and training requirements for all employees in analytical roles as well as certain employees in control roles." A third CRA noted that in assigning analysts to perform credit ratings, its head of analysis takes into account the analyst's experience, knowledge and familiarity with the issuer being evaluated, knowledge of the methodology to be used, educational level, and availability. Under this CRA's continuing training policy, the CRA pays in full for specialized courses in areas relevant to analysts' duties (*e.g.*, accounting, finance, economics, languages) and pays for at least 50% of the value of monthly tuition for postgraduate studies of all of its employees, whether analysts or not.

Finally, one CRA noted that although it does not have an ongoing training program, its analysts are encouraged to attend workshops and related events, as well as to take specific training courses if management deems such courses to be relevant to the agency's activities. It stated that any newly-hired analyst, regardless of seniority level, is required to attend a two-month introductory training course to learn about the CRA's rating concepts and methodologies, prior to any participation in rating activities. During this period, the analyst will not perform any ratings and will not vote in committee meetings, although he or she will still attend such meetings and participate in due diligence visits.

### *Question for comment*

- Q11* Are there any other key internal controls established by CRAs with respect to the rating committee structure and voting process that are not described above? If so, describe them.
- Q12* Are there CRAs that do not use a rating committee process? If so, what controls do they use in lieu of a rating committee designed to ensure that credit ratings are assigned by the CRA and not by any individual analyst and that the analyst has appropriate knowledge and experience to determine the credit rating?
- Q13* Are there situations where a CRA that normally uses a rating committee as part of the rating process may not use a rating committee? If so, when is it appropriate to not use a rating committee? What controls are used in lieu of the rating committee?
- Q14* Some CRAs noted that rating committee members are encouraged to freely express their views, including dissenting opinions. What measures are taken to encourage all rating committee members to freely express their views?

### **3.1.5 Dissemination phase – release of rating actions**

CRAs were asked to describe the internal controls they employ in connection with releasing rating actions. Specifically, firms were asked to describe whether and how their internal controls:

- Take steps to avoid issuing any credit analyses or reports that contain misrepresentations or are otherwise misleading as to the general creditworthiness of an issuer or obligation (Code 1.6); and
- Make clear in a prominent place, if the rating involves a type of financial product presenting limited historical data (such as an innovative financial vehicle), the limitations of the rating (Code 1.7).

CRAs may use internal and external reviews to ensure that a credit rating and any related materials to be published with the credit rating (*e.g.*, a press release announcing the credit rating) do not contain errors of fact or other mistakes. For example, one CRA stated that its most senior credit analyst supervisors, who typically serve as rating committee chairs, are responsible for ensuring that the content of the CRA’s press releases and rating reports are consistent with the content of the rating committee presentations and decisions made by the rating committees. Another CRA stated that it employs a “4 eyes principle” to allow for correction by both the main analyst and the secondary analyst involved in the rating process. In addition, the firm explained that all rating reports are checked and corrected by the head of analysis and by the “correction and checking area of the company.”

With respect to external reviews, CRAs may provide the issuer or obligor that is the subject of the credit rating with an opportunity to review materials to be published. For example, one CRA explained that “where feasible and appropriate,” prior to issuing or revising a credit rating, the

firm provides the issuer or obligor with a draft of the credit rating announcement. This allows the issuer to indicate whether or not the draft credit rating announcement contains any factual errors. Similarly, another CRA stated that it generally provides the issuer or obligor that is the subject of the credit rating with an opportunity to identify any misrepresentations or misleading statements in the credit rating rationale prior to its issuance. The issuer or obligor is permitted to appeal the credit rating if it believes that the CRA has missed or materially misinterpreted critical information.

CRAs also may have policies requiring that certain disclosures be made about credit ratings to inform users of the credit ratings of any potential limitations. For example, one CRA noted that its credit rating announcements include, among other things, identification of the sources of information used in the rating process, disclosures about the quality of information used in the rating process, and “disclosures regarding the attributes and limitations” of credit ratings. In this regard, the CRA discloses, at the end of each rating announcement, that it “is not an auditor and cannot in every instance independently verify or validate information received in the rating process.” With respect to structured finance products, the CRA also discloses, when applicable and through a separate rating metric, when “there is limited, but not unsatisfactory, historical performance data for the assets in the underlying pool (such as an innovative financial vehicle).” In addition, if the limitations on the information used to determine the rating are “sufficiently significant” and could influence that rating, the CRA also discloses that fact. The CRA stated generally that its policies describe and provide guidance on the disclosures to be included in credit rating announcements and that its internal audit function conducts periodic reviews of the process for issuing credit rating announcements, including the process for including appropriate regulatory disclosures.

A second CRA stated that its rating report lists the most important information received and attests as to whether it was enough to conduct the analysis within the applied methodology. It also attests as to whether there was any type of limitation or if some relevant information was not received and explicitly states whether and in what way this limited the analysis. Finally, the third CRA stated that for credit ratings that are to be made publicly available, it provides, among other things, an explanation of the assumptions, significance, and limitations of the determined credit rating, including an explanation on the limitations of the rating when applicable.

### ***Question for comment***

- Q15* Are there any other key internal controls established by CRAs with respect to the release of rating actions that are not described above? If so, describe them.
- Q16* Describe the steps of the issuer/obligor appeals process. What standards are applied to determine whether an appeal should be granted?
- Q17* With respect to disclosures about the limitations of the credit rating, does the lead analyst determine the substance of the disclosure or does the rating committee? What process is used to identify limitations?

- Q18* What controls do CRAs use to ensure the timely release of a credit rating after the decision of the rating committee or, if no rating committee was used, the analyst(s)?
- Q19* What controls are in place to ensure that a credit rating is not released prior to the completion of all steps of the rating process?
- Q20* If a CRA uses automated systems to release credit ratings and associated information, what controls are used to ensure that the credits and associated information that are released reflects the decision of the rating committee or, if no rating committee was used, the analyst(s)?

### **3.2 Structural support to ensure the quality of the rating process**

The IOSCO CRA Code provisions address the adequacy of resources a CRA devotes to the rating process. For example, the code provides that a CRA should ensure that it has and devotes sufficient resources to carry out high-quality credit assessments of all obligations and issuers it rates.

#### **3.2.1 Resources adequacy**

Each CRA was asked to describe the internal controls it employs that are designed to ensure that, in deciding whether to rate or continue rating an obligation or issuer, the firm assesses whether it is able to devote enough personnel with sufficient skill sets to make a proper rating assessment. (Code 1.7)

Some CRAs have processes to periodically review their resource needs. For example, one CRA noted that its risk management group produces a report every six months that evaluates whether the CRA has devoted sufficient personnel and financial resources to produce timely and rigorous ratings. In addition, this CRA's human resources group evaluates every three years whether the staff is of a sufficient quality to conduct a rating analysis that is robust given the needs and complexities of the entities and instruments that the CRA rates. Another CRA noted that a team of senior managers annually reviews the level and type of staff and other resources required on a regional and business unit basis. This firm-wide review process considers many different factors, including anticipated business needs, budgetary proposals, the complexity and volume of transactions, and the availability of qualified people and technology. Based on this review, the team decides whether and to what extent different groups within the CRA have additional personnel and related resource needs. The CRA stated that it also evaluates internal processes and market trends in order to maintain operational flexibility to allocate resources needed to monitor existing credit ratings and conduct reviews on a timely basis. As a result, in some circumstances the CRA may re-assign analysts from one sector or sub-sector to another based on need.

#### ***Questions for Comment***

- Q21* Are there any other key internal controls established by CRAs with respect to assessing the adequacy of resources that are not described above? If so, describe them.

Q22 What metrics and/or standards do CRAs use to assess the adequacy of their resources? Are different metrics and/or standards used for different classes of credit ratings?

### 3.2.1.a Resources adequacy – review function for new products

CRAs were asked to describe the internal controls they employ with respect to establishing a function to review the feasibility of providing a credit rating for a type of structure that is materially different from the structures the CRA currently rates. Specifically, firms were asked to describe whether and how their internal controls:

- Establish a review function made up of one or more senior managers with appropriate experience to review the feasibility of providing a credit rating for a type of structure that is materially different from the structures the CRA currently rates. (Code 1.7-1);
- Assess, for structured finance products, whether existing methodologies and models for determining credit ratings of structured products are appropriate when the risk characteristics of the assets underlying a structured product change materially (Code 1.7-3); and
- Refrain from issuing a credit rating, in cases where the complexity or structure of a new type of structured product or the lack of robust data about the assets underlying the structured product raise serious questions as to whether the CRA can determine a credible credit rating for the security (Code 1.7-3).

Several CRAs have established dedicated functions to approve new rating methodologies and material changes to existing methodologies. For example, one CRA explained that typically its rating groups are responsible for developing new credit rating methodologies or new components of existing methodologies, while the firm's credit policy function is responsible for reviewing and approving any new credit rating methodology produced by a rating group. Specifically, the CRA stated that all methodologies governing new industries, new sectors, or new asset classes must be approved by the firm's credit policy committee, which has the overall responsibility for the CRA's credit rating policies and sets the standards for its rating process. The CRA explained, however, that notwithstanding this policy, if the proposed methodology presented by the rating group is "very similar to an existing methodology and governs a closely related industry, sector or asset class, the chief credit officer for the rating group can unilaterally approve the methodology" unless the chief credit officer believes that further analysis is needed, in which case it must be reviewed by the appropriate credit policy standing committee. If the credit policy standing committee approves the methodology, the chief credit officer for the relevant rating group can either accept its recommendation or request a further review by the Credit Policy Committee. Moreover, the firm's two head regional credit officers receive copies of all proposed methodologies and can request a reconsideration of the proposed methodology even if it was previously approved by the chief credit officer for the rating group or the relevant credit policy standing committee. The credit policy committee's methodology decisions are final.



In addition, the firm stated that its policies require the convening of a “senior rating committee” when a rating outcome “might set a precedent in some way, affect an issuer that commands a particularly high degree of investor interest, or affect a large number or volume of credits.” Chief credit officers and senior managers across all lines of business, as well as analysts who ordinarily would participate in rating committees for the issuer or obligation under consideration, are invited to participate. The CRA also noted that its policies required its credit policy group to conduct an assessment of whether existing methodologies and models for structured finance products are appropriate when the CRA determines that the risk characteristics of the assets underlying a structured finance product have changed materially.

Another CRA indicated that it requires that all new criteria or new uses for existing criteria, including any criteria used for a new type of structure, be reviewed and approved. The firm’s guidelines require a practice criteria committee to review new or revised criteria. The guidelines require an escalation of a new or revised criteria in a number of circumstances, including when the criteria (i) involve the application of highly specialized expertise, (ii) involve a meaningful methodological change or the development of new tools or models, (iii) relate to a type of issuance that is rapidly growing, or (iv) carry meaningful franchise or reputational risk.

A third CRA noted that its head of analysis, together with its standing rating committee, “checks the requirements necessary to perform a high-quality analysis...within the methodologies used by the company, considering, among other things, the product characteristics, the experience and the technical knowledge of the analyst, as well as the information necessary for the analysis performance.” The CRA stated that if this assessment reveals that the rating will involve issues not explicitly addressed by the firm’s methodologies, it will not perform the rating.

A fourth CRA has a policy of not determining credit ratings if the CRA does not have sufficient experience as well as an “unwritten policy” of assigning analysts with more experience and involving directors and technical managers for “more complex operations.” All “technical decisions,” including whether or not to perform a rating, are made by two senior officers, one who has the overall responsibility for the firm and the other who is in charge of the analysts and accountable for all ratings issued by the CRA.

### *Question for comment*

- Q23* Are there any other key internal controls established by CRAs with respect to the review function for new products that are not described above? If so, describe them.
- Q24* What standards are used to determine whether a CRA has sufficient resources to determine an initial credit rating? Under what circumstances would a CRA refrain from determining an initial credit rating because of resource constraints?

### **3.2.1.b Resources Adequacy - periodic reviews of methodologies**

CRAs were asked to describe the internal controls they employ with respect to establishing and implementing a review function for the periodic review of credit rating methodologies. Specifically, firms were asked to describe whether and how their internal controls:

- Establish and implement a rigorous and formal review function responsible for periodically reviewing the methodologies and models and significant changes to the methodologies and models it uses (Code 1.7-2); and
- Where feasible and appropriate for the size and scope of its credit rating services, keep such function independent of the business lines that are principally responsible for rating various classes of issuers and obligations (Code 1.7-2).

Several CRAs have processes for reviewing existing methodologies. For example, the credit policy function of one CRA engages in a continuous review process, with the explicit goal of reviewing the firm's methodologies, models and significant changes to such methodologies and models at least once every twelve months. This team conducts such reviews with representatives from the relevant rating groups and, "where feasible and appropriate," issues a "request for comment" from market participants in connection with material modifications to existing credit rating methodologies prior to approval of such changes. The CRA explained that its methodology reviews are designed to determine if the methodology under review addresses the key credit risks and whether improvements should be implemented. The CRA has adopted internal policies for the conduct of such reviews, noting that the topics addressed in a methodology review will differ depending on the methodology in question and any changes in the sector or asset class associated with the methodology. The process for a credit rating methodology review entails both quantitative and qualitative analyses, including an analysis of the models and data underpinning a methodology and "[t]he reasonableness of the overall analytical rating framework." If a review leads to a determination that a change may be appropriate, the potential change is presented to the relevant ratings team. The ratings team responds point-by-point to the findings and either accepts the recommendations and proposes a timeline and path to resolution, or rejects them and provides a rationale. The firm added that changes to its credit rating methodologies "generally occur in incremental steps of continuous refinement."

Another CRA indicated that it reviews and changes, as necessary, its criteria articles pursuant to its criteria process guidelines on an annual basis. It added that as part of its annual review of models, its policies require assessing and ameliorating the risk that there is "a significant discrepancy between the model output and ultimate actual experience."

A third CRA has no defined or specific dates or timeframes for reviewing its methodologies but plans to establish them. Nevertheless, it reported that the review of the methodological standards "occurs regularly," as well as whenever necessary due to significant changes in the structure of the instruments rated, in regulations, in micro- and macro-economic factors, or in legal factors. The CRA stated that in light of its current status and size, it believes that for the time being it cannot establish a review function that is independent from the business lines responsible for the preparation of risk analyses. Instead, the members of the standing rating committee, the head of analysis, and the president of the company are responsible for the review. Similarly, a fourth CRA also has no regular review schedule but instead performs a review of a methodology "whenever a relevant change is deemed necessary," which typically results from changes in legislation or due to the "situational relevance" of a given risk factor. A fifth CRA reported that

its rating analysts were responsible for “regularly monitor[ing] the appropriateness and effectiveness” of its methodologies and bringing a proposal for revision, update or discontinuation of a methodology to the relevant rating committee.

***Question for comment***

- Q25* Are there any other key internal controls established by CRAs with respect to periodic reviews of methodologies that are not described above? If so, describe them.
- Q26* The ability to establish an independent function within a CRA’s organization to review rating methodologies may depend on the resources available to a CRA. Is it practical for smaller CRAs to establish such an independent control function? If not, explain why. In addition, if it is not practical, describe other measures small CRAs take that are a reasonable substitute to having such an independent control function.
- Q27* If a CRA relies on credit analysts to review a methodology, what controls has it established in lieu of using persons that are independent of the analytical process to review the methodology?
- Q28* What are the technical aspects and key steps undertaken during the process of a methodology review? For example, do methodology reviews utilize research and/or empirical studies on the quality, distribution, or performance of credit ratings? If so, how frequently are the research and empirical studies conducted and how are they documented? Are steps taken to ensure that the research and empirical studies are conducted in a manner that is independent from the analytical function that determines credit ratings?

**3.2.1.c Resources adequacy – structured finance initial ratings and surveillance**

CRAs were asked to describe the internal controls they employ to ensure that, if they use separate analytical teams for determining initial credit ratings and for subsequent monitoring of structured finance products, each team has the requisite level of expertise and resources to perform their respective functions in a timely manner (Code 1.9-1).

One CRA indicated that its risk management group produces a report every six months that evaluates whether the CRA has devoted sufficient personnel and financial resources to produce timely and rigorous ratings, which includes a review of the number of credit ratings that both new deal and surveillance analysts must follow, in those groups with separate analytical teams. Another CRA noted that it employs the same training procedures for its surveillance teams as it does for initial rating teams, in each case providing training designed to, among other things, help analysts maintain and enhance their knowledge of matters relevant to credit risk analysis and the rating process and familiarize them with credit-related issues, and emerging trends and issues in the market. A third CRA also stated that all employees in analytical roles, whether involved in initially determining ratings or surveilling existing ratings, are subject to the same ongoing education requirements.

***Question for comment***

*Q29* Are there any other key internal controls established by CRAs with respect to assessing the adequacy of resources devoted to determining initial credit ratings and conducting surveillance for structured finance products that are not described above? If so, describe them.

*Q30* What metrics and/or standards do CRAs use to assess the adequacy of their resources for rating and monitoring structured finance products? Are these metrics and/or standards different than those used to assess the adequacy of the resources for different classes of credit ratings?

### **3.2.2 Continuity in the rating process and avoidance of bias**

CRAs were asked to describe the internal controls they employ to ensure that their rating teams are structured to promote continuity and avoid bias in the rating process. (Code 1.8)

Several CRAs view the rating committee process as a measure that gives effect to this provision. For example, one CRA noted that the participation of multiple individuals in the analysis and rating process (at least two analysts, together with all the members of the standing rating committee, for each analysis) ensures continuity. It stated that the application of a proprietary methodology for the analysis performed, the use of a secondary analyst for each rating, the oversight provided by the head of analysis, the required presentation by the lead analyst to the standing rating committee, and the fact that ratings are assigned based on a majority vote by committee members helps avoid bias in the rating process. Similarly, another CRA cited its use of rating committees, which ensure that rating decisions reflect the committee and not individual analysts, as a “checkpoint to conflicts of interest.”

Two CRAs pointed to recordkeeping provisions as measures that give effect to this code provision. One of the CRAs stated that its record retention policies, procedures, and mechanisms help to preserve the firm’s institutional memory and thereby contribute to continuity. The other CRA stated that its analytical groups work in conjunction with its credit policy team to develop rating process manuals and other policies and procedures for the provision of credit ratings in order to ensure a level of commonality among its offices. This CRA also noted that its Credit Policy function is designed to contribute to continuity in the rating process and the avoidance of bias by exercising oversight over the rating process and over the development, vetting and review of rating methodologies.

One CRA stated that it has an analyst rotation policy designed to rotate primary analysts over time to protect against an analyst developing a long-term relationship with an issuer that causes a bias which could impact a credit rating. The same policy also requires the rotation of certain staff performing analytical roles in some jurisdictions as required by the regulatory requirements of the jurisdictions in which they operate. Another CRA stated that it promotes continuity by structuring its analytical teams to ensure that lead analysts are supported by one or more backup analysts.

#### ***Question for comment***

*Q31* Are there any other key internal controls established by CRAs with respect to the continuity of the rating process and avoidance of bias that are not described above? If so, describe them.

*Q32* CRAs with analyst rotation policies are asked to provide further details on these policies. For example, how long may an analyst work rating a specific issuer/obligor before being rotated? Are analysts rotated to different sets of issuers/obligors in the same class of credit rating (*e.g.*, from one set of corporate issuers to another set of corporate issuers) or are they rotated to a different class of credit ratings (*e.g.*, from corporate issuers to structured finance)? How do rotation policies account for offices/affiliates with relatively few analysts? Do small CRAs implement rotation policies? If so, how do they work?

### **3.3 Monitoring and Updating**

CRAs were asked to describe their internal controls designed to ensure that adequate personnel and financial resources are allocated to monitor and update their ratings. Specifically, firms were asked to describe whether and how their internal controls:

- Require regular reviews of an issuer's or instrument's creditworthiness (Code 1.9a);
- Require *ad hoc* reviews of the status of a rating upon becoming aware of any information that might reasonably be expected to result in a rating action (including termination of a rating), consistent with the applicable rating methodology (Code 1.9b);
- Require updating of a rating, as appropriate and on a timely basis, based on the results of a review (Code 1.9c);
- Seek to ensure that the ratings monitoring process incorporates all cumulative experience obtained since the initial rating, including, where appropriate, the application of changes in ratings criteria and assumptions (Code 1.9); and
- Require the disclosure, either publicly or to subscribers, as appropriate, of the discontinuation of any rating (Code 1.10).

#### **3.3.1 Regular ratings reviews**

Most of the CRAs surveyed seek to review their credit ratings at least annually and, with respect to some classes of credit ratings, more frequently. Several CRAs also noted that their surveillance is an "ongoing" process.

One CRA stated, "generally a rating is fully reviewed and a meeting conducted with senior management of the issuer on an annual basis." However, this CRA indicated that periodic reviews for structured finance ratings are more frequent, occurring upon such events as the receipt of performance reports or pool tapes associated with the interest payment date, which typically occurs either on a monthly or quarterly basis. The surveillance analyst is responsible

for notifying his or her supervisor and the lead rating analyst if the performance reports are not received in a timely manner. It is the responsibility of the lead analyst also to identify the types of metrics to be reviewed and the frequency of review at the initiation of the rating.

At a second CRA, the review frequency varies across industry sectors and asset classes and is based on the unique characteristics of each particular sector or asset class. The CRA, however, has an explicit objective to review each outstanding credit rating at least once per year. The CRA conducts surveillance of structured finance ratings through various types of rating reviews, which include high-level reviews of the performance of ratings in an asset class or sub-sector, portfolio reviews, and detailed reviews of individual transactions. For ratings in corporate finance, financial institutions and public and infrastructure finance, portfolio reviews are conducted at least once a year to assess the credit quality of issuers that are representative of an industry sector or sub-sector. This CRA noted that analysts may review public information as well as non-public information provided by the issuer or obligor in their monitoring. In addition, the firm's analysts use a range of tools to monitor and track rated issuers and obligations, which include comparing credit ratings with other measures of credit risk such as measures derived from the market prices of bonds and credit default swaps and accounting ratio-implied ratings based on default prediction and rating prediction models (for corporate and sovereign issuers).

#### *Question for comment*

*Q33* Are there any other key internal controls established by CRAs with respect to regular rating reviews that are not described above? If so, describe them.

*Q34* If the credit ratings of one type of issuer/obligor are based on the credit ratings of a second class of issuer/obligor (e.g., ratings of banks may be linked to sovereign ratings and ratings of bond insurers may be linked to ratings of the issuances they insure), do CRAs seek to sequence the regular reviews of the two types of issuers/obligors? If so, describe how they are sequenced.

#### **3.3.2 Ad hoc ratings reviews**

CRAs also have policies regarding rating reviews triggered by the receipt of new information about the issuer or obligor or by events that may impact the ratings such as changes in rating methodologies that may impact outstanding credit ratings. For example, one CRA noted that in addition to its regular periodic reviews, the firm also reviews its ratings upon the receipt of information that might have an impact on the creditworthiness of an issuer or obligor. Another CRA stated that it will review ratings that are affected by a change in methodologies, models or key assumptions used in the rating process.

#### *Question for comment*

*Q35* Are there any other key internal controls established by CRAs with respect to ad hoc rating reviews that are not described above? If so, describe them.

Q36 What is the process for determining whether an *ad hoc* review is warranted? For example, who (the lead analyst, a senior credit analyst, a rating committee) decides to initiate an *ad hoc* review?

### 3.3.3 Timely updates of ratings

A number of CRAs cited their internal policies and best practices in relation to updating ratings following reviews. One CRA's best practice guide provides that if, as result of the monitoring procedures, an analyst believes that a rating committee should consider an existing rating, a rating committee will be convened in a timely manner. Moreover, if there is a change in the rating after the rating committee's deliberation, a rating announcement will be published "as soon as possible." A second CRA explained that the timeliness in updating its ratings "depends on the promptness and quality of information" that the issuer or obligor provides to the firm. In cases where the CRA receives public information that has an impact on the rating, it requests that the issuer or obligor confirm the accuracy of the public information. If the issuer or obligor refuses, the CRA may revise the credit rating nonetheless but will include a caveat on the quality of the information used in the rating process in its rating announcement.

#### *Question for comment*

Q37 Are there any other key internal controls established by CRAs with respect to timely rating updates that are not described above? If so, describe them.

Q38 What time frame do CRAs consider to be "timely" in terms of updating a credit rating? Do the time frames differ across classes of credit ratings?

### 3.3.4 Comprehensive monitoring

Several CRAs noted their policies to ensure that monitoring includes consistent application of changes in rating methodologies and assumptions to initial and subsequent ratings. One CRA explained that the developmental process of a revised methodology entails an impact assessment if the firm believes that a proposed revision of a methodology could affect existing credit ratings. If the CRA believes that a proposed revision of a methodology may affect existing ratings, it will "review the potentially affected, existing credit ratings in advance of the publication of the methodology so that credit rating announcements regarding any rating changes can be published as soon as the methodology is published." Alternatively, the firm may "disclose a timeline for the review of existing credit ratings along with the publication of the methodology." A second CRA stated that the firm has a policy that provides that "changes in methodologies, models or key rating assumptions will trigger a review of affected credit ratings."

Two CRAs cited the use of records as a means to ensure that monitoring incorporates all cumulative experience. One CRA explained that it keeps and relies on records encompassing the history of all ratings issued for each issuer or asset. These records also reflected the firm's reasons for changing a rating, including those related to changes in the methodological criteria. The second CRA also noted its reliance on records of ratings, materials used, and minutes of the

rating committee for comprehensive monitoring purposes. At this CRA, the original analyst will be involved for all subsequent ratings and reviews.

***Question for comment***

*Q39* Are there any other key internal controls established by CRAs with respect to comprehensive monitoring that are not described above? If so, describe them.

**3.3.5 Disclosure of discontinued ratings**

A number of CRAs made reference to their policies addressing announcements of withdrawn ratings. Four CRAs, each of which operates on an issuer-paid basis, provided operational details.<sup>24</sup> Specifically, at one CRA, the withdrawal of the credit rating is publicized in one of two different forms: either in a credit rating announcement relating to the specific issuer or obligation, or in a monthly press release that lists all credit ratings withdrawn in the preceding month. The monthly press release includes credit ratings that were withdrawn due to an issuer's bankruptcy, liquidation, debt restructuring, reorganization, or because the obligation has been paid in full. The firm indicates in these monthly press releases the reasons (*e.g.*, bankruptcy, reorganisation, or maturity) for the withdrawal. In addition, all credit ratings that have been withdrawn are identified as such on the firm's website by a distinct symbol. A second CRA discloses the withdrawal of any public rating by publishing a commentary that identifies the current ratings of the issuer or obligor and provides notice that they have been withdrawn. The commentary also indicates that the firm will cease providing credit ratings and analytical coverage of the issuer or obligor. The third CRA provides notice of the withdrawal of a credit rating on its public website. The fourth CRA stated that upon the expiry of its service contract with its clients, it will announce on its website the expiration of the client's contract and the resulting withdrawal of its rating. This information will be made available on the firm's website for 30 days.

***Question for comment***

*Q40* Are there any other key internal controls established by CRAs with respect to the disclosure of discontinued ratings that are not described above? If so, describe them.

**3.4 Integrity of the Rating Process**

The IOSCO CRA Code has provisions that address the corporate culture of CRAs. Even well-designed internal controls may not achieve their intended effects in an environment of a poor compliance culture. Thus, the IOSCO CRA Code calls for a CRA to have organisational cultures and systems that encourage compliance with the firm's policies and procedures and strong ethics on the part of its employees. In addition, the IOSCO CRA Code also calls for proper recordkeeping in order to allow firms to monitor compliance.

---

<sup>24</sup> Typically, issuer-paid CRAs make their credit ratings publicly available for free.



CRAAs were requested to describe internal controls that are designed to ensure the integrity of their ratings process, in particular, the internal procedures and mechanisms that:

- Seek to ensure that internal records that support its credit opinions are maintained for a reasonable period of time or in accordance with applicable law. (Code 1.5)
- Seek to ensure compliance with all applicable laws and regulations governing the firm and its employees' activities in each jurisdiction in which it operates (Code 1.11);
- Clearly specify a person responsible for the firm's and its employees' compliance with the provisions of its code of conduct and with applicable laws and regulations, and ensure that such person's reporting lines and compensation are independent of the rating operations (Code 1.15);
- Provide for employee reporting of conduct that is illegal, unethical or contrary to the firm's code of conduct; seek to ensure that any of the firm's officers who receive such a report from an employee take appropriate action, as determined by the laws and regulations of the relevant jurisdiction and its own internal rules and guidelines; and prohibit retaliation by the firm or any of its employees against any employees who, in good faith, make such reports (Code 1.16);
- Seek to ensure that the firm and its employees deal fairly and honestly with issuers, investors, other market participants, and the public;
- Seek to hold their analysts to high standards of integrity and seek to avoid employing individuals with demonstrably compromised integrity (Code 1.12 and 13); and
- Seek to ensure that neither the firm nor its employees either implicitly or explicitly give any assurance or guarantee of a particular rating prior to a rating assessment (Code 1.14).

### **3.4.1 Firms' compliance culture**

One CRA discussed its compliance culture. This CRA believes that "it is essential to foster a culture that embeds compliance at all levels of the organization from the most senior to the most junior staff member." Employees are encouraged to seek advice and guidance from compliance officers as soon as questions arise because "early engagement" between the compliance officers and staff "can mitigate potential pitfalls and risks in a timely fashion." To facilitate "early engagement," contact details of staff from the compliance department are provided on an intranet site accessible to all employees. This CRA seeks to reinforce compliance behaviour through a procedural mechanism: employees must certify their adherence with the firm's general code of business conduct<sup>25</sup> and other policies on a regular basis. The CRA noted that disciplinary action, including termination of employment, may be taken against any violation of the firm's general

---

<sup>25</sup> This CRA explained that the firm's general code of business conduct is designed to guide employees and directors on how to apply the principles of honesty, integrity and good judgement in daily business activities.

code of business conduct. Another CRA also noted that a failure of any employee to adhere to the firm's code of conduct "could result in disciplinary action being taken against such employee, including the dismissal of such employee."

### *Question for comment*

*Q41* Are there any other key measures established by CRAs with respect to the establishing a culture of compliance that are not described above? If so, describe them.

*Q42* What steps do CRAs take to encourage a culture of compliance?

### **3.4.2 The role of compliance**

Several CRAs, including the largest CRAs, have established independent compliance departments, typically headed by a chief compliance officer. Generally, the compliance department personnel are responsible for monitoring adherence to global regulatory requirements and providing training and guidance on compliance related policies and guidelines of the CRA. For example, at one CRA, the principal responsibility of the compliance department is to monitor the adherence of the CRA and its employees to the CRA's code of conduct, ratings policies and procedures, and the local laws of the markets in which the firm operates. It provides guidance and updates on policies and procedures and trains staff to understand existing and new compliance obligations. Apart from assessing the effectiveness of the implementation of the firm's code of conduct; the compliance department also designs, and assesses employees' adherence to, policies and procedures that are put in place to safeguard objectivity and independence in the rating process. The compliance officers have the duty to report any non-compliance to senior management or the board, as appropriate, or to the authorities, as required and permitted by law. Senior management and the board look to the compliance department to recommend the appropriate disciplinary action for any non-compliance.

The compliance department is independent of the firm's lines of business and reports ultimately to the chief executive of the company. Moreover, the compensation of employees in the compliance department is not linked to the firm's financial performance. The compliance department personnel are prohibited from performing marketing or sales functions and participating in establishing compensation levels for other employees other than for compliance staff. The compliance department personnel also do not sit in any specific rating committees or opine on any particular rating action.

Another CRA noted that its compliance manager, who reports directly to the chief executive officer, is responsible for making sure that the firm's code of conduct is properly implemented and adhered to by its employees. In this regard, the compliance manager produces a "compliance report" in which he or she certifies that the firm's code of conduct has been implemented and observed by employees and identifies any implementation adjustments made.

On the other hand, one small CRA indicated that it does not have a full-time compliance officer; instead, the compliance function is undertaken by an employee who knows in detail the firm's

code of conduct. This employee reports directly to the general manager of the firm on compliance matters.

### *Questions for comment*

*Q43* Are there any other key internal controls established by CRAs with respect to the role of compliance that are not described above? If so, describe them.

*Q44* Some CRAs have established independent internal compliance function to review, among other things, whether analysts are consistently using methodologies as well as adhering to the procedures for employing the methodologies. Having an independent internal control function can promote the integrity of the rating process by, for example, reviewing whether credit analysts adhere to methodologies for determining credit ratings and consistently apply credit rating methodologies. Nonetheless, some CRAs have not established independent compliance functions. How do CRAs that have not established independent compliance and/or internal audit functions review for compliance?

### **3.4.3 Reporting of questionable behaviour**

Many of the CRAs surveyed have established “whistleblower” policies. For example, one CRA indicated that its code of conduct strongly encourages employees to report questionable conduct, either to the appropriate department or through a dedicated hotline service established by the firm. To facilitate reporting, contact details of the relevant officers in the legal and compliance departments and contact details of the hotline service are provided in the firm’s code of conduct.

This CRA pointed out that there are differences in practices between operations based in the EU and those based outside the EU. Employees who are located outside the EU are encouraged to report suspected misconduct. On the other hand, due to certain domestic data protection laws, employees based in the EU are generally not expected to report suspicious misconduct except in certain circumstances, for example, where an employee believes that certain misconduct may contravene the law. The firm provides for easy access on its intranet to guidance on how to report and who to report to as well as contact links to the appropriate department and the relevant hotline services. The CRA also explained that all employees at all levels, including those who hold managerial positions, are required to follow the firm’s code of conduct on reporting of misconduct.

This CRA also noted that the legal or compliance officers, upon receiving a “whistleblower” report, will, in the first instance, assess the information they received and then determine an appropriate course of action. The compliance department has the authority to independently initiate a compliance review or an investigation if it considers doing so to be appropriate and, where necessary, may escalate an incident to management and recommend disciplinary action be taken. Finally, the compliance department also may notify the firm’s board of directors of any such incidents, if it deems it necessary. According to this CRA, the firm maintains an “open door” policy in relation to such matters, and employees are “encouraged to report workplace concerns to their direct or indirect managers in an environment that is free of distractions and

secure in the knowledge that they will not be subject to reprisals when concerns are raised in good faith.”

At another CRA, complaints related to analytical matters are required to be reported to the direct manager of the employee in question or designated senior officers in the firm who are responsible for the rating process or senior officers in the legal department. All other matters are required to be reported to the compliance or regulatory affairs department. This CRA also provides a hotline service for reporting that is available to all employees worldwide. The CRA pointed out that any employee who retaliates against another employee for any bona fide reports or assistance in investigation of suspected misconduct would be subject to disciplinary action that may lead to termination.

A third CRA noted that its employees are required to promptly report to their immediate managers, department heads, or the chief compliance officer any known or suspected contraventions of laws and regulations, organizational policies and procedures or the firm’s code of conduct. To facilitate such reporting, all management and staff desktops have a “report” icon. This firm’s policies encourage reporting of misconduct to immediate managers. However, in situations where employees believe that it would be inappropriate to do so, or that their immediate manager has mishandled the concern, they are encouraged to escalate the matter to a more senior manager in their business line, or to the chief compliance officer or, where appropriate, to the board of directors, based on the severity of the violation and the potential adverse impact on the reputation of the firm.

Another CRA has established a committee responsible for investigating any reports of illegal or unethical behaviour. The committee works under the authority and supervision of the firm’s chief compliance officer. Employees are told to report any questionable behaviour to this committee. To discharge its function, the committee may engage external parties to carry out an investigation and may seek legal advice from outside law firms. After conducting its investigation, the committee may decide that there is no merit in the case or may recommend appropriate actions to be taken. The committee will notify the informant of its decisions as soon as possible. Where necessary, depending on the nature of the violations, the committee may bring the matter to the attention of the board of directors. To protect employees who make the report or cooperate with any related investigation, the identity of such employees is kept confidential. In the event that any such employee comes under any retaliation, the employee may report the matter to the committee, which will take “necessary measures” if it determines that there is sufficient basis in the allegations. The CRA also noted that if any rating analyst believes that “he or she suffered work-related disadvantages due to his or her statements [made] at the Rating Committee or the assertion of his or her judgment regarding the [credit rating business]”, the analyst may request the committee to convene a meeting to hear his or her case.

Three other CRAs require employees to report issues to the chief compliance officer. For example, employees of one of the CRAs are expected to report questionable activities to the chief compliance officer, who is responsible for assessing the merits of the situation and, if warranted, taking appropriate action in accordance with the firm’s policies and procedures as well as relevant laws and regulations. Another CRA requires the compliance officer, in his annual report on compliance matters to the general manager of the firm, to document any such

reports of concerns without disclosing the identity of the informants. However, the firm pointed to difficulties in preserving the confidentiality of the informant's identity as the firm has a small number of employees who work in a tightly knit environment.

#### ***Question for comment***

*Q45* Are there any other key internal controls established by CRAs with respect to the processes for reporting questionable behaviour that are not described above? If so, describe them.

#### **3.4.4 Staff ethics and integrity**

Most CRAs cited their code provisions in relation to dealing fairly and honestly with issuers, investors, other market participants and the public. One CRA went further and explained how this requirement is partially addressed by procedures, such as the complaint process, that allow outside parties to provide feedback. Based on public feedback, the firm can gauge the effectiveness of its implementation of the code requirement.

In terms of hiring practices, to avoid employing individuals with demonstrably compromised integrity, one CRA indicated that the firm conducts background checks on prospective employees. These checks include a criminal record search if this is legally permissible in the countries in which the employees are hired. For hiring in the United States, these checks, which include a criminal record search, education verification and prior employment search, are conducted via a third party vendor.

#### ***Question for comment***

*Q46* Are there any other key internal controls established by CRAs with respect to staff ethics and integrity that are not described above? If so, describe them.

#### **3.4.5 No “guarantee” of ratings**

Many of the CRAs have in their code of conduct general prohibitions against giving any assurance or guarantee of a rating prior to going through the firm's rating determination process. For those agencies that provide ratings for structured finance products, the general prohibition does not preclude the agencies from developing prospective assessments used in structured finance transactions. One CRA also noted that the prohibition does not prevent the firm from providing rating or credit assessments that are based on “hypothetical scenarios and/or limited information,” which the CRA does not regard as credit ratings.

One CRA explained that the firm provides a service where it assesses the concept of a potential structure and gives an initial view whether the structure concept is “strong” or “weak.” The assessment is based solely on information regarding the structure of the transaction provided by the client, and the firm does not apply the usual rating procedure (*e.g.*, a due diligence visit, micro and macroeconomics analysis) in the assessment exercise. The CRA stated that it makes it

clear to the client that the rating of the concept of the structure is only an indication and should not be disclosed to any third party.

### *Question for comment*

*Q47* Are there any other key internal controls established by CRAs with respect to ensuring that analysts do not provide rating guarantees that are not described above? If so, describe them.

### **3.4.6 Recordkeeping<sup>26</sup>**

Most of the CRAs responding to the questionnaire have recordkeeping policies. One CRA's recordkeeping policy provides detailed lists of documents that must be retained, their respective retention periods, and the record-keeping responsibilities of analysts and other employees. The employees are expected to be familiar with the policy and are required to certify their compliance with the policy on an annual basis. The policy also specifically provides that lead analysts have the duty to keep and maintain records of all credit-relevant documents (including emails and documents that were used as part of the credit analysis) relating to an issuer or obligation. These records are kept in electronic format within the firm's document management systems. The CRA generates bi-monthly status reports that identify record keeping delinquencies, which are sent to the analysts and their managers. If delinquencies persist for longer than 90 days, the compliance department is notified. Based on the bi-monthly reports, the compliance department produces monthly reports on the number of delinquencies in the filing of records and the number of delinquencies that were rectified in the same period. The monthly statistics generated by the compliance department enable the firm to assess the level of compliance of its recordkeeping policy. In addition, internal audits are also performed periodically at the CRA to assess compliance.

Another CRA retains all records of rating assessments in either physical form, digital form or both for at least three years after the termination of the service contract with its clients. The firm has an internal and an off-site backup for all digital records. In terms of handling confidential information, this CRA requires employees to sign a confidentiality agreement. In addition, the firm also installs in all ratings reports a "confidential code" to restrict and track access to the reports. Only users with an exclusive identification code may access the reports.

A third CRA keeps both physical and electronic files of all data used in the analysis process. The form in which these files are kept largely depends on the form in which they are provided by the clients. The firm also keeps records of committee meetings that will be made available to the analysts involved throughout the lifetime of an obligation and will be retained for two years after the obligation is fully repaid, after which only data "relating to meetings and committees" will be kept and stored in CD media.

---

<sup>26</sup> The discussion on recordkeeping in this section is in relation to the firm's policies and procedures in keeping and maintaining an audit trail of its rating process; while the discussion in Chapter 4 describes how CRAs use recordkeeping as a tool for identifying and recording the existence of actual or potential conflicts of interest.

### *Question for comment*

- Q48* Are there any other key internal controls established by CRAs with respect to recordkeeping that are not described above? If so, describe them.
- Q49* What types of records with respect to the rating process are made and retained? Do the records differ by class of credit rating? If so, explain.
- Q50* Are records made or retained relating to the decision of a rating committee to exclude elements of an established rating methodology or to use a pending methodology change prior to its being formally implemented? If so, describe them.

## **Chapter 4 Management of Conflicts of Interest Discussion**

### **4.1 Managing Firm-Level Conflicts**

CRAs were asked to describe the procedures they have established to manage firm-level conflicts. Specifically, firms were asked to describe whether and how their procedures:

- Seek to ensure that internal records that support its credit opinions are maintained for a reasonable period of time or in accordance with applicable law. (Code 1.5)
- Seek to ensure that the credit rating a CRA assigns to an issuer or security is not affected by the existence of or potential for a business relationship between the CRA (or its affiliates) and the issuer (or its affiliates) or any other party, or the non-existence of such a relationship (Code 2.4);
- Seek to ensure separation, operationally and legally, of the credit rating business and credit rating analysts from any other businesses, including consulting businesses that may present a conflict of interest (Code 2.5);
- Seek to ensure that ancillary business operations that do not necessarily present conflicts of interest with the rating business have in place procedures and mechanisms designed to minimize the likelihood that conflicts of interest will arise (Code 2.5);
- Define what they consider, and do not consider, to be an ancillary business and why (Code 2.5);
- Seek to identify and eliminate, or manage and disclose, as appropriate, any actual or potential conflicts of interest that may influence their opinions and analysis or the judgment and analysis of the individuals they employ who have an influence on ratings decisions (Code 2.6);
- Require the firm to disclose its conflict avoidance and management measures (Code 2.6);

- Structure the reporting lines for their staff to eliminate or effectively manage actual and potential conflicts of interest (Code 2.11);
- Prohibit employees who are directly involved in the rating process from initiating, or participating in, discussions regarding fees or payments with any entity they rate (Code 2.12); and
- Prohibit an employee from participating in or otherwise influencing the determination of the rating of any particular entity or obligation if the employee has a financial interest in the rated entity or obligation (Code 2.13).

#### **4.1.1 Rating committees and reporting lines**

One of the primary controls identified by the CRAs for addressing conflicts of interest is the rating committee process. Several CRAs also identified reporting lines as a measure to address conflicts. More specifically, they view reporting lines as a means of helping to ensure that management is made aware of any conflicts and how they are being managed. They noted that clearly delineated reporting lines can facilitate the separation of the business and analysis functions within a CRA.

With respect to rating committees, most of the CRAs responding to the questionnaire indicated that they require that credit ratings be determined by a committee and not by individual analysts. Several firms noted that they required ratings committee chairs to begin the committee process by inquiring whether any of the committee members has a conflict of interest with regard to the determination of the credit rating. A prospective rating committee member is required to refrain from participating in the committee if he or she has a conflict of interest. Firms also indicated that any potential conflicts identified through this process are subject to monitoring on an ongoing basis, and one firm specifically noted that if a conflict develops during the rating process, the analyst is replaced. Several CRAs noted that the requirement of a majority vote of the rating committee for a credit rating action to be taken serves to limit the influence of any one individual. Several firms also indicated that new analytical staff is not permitted to participate in the rating committee convened to determine a credit rating for an issuer or obligor if they were employed by the issuer or obligor during the past 12 months.

Most of the CRAs responding to the questionnaire identified specific reporting lines structured to address actual or potential conflicts of interest. For example, at one CRA, the chief credit officer, who is responsible for the oversight of the firm's overall credit policy structure, reports directly to the CRA's chief executive officer, president, and, on a quarterly basis, board of directors. One CRA cited the example of assigning a chairperson for each rating committee, while another noted that it had a risk manager who is solely responsible for coordinating analyst teams and is ultimately responsible for all ratings recommendations. One firm noted that the individual who is responsible for issuing all contracts and invoices works in an area physically separated from the firm's analysts and reports directly to the general manager of the firm. Finally, one firm explained that it created a director position tasked with overseeing compliance with applicable regulations, the firm's code of conduct, and its conduct policies by all employees, board



members, and shareholders of the firm. In particular, the director is assigned the task of discussing and analyzing all potential employee conflicts of interest.

*Question for comment*

*Q51* Are there any other key procedures for managing conflicts established by CRAs with respect to rating committees, reporting and analyst assignment that are not described above? If so, describe them.

*Q52* What specific types of conflicts are the procedures described in this section designed to address?

**4.1.2 Corporate and business structures**

The majority of CRAs responding to the questionnaire cited the separation of their business and analytical functions as a key element of their conflict management policies and procedures. The firms reported that they effect such separations through a variety of mechanisms. For example, several CRAs noted that they issued ratings through a subsidiary designed exclusively for that purpose in order to segregate the credit analysis business from other companies operating under the same holding company. One firm noted that, in addition to physically separating its rating business from the rest of its businesses, it used separate servers and data storage for its rating business as well.

Several CRAs noted that they require segregation of analytical personnel from all commercial activities. For example, one CRA explained that all analytical personnel and staff involved in credit rating activities are prohibited from initiating, arranging, negotiating or participating in discussions regarding fees or payments for ratings. Instead, the firm requires that all aspects of the fee and payment process be conducted by non-analytical personnel who are not directly involved in credit rating activities. Another CRA noted that ratings analysts are prohibited from attending any portions of meetings or events in which commercial activities or sales activities are discussed.

One firm noted that its independent credit policy function operates independently of the rating function and is charged with promoting consistency, quality and transparency in rating practices globally and across diverse sectors and regions in order to ensure that decisions taken on methodological or ratings performance issues are made independently of any non-rating business objectives. Another CRA noted that all conflict of interest issues are discussed and analyzed by its administrative and human resources department and the president of the firm. The firm explained that while a potential conflict of interest is being evaluated, the affected individual is not permitted to participate in the rating or analysis process for the issuer and/or offering that is the subject of the potential conflict. In addition, at this firm, the administrative and human resources department is responsible for handling and collecting fees and charges, thus ensuring that this process remains independent from the departments responsible for credit analyses and ratings.

*Question for comment*

*Q53* Are there any other key procedures for managing conflicts established by CRAs with respect to corporate and business structures that are not described above? If so, describe them.

*Q54* What steps do small CRAs take to separate business and analytical functions?

#### **4.1.3 Recordkeeping**

CRAs reported that the records they retained to support their credit opinions generally include all rating reports issued by the firm, the individual ratings history of all rated issuers, and all materials, including electronic data and physical files, used in the preparation of rating reports. Firms indicated that they maintained this information in databases that would support a systematic comparison of the ratings actions taken by the CRA by asset and issuer type, including initial ratings and all downgrades and upgrades. More specifically, firms explained that their retained records could include minutes of meetings of ratings committees, as well as records of formal presentations to ratings committees, sensitivity and stress tests, scenarios, individual statements from committee members confirming that there were no conflicts of interest for a given rating, and any reports from the firm's compliance function.

One firm described its mechanisms for identifying and recording the existence of actual and potential conflicts of interest, which it applies prior to beginning the analytical process, at the outset of a rating committee's work, and, where appropriate, when an analyst leaves the firm. The firm noted that all responses to queries about potential conflicts received by the firm are recorded and retained. This firm also noted that it retains conflicts certification questionnaires that ratings personnel are periodically required to complete, along with an annual certification that the employee has read the firm's code of conduct and is in compliance with it.

#### ***Question for comment***

*Q55* Are there any other key procedures for managing conflicts established by CRAs with respect to recordkeeping that are not described above? If so, describe them.

*Q56* What steps do CRAs take to identify and record conflicts of interest?

#### **4.1.4 Disclosure**

All of the CRAs responding to the questionnaire indicated that they generally make disclosures about potential conflicts of interest and their credit ratings through their public web sites. Among other things, this transparency can provide users of credit ratings with information to analyze the potential for conflicts to influence credit rating decisions. The information CRAs indicated they disclosed on their Web sites included:

- The affiliation of directors with issuers and all known holders of 5% or more of the firm's outstanding stock who have been rated by the firm;

- Information about whether a firm is paid by issuers, underwriters, obligors or investors to determine a rating, or when the firm is paid for services in addition to determining credit ratings; and
- Information on ratings, changes to ratings, and withdrawal of ratings, including the name of the issuer, the offering code, the type of offering, term, amount authorized, and date of the initial rating, including the justification for the act.

*Question for comment*

*Q57* Are there any other key procedures for managing conflicts established by CRAs with respect to disclosures that are not described above? If so, describe them.

*Q58* In addition to Web site disclosure, what other methods do CRAs use to disclose conflicts of interest? For example, do CRAs make conflicts disclosures in rating reports? If so, describe the types of disclosures.

**4.2 Managing Employee -Level Conflicts**

CRAs were asked to describe the procedures and mechanisms they have established to manage employee-level conflicts. Specifically, firms were asked to describe whether and how their procedures:

- Prohibit analysts from making proposals or recommendations regarding the design of structured finance products that a CRA rates (Code 1.14-1);
- Seek to ensure that the credit rating a CRA assigns to an issuer or security is not affected by the existence of or potential for a business relationship between the CRA (or its affiliates) and the issuer (or its affiliates) or any other party, or the non-existence of such a relationship (Code 2.4);
- Seek to identify and eliminate, or manage and disclose, as appropriate, any actual or potential conflicts of interest that may influence the opinions and analysis they make or the judgment and analysis of the individuals that they employ who have an influence on ratings decisions (Code 2.6);
- Require the CRA to disclose its conflict avoidance and management measures (Code 2.6);
- Prohibit the CRA and its employees from engaging in any securities or derivatives trading presenting conflicts of interest with the CRA's rating activities (Code 2.9);
- Seek to ensure that reporting lines for CRA employees and their compensation arrangements are structured to eliminate or effectively manage actual and potential conflicts of interest and state that a CRA analyst will not be compensated or evaluated on

the basis of the amount of revenue that the CRA derives from issuers that the analyst rates or with which the analyst regularly interacts (Code 2.11);

- Prohibit employees who are directly involved in the rating process from initiating, or participating in, discussions regarding fees or payments with any entity they rate (Code 2.12);
- Prohibit an employee from participating in or otherwise influencing the determination of the rating of any particular entity or obligation if the employee has a financial interest in the rated entity or obligation, has had a recent employment or other significant business relationship with the rated entity, or has or had any other relationship with the rated entity or any related entity thereof that may cause or may be perceived as causing a conflict of interest (Code 2.13).
- Prohibit CRA's analysts and anyone involved in the rating process (or their spouses, partners, or minor children) from buying, selling, or engage in any transaction in any security or derivative based on a security issued, guaranteed, or otherwise supported by any entity within such analyst's area of primary analytical responsibility, other than holdings in diversified collective investment schemes (Code 2.14);
- Prohibiting CRA employees from soliciting money, gifts or favors from anyone with whom the CRA does business as well as accepting gifts offered in the form of cash or any gifts exceeding a minimal monetary value (Code 2.15); and
- Requiring that any CRA analyst who becomes involved in any personal relationship that creates the potential for any real or apparent conflict of interest (including, for example, any personal relationship with an employee of a rated entity or agent of such entity within his or her area of analytic responsibility) disclose such relationship to the appropriate manager or officer of the CRA, as determined by the CRA's compliance policies (Code 2.16).

#### **4.2.1 Compensation setting structures**

Although the surveyed CRAs employ a variety of structures for determining firm and employee compensation, all of the firms stated that they seek to ensure that compensation issues do not affect ratings decisions. Each of the CRAs indicated that analyst compensation is not based on the amount of revenue derived from issuers rated by the analyst. Instead, analyst performance is assessed based on qualitative factors. The specific methods cited by firms as their means for determining analyst compensation in a manner designed to manage or eliminate conflicts of interest include:

- Linking cash bonuses and, for higher-level employees, equity awards to individual analyst performance;

- Using incentive compensation plans for employees in analytical and control roles that are different from those used for employees in commercial roles and general management roles;
- Basing compensation on factors such as analytical competence and analytical thinking;
- Basing compensation on a defined salary formula tied to the volume of work done within a specified timeframe; and
- Paying fixed salaries to analysts.

One CRA provided a detailed explanation of the structures it has established to determine compensation levels in a manner designed to address potential conflicts. Specifically, the firm has established a governance and compensation committee, whose responsibilities include, among other things, overseeing the firm's overall compensation structure and policies. The committee also is responsible for assessing whether these compensation structures establish appropriate incentives for management and employees. The firm explained that all members of this committee are outside (i.e., non-management) directors who meet the independence criteria established by a major exchange for publicly traded companies. The committee conducts formal, annual reviews of the firm's overall compensation structure, policies and programs. The CRA has established a remuneration program for members of its credit policy group and compliance department that consists of an annual base salary, performance-linked cash bonuses, performance-linked equity awards and personal benefits. Cash bonuses are based solely on an individual's performance and do not take into account the overall financial performance of the firm.

### *Question for comment*

*Q59* Are there any other key procedures for managing conflicts established by CRAs with respect to compensation that are not described above? If so, describe them.

### **4.2.2 Analyst selection**

One CRA requires the lead analyst for the issuer or obligation in question to determine who is eligible to participate in the determination of a credit rating. At the beginning of the rating process, the lead analyst (or his or her designee) uses a web-based system to identify analysts for participation in the analytical process and/or a rating committee as well as the issuer and parties involved in the transaction that is the subject of the rating action. Each proposed participant then receives an email requiring him or her to acknowledge that:

- he or she has been asked to participate in the proposed rating action;
- under relevant law and the firm's policies and procedures, employees subject to prohibited conflicts may not participate in or approve the determination of a credit rating;
- he or she is not subject to a prohibited conflict of interest; and

- if relevant circumstances change that give rise to a prohibited conflict of interest during the course of his or her participation in, or approval of, the rating action (or the monitoring of the rating), his or her participation will cease immediately.

The firm explained that if the parties involved in the transaction change, the lead analyst updates the self-certification process and each participant is then required to re-certify that he or she has no prohibited conflicts of interest.

*Question for comment*

*Q60* Are there any other key procedures for managing conflicts established by CRAs with respect to the analyst selection that are not described above? If so, describe them.

**4.2.3 Outside employment and other business relationships**

The majority of CRAs responding to the questionnaire stated that they do not permit their analysts to have any outside employment, paid or unpaid, that would present a conflict of interest with regard to their ratings analysis. Several firms require that an analyst make an attestation that he or she does not have any outside employment. On the other hand, one CRA permits outside employment; however, employees must obtain written authorization of the administration/human resources department and the firm’s president in order to take on outside employment.

Some CRAs reported that they extend this prohibition to apply to the employment of relatives as well as to past employment. One firm, for example, stated that an analyst is not permitted to participate in or otherwise influence the determination of a rating for any particular issuer or issuance if the analyst has an immediate family member that currently works for the rated entity or has or had, within the six months immediately preceding the date of the meeting of the rating committee, any other relationship with the rated entity or any related entity thereof that may cause or may be perceived as causing a conflict of interest. Another firm stated that it forbids an analyst from working on the rating of an issuer if the analyst or a direct relation has or has had any business relationship with that issuer in the past five years.

One CRA explained that all employees, board members, and shareholders are obliged to reveal any relationship that may create a potential conflict of interest in relation to the issuers being rated, including certain employment relationships, both personal and familial. The firm stated that it also required individuals to notify the administration and human resources department and the firm’s president, in writing, of any potential conflict of interest, detailing the reason for and timing of the possible conflict. Another firm stated more broadly that it requires analysts to disclose “any personal relationship that creates the potential for any real or apparent conflict of interest” to “an appropriate manager.”

*Question for comment*

*Q61* Are there any other key procedures for managing conflicts established by CRAs with respect to outside employment and other business relationships that are not described above? If so, describe them.

#### **4.2.4 Designing securities**

Several CRAs stated that they prohibit their analysts from making proposals or recommendations regarding the design of structured finance products that the firm rates. One firm explained that it prohibits its employees from making any recommendation to an issuer if the firm issues, reasonably anticipates issuing, or maintains a credit rating with respect to the issuer. Another firm noted its policy not to issue or maintain a credit rating with respect to an issuer or any security issued, underwritten, or sponsored by an issuer where a firm employee made any recommendation to the issuer. The firm noted that it will withdraw an existing credit rating if it learns that a recommendation was made to the issuer by an employee in connection with a credit rating. The CRA explained, however, that in assessing the credit risk of a structured finance transaction, analysts may hold a series of discussions with the issuer or its agents in order to understand and incorporate into their analysis the particular facts and features of the structured finance transaction and any modifications proposed by the issuer or its agents and to explain to the issuer and its agents the credit rating implications of the firm's criteria and methodologies as applied to the issuer's proposed facts and features.

#### ***Question for comment***

*Q62* Are there any other key procedures for managing conflicts established by CRAs with respect to designing securities that are not described above? If so, describe them.

*Q63* Are there key procedures and safeguards established by CRAs to manage conflicts arising from the performance of credit assessments or preliminary ratings? If so, describe them.

#### **4.2.5 Trading securities and owning investments**

All CRAs responding to the questionnaire have established policies and procedures with respect to owning and trading securities. Generally, these policies and procedures prohibit analysts from owning and trading certain securities and impose requirements for owning and trading other securities. In terms of prohibitions, one CRA, for example, generally prohibits analysts and others involved in the rating process (or any member of their immediate family) from owning, buying or selling, or engaging in any transaction involving a security issued, guaranteed, or otherwise supported by any entity within such analyst's area of primary analytical responsibility. A second CRA, for example, prohibits all employees and their family members from engaging in any transaction of a security while in possession of material non-public information relating to the rated issuer of the security or to the security itself. Another CRA prohibits employees and their immediate family members from having direct ownership of securities issued by any organization that is currently rated by the firm or is affiliated with an organization rated by the firm. This prohibition continues to apply for three months following the discontinuation of a rating, with the exception of certain listed securities. One CRA stated more generally that it

prohibits employees from engaging in any securities trading presenting actual conflicts of interest with the firm's rating activities.

With respect to non-prohibited securities transactions, several CRAs require employees to report such transactions. For example, one CRA requires all "covered" employees to disclose their securities holdings and trades, as well as those of their family members. Another CRA has established specific "securities disclosure profiles" that rank all employees with respect to general and specific influence and access to material non-public information. This profile identifies an employee's level of access and influence and extent of restrictions by practice area, business or sector.

One surveyed firm explained its policy with regard to private investments held prior to becoming employed by the firm that could create a conflict of interest. An employee is prohibited from selling such an investment and must notify the administration and human resources department and the firm's president of the investment. The employee also is prohibited from participating in the credit quality evaluation process for the relevant issuer or offering. Further, any long-term loans or investments obtained by an employee prior to a rating process and that are related to any issuer or offering in which the employee is involved must be reported in writing to the administration and human resources department and to the firm's president. The employee must disclose, as applicable, the type of loan or investment, the term, loan rate, and also the contract date. The firm notes that it prohibits all employees from trading in derivative instruments.

#### *Question for comment*

*Q64* Are there any other key procedures for managing conflicts established by CRAs with respect to securities holding and trading that are not described above? If so, describe them.

*Q65* Are certain types of employees exempt from securities trading policies or certain components of securities trading policies? If so, explain.

#### **4.2.6 Gifts**

Most of the surveyed CRAs reported that they prohibit their employees from soliciting money, gifts, or favors from anyone with whom the firm does business. These firms generally prohibit analysts from accepting gifts offered in the form of cash and any other gifts exceeding a minimal monetary value. Two CRAs explained that they impose an absolute prohibition on the acceptance of gifts for all employees in an analytical role. In contrast, one firm noted that it allows analysts to accept gifts after the rating has been released to the general public and the other requirements of the firm's gift policies have been met.

One firm noted that in the event any person with which the firm has business dealings solicits from or offers to the firm's personnel, whether explicitly or implicitly, any "remuneration, good, donation, gift, gratification, or entertainment," the firm's personnel must report this immediately to the firm's administration and human resources department as well as to its president. Employees also must detail the characteristics of the items in question, the date delivered, and



the type of relationship with the company or issuer. If the solicitation or offer is determined to present a conflict of interest, a request will be made, in writing, to terminate the business relationship with the person in question, informing the person of the cause and the creation of the conflict of interest that violates the ethical standards of the firm. With regard to remuneration, goods, donations, gifts, gratifications, or entertainment that are not given with such intention, the firm explained, company management, technical personnel, and other employees may accept these items provided they are not made in cash and their value does not exceed approximately \$70 US over a twelve month period.

*Question for comment*

*Q66* Are there any other key procedures for managing conflicts established by CRAs with respect to gifts that are not described above? If so, describe them.

*Q67* Are all employees covered by gift policies or, for example, only analysts? Please explain.