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February 8, 2005

Statement of Micah S. Green

President
The Bond Market Association

Testimony Before
The Committee on Banking, Housing and Urban Affairs
United States Senate

Hearing on the Role of Credit Rating Agencies in the Capital Markets

Thank you, Chairman Shelby, for the opportunity to testify today on credit rating agencies. My name is Micah S. Green and I am the president of The Bond Market Association. As you know, the Association represents securities firms and banks that underwrite, distribute and trade debt securities in the United States and internationally—a global market estimated at $44 trillion today. The Association speaks for the bond industry worldwide, advocating its positions and representing its interests in New York, Washington, London and elsewhere. The Association also works with bond issuers—companies, governments and others who borrow in the capital markets—and investors in fixed-income products from across the globe.

Our members account for approximately 95 percent of U.S. municipal bond underwriting and trading activity. The membership also includes all primary dealers in U.S. government securities, as recognized by the Federal Reserve Bank of New York, and all major dealers in U.S. agency securities, mortgage- and asset-backed securities and corporate bonds, as well as money market and funding instruments. In recent years, the Association has sponsored both the American and the European Securitization Forums. These are affiliated organizations that focus on the rapidly growing securitization markets in the United States and Europe. Another Association-sponsored organization, the Asset Managers Forum, brings together institutions that are active in the bond market as investors to address major operational, accounting, public policy and market practice initiatives. The comments here reflect the collective views of the Association and our forums.

The Bond Market Association is deeply involved in investor education. Although most bond markets are dominated by large, sophisticated institutional investors, it is our strong belief that retail investors must have sufficient background and data to not only make informed investment decisions but also to realize that allocating their assets in a diversified manner is an important investment strategy. Last week, the Association launched an updated version of our award winning investor education website, Investinginbonds.com. The site provides investors with background, news, data and commentary on the bond markets in addition to bond prices. Included in this information is the very important credit rating that is attached to most fixed-income investments.

We welcome the opportunity to testify here today on the role of credit rating agencies in the capital markets. The past 15 years have seen dramatic growth in the number of issuers and the range and complexity of fixed-income securities. The importance of credit ratings to investors and other securities market participants has increased proportionally. The role of rating agencies is critical to the efficient functioning of the fixed-income markets. It is both important and useful for this committee to focus on an industry that plays such a vital role in the capital markets.

Credit Rating Agencies and the Fixed-Income Markets

All investments involve risk. One important type of risk associated with certain bonds and other fixed-income investments is credit risk—the chance that a bond will default, or the issuer will fail to make all interest and principal payments under the bond's terms. A credit rating is essentially an opinion offered by a rating agency on the credit risk of a bond. The credit rating process employs both quantitative tools and subjective judgment. In addition to analyzing a company's balance sheet, for example, credit ratings may also take into account subjective forecasts of the issuer's ability to generate revenue in the future. An investor can determine objective factors such as a security's coupon, maturity, call features and covenants from the issuer's mandated disclosure. Analysis of an issuer's credit quality, however, involves individual judgments about a variety of complex financial and other information. A credit rating is a valuable complement to an investor's own credit analysis precisely because it is both expert and independent. Credit ratings also guide the market's pricing decisions. Bonds with lower ratings are viewed as riskier than higher-rated bonds by investors who demand a yield premium as compensation for this risk. Conversely, higher-rated bonds will offer a relatively lower yield as a reflection of their stronger credit standing. In addition, ratings play an important role in market regulation.

Rating agencies in general, and certainly the more established agencies, approach the rating process in similar ways. Rating analysts are grouped by market, such as corporate, asset-backed or municipal bonds, and also industry or sector, such as financial services or transportation and rating decisions are made by committee. As part of the process of gathering information, rating agency personnel maintain regular contact with issuers and also rely on regulatory filings, news and industry reports, among other information. Nonpublic information, such as proprietary business forecasts, also may be available to rating agencies under promises of confidentiality and under an exemption from the Securities and Exchange Commission's (SEC) Regulation FD. The Association strongly supports maintaining this exemption.

Rating agencies generally inform issuers and investors of their rating methodologies for particular asset classes. These are detailed descriptions that provide useful information to issuers and investors, and also help the rating agencies ensure the consistency of their ratings even when different rating analysts are involved.

Once ratings are published, they are available to all market participants and the public. To receive a detailed analysis of the rationale for the rating decision, however, generally requires a fee-based subscription. These subscription fees and the fees paid by the issuer for the rating itself are the principal revenue sources for most rating agencies. The ratings assigned by the three major firms by category are shown in the chart below.

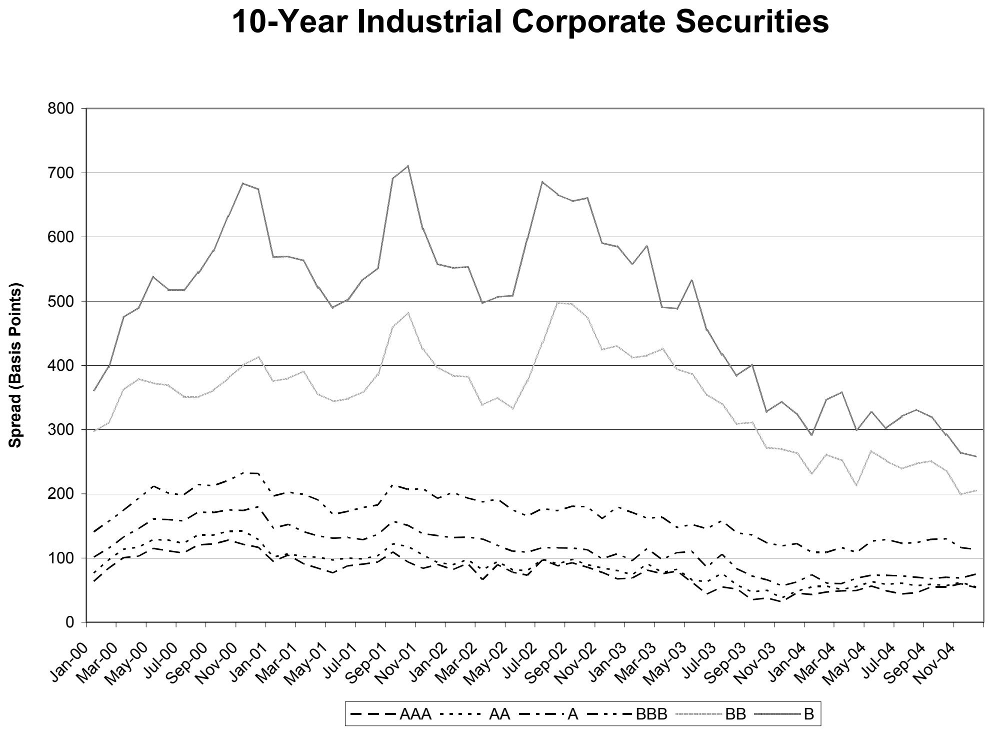
	Moody's	Standard & Poor's	Fitch Ratings	Dominion Bond Rating
Investment	**Grade**			
Highest Quality	Aaa	AAA	AAA	AAA
High Quality (very Strong)	Aa	AA	AA	AA
Upper Medium Grade	A	A	A	A
Medium Grade	Baa	BBB	BBB	BBB
Non Investment	**Grade**			
Somewhat Speculative	Ba	BB	BB	BB
Speculative	B	B	B	B
Highly Speculative	Caa	CCC	CCC	CCC
Most Speculative	Ca	CC	CC	CC
Imminent Default	C	C	C	C
Default	C	D	D	D

Capital market participants make use of rating information and interact with rating agencies differently depending on their role in the market. For issuers of fixed-income securities, credit ratings typically have a direct effect on the rate at which they can borrow in the capital markets. As noted above, investors will assign a risk premium on lower-rated securities to reflect the higher chance of default. The premium translates into a higher interest rate on the issuer's debt, or an increase in the cost of capital.

To better appreciate the relationship between ratings and yields it is important to consider how the market prices bonds. With few exceptions, prices for fixed-income products are quoted as a number of basis points[1] over a benchmark such as U.S. Treasury securities of a comparable maturity, the London Interbank Offered Rate (LIBOR), the rate on interest rate swaps of comparable duration or some other benchmark that represents an investment perceived to be free of credit risk. The amount that the return on a given investment exceeds the return on the benchmark—a bond's "credit spread"—represents the risk premium investors receive as a result of the degree of risk, principally credit risk, the investment carries. Higher rated bonds have a smaller spread than lower rated bonds of the same maturity. As the chart below shows, the correlation between rating and spread is historically consistent. It is a trusted metric that promotes market efficiency as it allows a participant to commoditize partially what are disparate assets. A bond dealer asked for a quote on a corporate or municipal security, for example, will look not only at any recent trades for the same security but also at the current yield on similar bonds that have a similar credit rating.

[1] One basis point equals 1/100th of a percentage point.

Bond investors are overwhelmingly comprised of mutual funds, pension funds, endowments and asset management firms and other institutions that employ sophisticated, professional money managers.[2] As of the end of 2003, less than ten percent of all bonds outstanding in the U.S. were held directly by individual investors, although in the tax-exempt municipal bond market that figure is about 35 percent. Institutional investors often conduct their own credit analysis of issuers but also rely on credit ratings as part of their overall risk analysis.



Source: Bloomberg

It is common for some institutional investors to have in-house rules limiting investment in any fixed-income security that does not have at least an investment grade rating.[3] Similarly, most states have laws dictating the permitted investments of insurance companies on the basis of credit rating. Some states require two ratings. The National Association of Insurance Commissioners (NAIC) maintains a list of rating agencies whose ratings are acceptable for this purpose.

Broker-dealers also use credit ratings to supplement proprietary credit analysis. They also advise issuers of the effect of ratings on the cost of capital. Credit ratings, of course, are also important to investors with whom broker-dealers interact in the

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[2] A majority of outstanding municipal debt is beneficially owned by individuals through mutual funds and individual holdings, but investment decisions for a majority of outstanding municipal bonds are made by professional money managers.

[3] An investment grade rating is defined as at least a BBB rating offered by Fitch Ratings or Standard and Poor's or a Baa rating offered by Moody's. A sub-investment grade rating, also known as high-yield or speculative grade, is defined as any rating below investment grade. Some institutional investors purchase a mix of investment grade and sub-investment grade bonds and some specialize in sub-investment grade exclusively.

market place. In September 2004, the Corporate Debt Market Panel sponsored by the National Association of Securities Dealers (NASD) released a report recommending the disclosure of credit ratings immediately prior to an investor's decision to buy or sell a bond as well as upon confirmation of a trade.

Credit ratings are also used in the regulation of broker-dealers and different types of institutional investors. One notable example is the Securities and Exchange Commission's net capital rule, which requires broker-dealers to maintain specified minimum capital levels to support their assets or customer liabilities. Since 1975, the net capital rule has imposed different capital charges for assets depending upon whether (and at what level) the assets are rated by what the SEC defined as a "Nationally Recognized Statistical Rating Organization" or NRSRO. Higher-rated securities receive a lower capital charge than lower-rated securities. Similarly, SEC-registered money market funds are permitted to invest in short-term debt securities that receive one of the two highest NRSRO ratings. Investment grade ratings can also provide an issuer with the option of short-form SEC registration in some cases.

The Bank for International Settlement's Committee on Banking Regulation stipulates the use of credit ratings in assessing the capital charges for banks under the new Basel Capital Accord, Basel II. Basel II articulates a set of criteria a firm must satisfy in order to qualify as an External Credit Assessment Institution (ECAI) which allow its ratings to be used in this calculation.[4]

TBMA Response to U.S. and European Regulatory Proposals

Recently, regulators in the U.S. and Europe have stepped up their focus on rating agencies and raised the prospect of changes in the current approach to regulatory oversight. The Association's view on the regulation of credit rating agencies is simple:

- We believe that the criteria adopted by regulators for approving NRSRO's or ECAI's should be flexible enough to allow increased competition between a larger number of entities, while ensuring that designated rating agencies have the expertise to produce accurate ratings. In the U.S., this means eliminating the current requirement that a rating agency be widely recognized, rather than accepted in a defined sector of the market.

- We believe credit rating agencies should have policies and procedures to ensure the independence of the credit rating process.

- We believe credit rating agencies should publish their rating methodologies for various types of securities, so that both issuers and users will understand the agencies' requirements and standards, and so that different rating analysts in the same agency will produce consistent ratings.

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[4] *International Convergence of Capital Measurement and Capital Standards*, Basel Committee on Banking Supervision, June 2004. Page 35. The six criteria include objectivity, independence, transparency, disclosure, resources and credibility.

- We do not believe that regulation of the credit rating process is necessary or desirable, since government regulation would tend to result in less diversity of opinion and would be less responsive to new product developments.

- We believe issuers should be given an opportunity to correct factual misstatements in rating agency reports, but not to appeal rating designations outside the rating agency.

- We believe rating agencies should publish information on the historical accuracy of their rating assessments.

As the capital markets develop and mature globally, the need for a measured approach by regulators toward the conduct of rating agencies grows in importance. The Association does support those actions by regulators—such as modifying the criteria for NRSRO designation—that we believe will help enhance competition among rating agencies. We do not support steps that would limit the independence of rating agencies to determine their opinions of the creditworthiness of issuers.

For more than a decade, the SEC has contemplated a rule-making to address the credit rating industry, the role it plays in the securities market and how it should be regulated. A 1994 concept release led to a proposed rule in 1997 that would have set new criteria for NRSRO status. The SEC did not act on the proposal but in 2003 issued a report[5] in accordance with the Sarbanes-Oxley Act followed by a concept release. The concept release addressed questions of NRSRO regulation, potential conflicts of interest between rating agencies and issuers and competition within the industry. (The Association's 2003 response to the concept release is attached in appendix 1.)

In response to the concept release, the Association filed a comment letter endorsing the NRSRO designation with some clarification to address competition and other issues. Generally speaking, the Association acknowledges the important role rating agencies play in the capital markets. All market participants—investors, dealers, issuers (and their advisors) and regulators—count on rating agencies as reliable sources of analysis whose judgments are sound. A number of statistical studies show a correlation between strong ratings and a low probability of default. At the same time, rating agencies cannot be expected to evaluate risk perfectly. Their analysis relies on the integrity of an issuer's disclosure.

In 2004, the International Organization of Securities Commissions (IOSCO), of which the SEC is a member, proposed a code of conduct for rating agencies, which was followed by a request from the European Commission for public input on how the code of conduct should be implemented. In response, the Committee of European Securities Regulators (CESR) produced a consultative paper suggesting a range of regulatory approaches based on the IOSCO principles. In our comments to CESR,

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[5] *Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets*, *U.S. Securities and Exchange Commission, January, 2003*. *Rating Agencies and the Use of Credit Ratings Under the Federal Securities Laws*, S.E.C. Concept Release June, 2003.

the Association stressed the need to avoid the creation of a detailed set of regulatory requirements after the initial certification.

The Association's position on the regulatory proposals dealing with the credit rating process in the U.S. and Europe is centered on the fundamental issues of competition and market conduct. (The Association's response to both IOSCO and CESR can be found in appendix 2.)

Competition

Some observers have questioned whether the credit rating industry is as competitive as it should or could be and suggest that inappropriate barriers to entry exist. In the U.S., the nature of the NRSRO designation is often brought up as a factor in this debate. The Association supports the retention of this designation. We have also called for greater clarity in the SEC's approval policy and the elimination of the requirement that a rating agency be "widely accepted" in order to gain the designation. The Association certainly welcomes additional entrants to the marketplace from any part of the globe. Increasing competition among qualified rating agencies could only benefit issuers, investors and the market generally.

The Association responded to the 2003 concept release with suggestions for improving the transparency of the designation process. Increased transparency will aid public understanding of the process and improve the ability of other rating agencies to gain the NRSRO designation leading to enhanced competition in the industry. The SEC should adopt a formal and standardized application process. Applications should be public and the subject of public comment. Applicants likely to receive an adverse decision should have the option to withdraw their applications to prevent the release of proprietary information. The SEC's reasons for accepting or rejecting an application should be explicitly stated and existing NRSROs should also complete the application process to ensure uniform treatment.

At present, the SEC primarily considers whether an agency is "widely accepted" when deciding whether to grant NRSRO status. Other factors such as an agency's financial resources, staff experience, independence and rating procedures are also considered. The Association believes the "widely accepted" standard should be relaxed in the cases where a rating agency meets all other criteria but happens to specialize in only a single market or industry or geographic sector. The NRSRO status of such a rating agency could be limited to its area of expertise. This will reduce barriers to entry and enhance competition. An obvious way to increase the number of agencies whose ratings are widely accepted is to approve niche credit raters which can then—after gaining experience and market acceptance—expand to cover a broader range of industries and securities.

In Europe, CESR has listed barriers to entry that exist in the credit rating field and asked how regulators should address them. The credit rating industry is difficult to penetrate for new firms. Much of the value the market assigns to credit ratings is based on reputation and track record, something new entrants necessarily lack. This dynamic, however, is not unique to the rating industry and CESR itself has described barriers as "natural." It also has not created a market failure or a condition in which a segment of issuers goes without service. The flexibility of an IOSCO-type code-of-conduct approach, as opposed to detailed regulation of rating agency business practices, will facilitate the entrance and expansion of new credit rating agencies in the market.

The NRSRO designation serves a unique purpose in SEC regulations for which a substitute is either not available or not practical. Using credit spreads or internal credit ratings as alternatives to NRSRO ratings for computing net capital requirements is possible, for example, but would add significant costs. In addition, in the case of internal ratings it could result in the non-uniform treatment of the same assets by different firms.

Rules of Conduct

The day-to-day operations of rating agencies should never be controlled by regulation. With respect to both the United States and Europe, specific rating methodologies and standards of due diligence should not be mandated by regulators. The rating process is subjective in some respects and cannot be evaluated for appropriateness by a government agency. The Association does believe it would be appropriate for rating agencies to disclose internal statistics on the accuracy of their ratings. Government mandates of rating methodology, however, could be construed as a government approval of securities that receive high ratings from designated rating agencies. It would also effectively eliminate differences in the analysis of competing rating agencies and undermine the value of independent credit analysis.

Similarly, while conflicts of interest between rating agencies, issuers and subscribers may exist, it would not be appropriate for regulators to prescribe specific methods for dealing with the issue. A more favorable approach—and one the IOSCO code now requires—would be for rating agencies to adopt policies and procedures to address and disclose potential conflicts of interest, such as issuer and subscriber influence and the potential misuse of public information. It is the view of some institutional investors—particularly with respect to structured finance products—that such policies and procedures should be designed to discourage participation in the practice known as “ratings shopping,” a situation in which an issuer employs a rating agency based on real or perceived differences in methodology that could result in more favorable ratings.

Conclusion

The Association is pleased to offer the above comments on credit rating agencies. As we have noted, the credit rating industry plays an important and unique role in the capital markets. It is also an industry whose integrity is effectively ensured by market discipline. Rating agencies that appear biased or corrupt or supply dishonest analyses would find their services without value. Regulators can best ensure the credit rating industry remains robust and independent by endorsing a principles-based approach to industry oversight, like the IOSCO code, that supports competition but does not dictate specific methodologies or other rules of conduct. Regulators need to address the barriers to entry by clarifying the criteria for designating NRSROs and changing the “widely recognized” requirement so niche players can enter the market.

APPENDIX 1

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THE BOND MARKET ASSOCIATION

July 28, 2003

Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549-0609

Re: Concept Release: Rating Agencies and the Use of Credit Ratings
Under the Federal Securities Laws (File No. S7-12-03)

Dear Mr. Katz:

The Bond Market Association[1] (the "Association") welcomes the opportunity to comment on the above-captioned concept release (the "Concept Release") issued by the Securities and Exchange Commission (the "Commission").

I. Executive Summary.

Credit rating agencies play a critical role in the efficient functioning of the fixed income markets. In addition, they have a significant function under a number of Commission regulations, including the net capital rule applicable to broker-dealers. Although the Concept Release and the Commission's January 2003 Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets note a number of issues relating to credit rating agencies and their operations that may be of concern to the fixed income markets, as a general matter the Association believes that the current system of oversight of credit rating agencies functions reasonably well. As a result, the Association believes that the nationally recognized statistical rating organization ("NRSRO") designation should be retained in substantially its current form and that significant additional regulatory oversight of credit rating agencies is unwarranted. In particular, the Association is concerned that adoption of rules that mandate or specify particular rating practices or procedures could adversely affect the quality and diversity of rating information available to market participants. Moreover, rules that subject individual rating determinations to Commission review could chill communication between issuers and rating agencies and also adversely affect the quality of rating information.

The Association does believe, however, that given the important role played by credit rating agencies in the fixed income markets and for regulatory purposes, the process by which agencies are designated as NRSROs for purposes of the Commission's rules should be made more transparent. In this regard, the Association recommends that the Commission adopt regulations that specify the procedures and requirements for NRSRO designation, rather than continuing to rely on designation by staff no-action letters. In addition, the Association believes that the Commission should encourage competition in the credit rating industry, consistent with the goal of maintaining rigorous standards in the industry, by applying the designation standards in a way that will facilitate designation of new NRSROs, including NRSROs that rate securities only in a single or a limited number of market sectors or in non-U.S. jurisdictions.[2]

II. General Considerations.

In assessing the appropriate level of Commission oversight of credit rating agencies, it is useful to consider the critical role that credit rating agencies have long played in the efficient functioning of the fixed income markets. Unlike certain factors that affect the value of a credit instrument, such as maturity, yield, call features and priority vis-à-vis other classes of creditors, issuer creditworthiness inherently cannot be measured with precision. Many of the factors that relate to a determination of issuer creditworthiness, including the capability and experience of management, the quality of risk controls, and the ability to adapt to changing market conditions, among others, require a significant degree of subjective assessment. Credit rating agencies, by aggregating factors, both objective and subjective, that form a part of credit standing give market participants an additional source of information that can help to confirm market assessments of credit risk. Because ratings provide a reasoned and categorical assessment of the relative creditworthiness of credit instruments and issuers, it is appropriate that Commission rules permit references to ratings as benchmarks in specific contexts that are sensitive to the relative safety of different investments.

At the same time, it is important to appreciate that credit ratings represent only one information source available to market participants about credit quality. Sell-side and buy-side firms that are active in the fixed income markets conduct their own intensive credit analyses for risk management purposes, including the maintenance of adequate capital, and for purposes of identifying pricing discrepancies in conducting their trading operations. Further, much information is available to the marketplace in the form of research conducted by securities and independent research firms. From the standpoint of major market participants, therefore, ratings do not substitute for the need to carefully monitor the credit of issuers as to which firms have substantial credit exposure, but instead form one part of the mix of information that they use in performing that function.

Ratings issued by the major rating agencies have generally proved to be a reliable source of information for the fixed income markets. The reputational and commercial interests of the agencies provide a strong motivation to maintain the credibility of their ratings. Historically, a variety of studies have demonstrated a consistent and clear correlation between long-term corporate debt ratings and the probability of default.[3] There should not, however, be an expectation on the part of regulators or market participants that any rating agency, or ratings system, will act as a perfect evaluator of credit risk or quality. This is true because of the complexity of evaluating the various objective and subjective factors that affect creditworthiness and reflecting them in a single symbolic rating.

In addition, rating agencies should not and cannot be reasonably charged with uncovering and evaluating all possible undisclosed risks or liabilities that might affect credit quality, or with uncovering fraud or other misconduct by issuers. Rating agencies, like other market information that is accurate and complete. Although rating agencies may have access to certain information not contained in public disclosures of issuers pursuant to the exemption from Regulation FD for certain disclosures to credit rating agencies,[4] the agencies lack the resources and expertise to conduct an independent audit of all the financial information produced by the issuers they rate and cannot be expected to police in any meaningful way the review conducted and decisions made by accounting professionals.

III. Comments on the Concept Release.

In light of these considerations, the Association generally believes that the Commission should retain the current level of regulatory oversight of credit rating agencies, with some modifications. Specifically, the Commission should (i) retain the current uses of the NRSRO designation under its rules, (ii) improve the transparency of the designation process by adopting a formal application procedure, (iii) clarify the designation criteria to more easily permit certain rating agencies, including those that rate issuers only in certain sectors or jurisdictions, to become NRSROs, and (iv) address ongoing examination and compliance considerations by requiring annual certifications by NRSROs of continued compliance with the applicable designation criteria.

A. Retention of the NRSRO Designation.

The Association believes that the NRSRO designation performs an important function for purposes of the Commission's regulations that cannot easily be replaced or duplicated. Although there may be alternatives to using NRSRO credit ratings in some regulatory contexts, such as permitting the use of internal credit ratings or credit spreads in computing net capital requirements,[5] these alternatives may entail significant costs and may not be practical in all situations, or for all firms. Overall, the Association does not believe that there is any single existing replacement or proxy for NRSRO ratings that is as useful as such ratings for all of the functions that such ratings now serve under the Commission's regulations.

For certain of the Commission's regulations, there is no readily apparent substitute for reliance on NRSRO credit ratings. In the context of the exemption from Regulation M for transactions in investment grade debt securities, for example, reliance on external credit ratings is necessary for the exemption to apply uniformly for all market participants. Use of an internal ratings-based approach, where different broker-dealers could have different determinations of whether an obligation is investment grade, would not be appropriate. There is similarly no easy substitute for reliance on investment grade ratings in the Form S-3 eligibility criteria for asset-backed issuers. As a general matter, for those regulations where a uniform set of standards across market participants is desirable, reliance on NRSRO credit ratings works particularly well.

In the Association's view, whatever imperfections may exist in the practices of credit rating agencies do not warrant eliminating the use of NRSRO credit ratings for purposes of the Commission regulations that currently rely on such ratings.

B. NRSRO Designation Process.

If the Commission determines to retain the use of NRSRO ratings for purposes of its regulations, the Association generally supports the suggestions in the Concept Release (and in the Commission's 1997 proposed rule regarding NRSRO designation)[6] for improving the transparency of the designation process. Improving transparency would make the ratings process more understandable to the investing public and facilitate the designation of additional NRSROs, which could beneficially increase competition among rating agencies and thereby improve the quality and availability of rating information.

In this regard, given the importance of credit rating agencies to the investing public as well as for regulatory purposes, the Association would support a more formal application process established pursuant to Commission regulations, rather than the current no-action approach. Preferably, designation of NRSROs should occur through Commission action (or by staff decision with a process of appeal to the Commission). Specifically, the Association recommends as follows:

- The Commission should adopt a specific form of application that specifies the information to be provided by the applicant. This will help ensure that the application process is standardized, and that each applicant is required to provide information of the same type and scope.

- Applications (and related exhibits) should be made public at the time they are acted upon by the Commission (or its staff). In light of the importance of NRSRO designation to the fixed income markets, the Commission should invite public comment on NRSRO applications. As with other application procedures, an applicant likely to receive an adverse determination could be permitted to withdraw the application without public disclosure prior to the beginning of any public comment period. The Commission could permit, in accordance with the Freedom of Information Act and related Commission rules, confidential treatment of certain information provided by an applicant if necessary to protect legitimate confidential commercial or financial information of the applicant.

- The decision by the Commission (or its staff) to grant or deny an application should explicitly set forth the reasons for the decision by reference to the requirements in the Commission's regulations and the information provided by the applicant. The decision should also fully describe any conditions that are imposed in order to obtain or maintain the NRSRO designation. It is critical to the integrity of the designation process that investors and other interested parties be able to understand the Commission's (or its staff's) reasoning in acting on an application.

- Existing NRSROs should be required to complete the application process, in order to ensure that all applicants are treated fairly and held to the same standards. To avoid disruptions to the markets, existing NRSROs could remain designated as such pending action by the Commission (or its staff) on their applications, however.

C. NRSRO Designation Criteria.

In its no-action letters granting NRSRO designation, the staff of the Division of Market Regulation has indicated that the most important criterion for obtaining designation is that the rating agency is widely accepted in the United States as an issuer of credible and reliable ratings by the predominant users of securities ratings. The staff has also stated that it reviews the operational capability and reliability of the rating agency, including (1) the organizational structure of the rating agency, (2) its financial resources (to determine, among other factors, whether it is able to operate independently of economic pressures or control by the companies it rates), (3) the size and experience and training of its staff (to determine if it is capable of thoroughly and competently evaluating an issuer's credit), (4) its independence from the companies it rates, (5) its rating procedures (to determine whether it has systematic procedures designed to produce credible and accurate ratings), and (6) whether it has internal procedures to prevent the misuse of nonpublic information and whether those procedures are followed.[7]

The Association generally believes that it is appropriate for the Commission to continue to use criteria along these lines in evaluating applications for NRSRO status. As described above, however, the Association believes that the Commission should implement formal procedures for the application process, and as part of that process adopt regulations setting forth these criteria in more detail.

In addition, the Association believes that the Commission should undertake, in reviewing its designation criteria and application process, to promote competition, consistent with a rigorous application process and prudent application of the Commission's regulatory standards. As noted in the Concept Release, there are currently only four entities designated as NRSROs. Although this situation undoubtedly results in part from market-driven factors like economies of scale and consolidation in the credit rating industry, it may also be affected by past reluctance by the staff to countenance new entrants.[8]

In this regard, the Association recommends that the Commission revise the current "widely accepted" standard to permit the designation as NRSROs of rating agencies that otherwise satisfy the Commission's criteria but rate securities only in certain market sectors or jurisdictions. For example, an agency that is well established in a foreign jurisdiction may not be widely recognized or accepted in the United States but may still be capable of credibly rating instruments of issuers from that jurisdiction. Rating agencies with expertise in a particular industry sector should also be permitted to be NRSROs for purposes of rating issuers in that sector. For rating agencies whose expertise is limited to a particular sector or jurisdiction, the Commission could limit their NRSRO status to ratings of issuers in that sector or jurisdiction.

In terms of adopting additional designation criteria, the Association would oppose the Commission's mandating particular rating methodologies, practices or procedures as a condition to NRSRO designation. For example, the Commission does not need to, and should not, require minimum due diligence standards and/or the use of a particular rating methodology (*e.g.*, the use of statistical models versus more qualitative models or vice versa). The Commission also should not attempt to specify the process by which individual ratings are assigned or updated. The complex nature of the ratings process, its application to individual companies and the judgments it requires, do not lend themselves to a system of rigorous government oversight. Neither the Commission nor any other government agency is well positioned to evaluate the validity of individual rating decisions based on numerous, and in some cases subjective, factors.

In addition, the federal scheme of securities regulation is designated generally to avoid "merit regulation," or the endorsement or certification of the value or safety of any particular investments, for at least two reasons. First, it is impossible for any one authority to accurately measure, or even to specify a method for accurately measuring, relative investment merits in the context of a constantly changing marketplace. Second, Congress, the Commission and other regulators have made a determination that the markets work most efficiently and provide the maximum common benefit when the merits of individual securities are judged by the countless decisions of individual market participants, subject to to mandate or specify the process by which ratings decisions are made would necessarily carry with it a governmental imprimatur that investors might rely upon. It is critical that investors understand that ratings are not infallible, and that a favorable rating is not a guarantee of safety. Excessive government involvement in the rating process might imply a different message that would give investors false comfort which could ultimately undermine rather than reinforce investor confidence.

D. Examination and Oversight.

The Association believes that, consistent with the goal of establishing a more formal application procedure, the Commission should also require an annual certification by each NRSRO that it continues to satisfy the requirements of the Commission's regulations and any other conditions imposed in connection with its NRSRO status.[9] On the other hand, the Commission should not, in the Association's view, subject NRSROs to additional ongoing examination or oversight, especially with respect to particular rating methodologies, practices or individual rating determinations. Such examination or oversight could have the effect of limiting issuers' willingness to communicate with rating agencies and thereby adversely affect the quality of rating information.

The Association supports an annual certification on the grounds that in assuring that a rating agency continues to meet the standards that have been set, it is not sufficient to hold out the threat of withdrawing NRSRO designation based on a subsequent determination that the standards are no longer satisfied or conditions have not been met. Annual certification by NRSROs could help ensure that NRSROs themselves conduct a comprehensive ongoing review of their compliance with applicable requirements and conditions. If an NRSRO fails to make the required annual certification, the Commission could, of course, investigate further and, if appropriate, withdraw or suspend its NRSRO designation.

Aside from this type of annual certification, however, the Association does not believe that NRSROs need to be subject to significant additional ongoing examination or oversight. As an initial matter, it is not clear what the purpose would be of additional oversight, beyond that necessary to ensure compliance with the conditions of designation. For the reasons discussed above, the Association does not believe that the Commission should attempt to mandate or specify particular rating methodologies or practices. In addition, the Commission should not involve itself in, or attempt to review, individual rating determinations with respect to particular issuers.

The Association believes that certain recordkeeping requirements, including those related to a rating agency's satisfaction of NRSRO designation criteria, are appropriate, and that the Commission may have reason to examine those records under certain circumstances.[10] The Association believes, however, that the Commission should be mindful of the concern that any such recordkeeping or examination requirements could chill communication between issuers and rating agencies and among analysts within a rating agency, and thereby adversely affect the quality of rating information that is available in the marketplace, particularly if the requirements relate to records of confidential communications with issuers or internal discussions as to individual rating decisions and the reasons for those decisions.[11]

E. Conflicts of Interest.

The Association recognizes that conflicts of interest between rating agencies, the issuers they rate and their subscribers may exist. As a result, it may be appropriate to require, as the current designation criteria do to some extent, that a rating agency have policies and procedures to address potential conflicts of interest, including potential issuer and subscriber influence and misuse of nonpublic information, as part of the NRSRO designation criteria.

Nonetheless, the Association believes that the Commission should not mandate specific approaches or methods for addressing conflicts of interests, such as firewalls, compensation structures, revenue or asset tests or, in particular, restrictions on non-rating activities of NRSROs, such as advisory services. Such services in particular are beneficial to many issuers and market participants, and the Association is aware of no evidence that such services present a significant conflict of interest warranting restriction. Subject to a general requirement to demonstrate, as part of the application process, that the firm maintains appropriate policies to address conflicts of interests, rating agencies should have some flexibility in terms of the approaches taken, in light of the particular characteristics of their business and operations. This approach will also help facilitate the designation of new rating agencies as NRSROs, as procedures appropriate for large, broad-based rating agencies may not be suited to newer agencies or agencies rating in only limited sectors or jurisdictions.

F. Anticompetitive, Abusive and Unfair Practices.

The Association notes that certain allegations have been made as to anticompetitive, abusive or unfair practices by credit rating agencies. As a general matter, the Association does not believe that these issues are appropriately addressed by a Commission rulemaking at this time.[12] The Association notes in this regard that many of these allegations concern abuse of market position, tying and other practices that may be subject to applicable antitrust law. In addition, the Association believes that increasing competition among credit rating agencies, such as by facilitating designation of new NRSROs, will help reduce the risk of anticompetitive practices.

* * *

The Association and its members appreciate the opportunity to comment on the Concept Release. If the Commission determines to proceed with a rulemaking, the Association would be pleased to continue to work with the Commission and its staff and other market participants to address the issues raised by the Concept Release.

Please feel free to contact the undersigned or Paul Saltzman at 646.637.9200 with any questions.

Respectfully submitted,

John M. Ramsay
Senior Vice President and Regulatory Counsel

cc: William H. Donaldson, Chairman
Cynthia A. Glassman, Commissioner

Harvey J. Goldschmid, Commissioner
Paul S. Atkins, Commissioner
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Stephen M. Cutler, Director, Division of Enforcement
Annette L. Nazareth, Director, Division of Market Regulation
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[1] The Association represents securities firms and banks that underwrite, distribute, and trade in fixed income securities, both domestically and internationally. More information about the Association is available on its website, http://www.bondmarkets.com. The Association's committees that have been involved in providing these comments include the Legal Advisory Committees of the Corporate Credit Markets Division, Funding Division, Municipal Division, MBS/ABS Division, and Government Division, and various cross-market committees of the Association.

[2] The Association accordingly views the recent recognition of Dominion Bond Rating Service Limited as an NRSRO as a positive development in this regard. *See* Dominion Bond Rating Service Limited (Feb. 24, 2003).

[3] *See generally* Credit Ratings and Complementary Sources of Credit Quality Information, Basel Committee on Banking Supervision Working Papers (August 2000).

[4] The Association strongly supports maintaining this exemption. Eliminating it would provide a substantial disincentive to rating agencies to "dig beneath the numbers," and thereby might sharply limit the value added by rating agencies to the fixed income markets. The Association also opposes the adoption of rules that would prohibit or limit the ability of NRSRO analysts to discuss rating actions with subscribers. Existing legal and contractual requirements, together with reputational considerations and reasonable conditions imposed by the Commission as part of the designation process, are sufficient incentive for NRSROs to manage any confidentiality and conflict of interest concerns arising from such discussions.

[5] The Association encourages the Commission to continue to explore the possibility of allowing broker-dealers to use internal risk models for net capital purposes, along the lines of the internal ratings-based approach being developed under the revised Basel bank capital accord. We note, however, that mandating such an approach in lieu of the current approach based on NRSRO ratings might impose significant additional costs on some broker-dealers.

[6] Capital Requirements for Brokers or Dealers under the Securities Exchange Act of 1934, Release No. 34-39457, 62 Fed. Reg. 68018 (Dec. 30, 1997).

[7] *See, e.g.*, Dominion Bond Rating Service Limited (Feb. 24, 2003). The Association notes that the Commission's 1997 rule proposal set forth a similar list of criteria and would in addition have required each NRSRO to be registered as an investment adviser under the Investment Advisers Act of 1940 (the "Advisers Act").

[8] *See, e.g.*, Lawrence J. White, Stern School of Business, New York University, "The Credit Rating Industry: An Industrial Organization Analysis" (2001).

[9] The Association does not, however, believe that annual certifications need to be subject to public comment.

[10] The Association notes, however, that the Commission may as a practical matter already have access to such information pursuant to the recordkeeping requirements for investment advisers under Investment Advisers Act Rule 204-2.

[11] Of course, in the case of specific Commission investigations of fraud or other misconduct, rating agencies would generally be subject to the Commission's investigative authority in accordance with applicable law to the same extent as other persons.

[12] With respect to the specific issue of unsolicited ratings, the Association does not believe that the Commission needs to restrict the practice, although in the interest of promoting transparency of the rating process it would be appropriate to require rating agencies to disclose the fact that a rating is unsolicited or issued without discussions with the management of the issuer. With respect to allegations of anticompetitive conduct generally (as well as conflicts of interest), specific concerns would be appropriately raised as part of the public comment process following submission of an application.

APPENDIX 2

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Fabrice Demarigny
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28 January, 2005

Dear Mr Demarigny

Response to CESR's technical advice to the European Commission on possible measures concerning credit rating agencies (CRAs") - Consultation Paper November 2004

The Bond Market Association's European office and its Credit Rating Agencies Working Group[1] welcome the opportunity to respond to this Consultation Paper.

We congratulate CESR for its generally thorough and thoughtful analysis of the various issues raised by the European Commission. Our comments follow the structure of CESR's Consultation Paper.

For your quick reference, we attach in Annex the detailed summary of our response which was submitted to the Chairman and Rapporteur of CESR's Task Force on CRAs on 21st January, 2005.

I. INTRODUCTION

Definitions

Q1. Do you agree with the definition of CRAs? If not, please state your reasons.
While we believe that CESR's focus on those entities whose main business is the issuance of ratings of debt securities and issuers is the correct approach for the purpose of this Consultation Paper, we do not think that CESR's definition should be adopted for the purpose of future EU regulation of CRAs. Any proposed definition of CRAs in the context of further regulation of CRAs would need to take account of the following.

First, it would need reconciling with the broader definition of CRAs in the IOSCO

[1] 1 The Bond Market Association is an international trade association representing investment firms and banks that underwrite, trade and distribute fixed income securities and other financial products globally. TBMA's CRA Working Group consists of European and global heads of Rating Advisory Services functions at investment firms which, between them, cover a significant proportion of new issues of rated debt in the European market. More information about the BMA and its members and activities is available on its website www.bondmarkets.com.

Code of Conduct Fundamentals for Credit Rating Agencies ("IOSCO Code"), which omits the word "primary" from its definition of CRAs. This, however, would raise the concern that investment firms'/banks' research departments may be covered by the broader definition.

Second, it is arguable that the proposed definition can be read to only apply to entities with legal personalities. One would need to ensure that it also captures divisions of larger firms, such as, for example, Standard & Poor's, Rating Services, a division of The McGraw Hill Companies. Otherwise there is a risk that the definition applies to the larger legal entity, whose main business is not the issuance of credit ratings.

Q2. Do you agree with the definition of credit ratings? If not, please state your reasons.

We agree with CESR's proposal to follow the IOSCO Code definition. As such, CESR's definition should read: "an opinion regarding the creditworthiness etc." It is also important to make it clear that credit ratings are not recommendations.

Q3. Do you agree with the definition of unsolicited ratings? If not, please state your reasons.

We support CESR's attempt at bringing more clarity to the market in this area. This is a critical issue for CRAs, issuers and investors alike.

We fear however that CESR's definition, namely that unsolicited ratings are credit ratings produced by a CRA on its own initiative, does not achieve the desired outcome and could, in some instances, be misleading to investors.

We do not think that initiative alone is an appropriate benchmark. One reason is that it may be difficult to prove; another is that it may not matter. Who first picks-up the phone is not necessarily relevant. The CRA may have done, but if the issuer then wishes to participate, the resulting rating should not appear as unsolicited. Conversely, if the issuer approaches a CRA and then decides to stop the process or use another CRA, it would be inappropriate for the CRA first approached to be allowed to publish a rating as solicited.

This issue arises because of the lack of market clarity regarding the nature and extent of issuer participation in both "solicited" and "unsolicited" ratings. The market generally views unsolicited ratings as solely based on publicly available information, and therefore "weaker" than solicited ratings. However, the market also knows, as CESR rightly points out, that unsolicited ratings do not equate automatically to ratings produced without co-operation from the issuer. Conversely, the market recognises that solicited ratings do not necessarily mean ratings produced with full issuer participation.

We would therefore suggest that CESR does not attempt to define unsolicited ratings. CESR should instead advise the Commission that CRAs to be more transparent in (1) publishing their policies on unsolicited ratings, and (2) defining the nature and contents of each unsolicited rating, having regards, in particular, to the degree of issuer participation based on factors such as (i) the willing provision of information (which may include confidential information) by the issuer to the CRA, (ii) regular issuer management involvement, and (iii) ongoing dialogue between the issuer and the CRA.

This is an area where the IOSCO Code provides great opportunities for increased competition in the way CRAs may implement its provision on unsolicited ratings.

Q4. Do you think that issuers should disclose rating triggers included in private financial contracts?

We believe that issuers should disclose material rating triggers and that this is becoming increasingly the practice as a result of the Prospectus Directive.

Q5. Do you think that the use of ratings in European legislation should be encouraged beyond the proposed framework for capital requirements for banks and investment firms? If yes, please provide examples.

We do not think that this is needed. We agree with CESR that this would require a case by case approach and compelling cost/benefit analysis.

II. COMPETITIVE DIMENSION: REGISTRATION AND BARRIERS TO ENTRY

Q1. Do you think there is a sufficiently level playing field between CRAs or do you think that any natural barriers exist in the market for credit ratings that need to be addressed?
Q2. Do you believe that coverage of certain market segments or certain categories of economic entity (such as SMEs) may be sub optimal? Are there measures that regulators could use to affect this scenario? Which are they, and would it be appropriate to use them?

We recognise that the business of providing credit ratings has historically been a difficult one for new entrants to penetrate because of the market's tendency to seek ratings from firms with a proven track record and global reach. Importantly, we do not believe that this has caused a market failure or that it is preventing debt capital markets from operating efficiently.

Barriers to entry in the CRA industry are natural rather than the result of any anticompetitive behaviour from the more established CRAs. We note that size and experience, resource levels, unwelcome practices from competitors, start-up and other costs, consolidation and specialisation are day-to-day challenges that all businesses face.

We do not believe that the difficulties that new entrants encounter in increasing market share are likely to be reduced as a result of regulatory intervention. On the contrary, we would submit that the introduction of new registration procedures or regulation for CRAs would most likely increase barriers to new entrants and would duplicate envisaged requirements under Basel II. On the other hand, the quality and reliability of ratings could be damaged if registration thresholds were lowered to ensure recognition of some small CRAs that have no track record or weak processes. Finally, further regulation of the ratings sector is likely to have a disproportionate compliance impact on smaller players as compared to larger, established CRAs.

We also believe that the argument that obtaining registered status would help a CRA gain market credibility is flawed. In a reputations-based industry, such as the ratings industry, the market is the real judge of credibility.

We think that it is important, in this debate, to bear in mind both the immature state and specific features of the European bond market in which CRAs operate, as highlighted in a recent European Central Bank Study.[2]

The introduction of the Euro has shifted investors' focus from currency risk to credit risk. This has increased the role of CRAs; however the European market for ratings remains under-developed (compared to the US). Moody's recently estimated that there are 1,500 unrated European institutions with annual revenues of at least Euro 1 billion. Therefore, we believe there are significant opportunities for CRAs of all types and sizes to develop.

In addition, the European market still relies heavily on bank intermediation financing, which can be monitored without recourse to CRAs. Further, European corporations still place enormous importance on relationship banking, thereby reducing the need for independent credit assessment. Finally, companies in Europe still very much rely on "domestic name recognition" for raising funds locally without being rated. We believe, therefore, that these characteristics of the European financial market explain to a large extent the relatively low level penetration of SMEs in the European ratings market.

However, growing disintermediation and the related development of the European bond market offer real opportunities for increased competition between CRAs and further market penetration by small CRAs in the context of greater overall ratings coverage. These opportunities are further enhanced by the flexibility that IOSCO offers in the way CRAs might implement the provisions of its Code. Additional regulation raises a significant risk of these opportunities being lost and of negatively impacting the growth of a still developing European bond market.

III. RULES OF CONDUCT DIMENSION

Interests and conflicts of interest

Q1. To what extent do you agree that in order to adequately address the risk that any conflicts of interest might adversely affect the credit rating it is sufficient to have the CRA (i) introduce and disclose policies and procedures for management and disclosure of conflicts of interests, and (ii) disclose whether the said policies and procedures have been applied in each credit rating?

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[2] The Euro Bond Market Study, December 2004, available at http://www.ecb.int/pub/pdf/other/eurobondmarketstudy2004en.pdf

We agree with CESR that user and issuer confidence in credit ratings is vital for the smooth functioning of securities markets and that to enhance market confidence CRAs must issue independent, objective and high quality credit ratings and must be perceived to do so. We recognise that potential conflicts of interest may exist between CRAs, the issuers they rate and the users of ratings. However, as CESR points out, the mere existence of conflicts of interest does not automatically imply a market failure. As a result, it is appropriate to require that a CRA have policies and procedures to address

We agree with CESR that user and issuer confidence in credit ratings is vital for the smooth functioning of securities markets and that to enhance market confidence CRAs must issue independent, objective and high quality credit ratings and must be perceived to do so. We recognise that potential conflicts of interest may exist between CRAs, the issuers they rate and the users of ratings. However, as CESR points out, the mere existence of conflicts of interest does not automatically imply a market failure. As a result, it is appropriate to require that a CRA have policies and procedures to address potential conflicts of interest, including potential issuer and subscriber influence.

We believe that the IOSCO Code Provision 2.6, in requesting that CRAs adopt and disclose internal procedures and policies to deal with the identification, elimination, management and disclosure of any actual or potential conflicts of interest that may influence the CRA, will, if properly implemented, adequately address the risks of such conflicts of interest arising.

It is unnecessarily cumbersome to require CRAs to disclose that the policies and procedures have been observed for each rating; however, each rating opinion should contain an internet hyperlink, displayed prominently, to the policies and procedures in question so they can be accessed by users of rating.

Ancillary services

Q2. Do you consider that to adequately address the risk that the provision of ancillary services might influence the credit ratings process it is necessary to prohibit a CRA from carrying out those services? If your answer is yes, how would you address the entry barriers that could be created by imposing such a ban?

Q3. Do you think that structured finance ratings give raise to specific conflicts of interest that should be addressed in CESR's advice to the Commission?

Q4. To what extent do you agree that in order to adequately address the risk that the provision of ancillary services might influence the credit ratings process it is sufficient to have the credit rating agency (i) introduce and disclose policies and measures managing and disclosing multiple business relationships with issuers in general and the issuer being rated in particular, and (ii) disclose whether the said policies and procedures have been applied in each credit rating?

We first address Q2 and Q4.

It is essential to understand that two of the services categorised by CESR as ancillary services are in fact core ratings services that are central to the proper functioning and reliability of a CRA's ratings business. These two core services are (i) research services, and (ii) rating assessment (or evaluation) services ("RAS/RES").

(i) Research Services

It is critical that CRA research be understood as a core ratings service. Most of the research provided by CRAs is of an explanatory nature regarding a particular rated company, issue or sector. It is an indispensable by-product of the rating that provides issuers and investors with the background and rationale for a rating decision and is provided free of additional charge to existing subscribers.

As a result, there is no opportunity for conflicts of interest to arise in this situation and it is important for the quality of the rating that the rating analyst should also be involved in the research. We urge CESR not to approach the provision of research by CRAs in the way that MAD approaches the provision of research recommendations by investment firms. Once again, ratings are opinions, not recommendations. Related research that further supports ratings does not turn them into recommendations.

(ii) RAS/RES

CRAs provide RAS/RES services to issuers, which involve providing a specific opinion to an issuer on the rating impact of one or more theoretical scenarios backed by a formal committee-based process. We consider this service to be an integral part of a CRA's ratings business, and we do not believe that rating analysts should be prohibited from both participating in RAS/RES activities and performing work on a rating for the same issuer. Nor do we believe it appropriate to ban the provision of this type of service simply because of the potential conflicts that arise. The analysis involved in the two activities is the same and having a single analyst performing the work for both results in a higher quality of service to issuers and of ratings generally. Further, we do not believe that performing one activity affects the judgment of an analyst in performing the other. We believe, however, that analysts should be prohibited from soliciting RAS/RES work from issuers, since such involvement might exert subtle pressure on issuers to purchase RAS/RES services. Similarly, issuers being solicited for RAS/RES work should be informed that refusal of the service will in no way be disclosed to the rating team and will have no effect on a rating. These aspects should be reflected in CRAs' codes of conduct.

With regard to other services, which might more accurately be categorised as "ancillary" services, we would strongly oppose bans or other regulatory restrictions on the provision of such services by CRAs as the answer to conflict resolution. Firstly, because it would create additional barriers to entry for smaller CRAs and new entrants who may need to rely significantly on the revenues from such services. Secondly, because if properly managed, potential conflicts of interest arising from the provision of ancillary services by a CRA to an issuer should not prevent the CRA from delivering and being seen to deliver independent, objective and high quality credit ratings in which users have confidence. We believe that the

IOSCO Code Section 2, in requiring CRAs to (i) separate their ratings and ancillary businesses, (ii) have conflict of interest policies in place even in respect of ancillary services that do not necessarily present a conflict, and (iii) disclose such policies as well as actual and potential conflicts in a "timely, complete, clear, concise, specific and prominent" manner, provides ample adequate safeguards.

It is unnecessarily cumbersome to have CRAs disclose that the policies and procedures have been observed for each rating; it is sufficient that each rating opinion contains an internet hyperlink to the policies and procedures in question that users can access.

Regarding **Q2**, CESR is correct in stating that CRAs providing input on structured finance ratings play a more active role than in corporate ratings and that the sponsor has (generally) greater flexibility to adapt the features of the transaction in order to achieve the desirable outcome; however, we do not believe that structured finance ratings raise additional conflicts of interest concerns. Rather, we believe that this reflects how these markets differ from corporate ratings because of their more complex aspects and the fact that the rating focuses not so much on the creditworthiness of the issuer but instead on the quality of the underlying assets and on the robustness (in terms of insolvency remoteness of the rated entity) of the transaction structure. As such, it is inevitable that CRAs play a more active role as they need to ensure that they fully understand and adequately rate the proposed structures. It is essential to the production of good ratings in this area that the banks' structuring desks and legal departments have a full and close dialogue with CRAs.

Because of the greater complexities, the main issues with structured finance ratings are the transparency of CRA methodologies and the consistent application of such within the same CRA[3] we therefore welcome the latest addition to IOSCO Code Provision 1.3, now requiring that analysts apply a CRA's methodologies in a consistent manner.

Payments by issuers

Q5. To what extent do you agree that in order to adequately address the risk that an issuer paying for a credit rating might influence its rating it is sufficient to have the CRA (i) introduce policies and procedures, including but not limited to the introduction of a fee scheme, (ii) disclose its fee scheme and (iii) disclose whether the fee scheme has been applied in each credit rating?

We find CESR's reduction of the potential for conflicts to diverging interests between CRAs (profit making) and issuers (obtaining the best rating) somewhat simplistic. We would argue that CRAs' and issuers' interests strongly converge towards the production of independent and accurate ratings that are stable over time and that this by far outweighs the above. Further, the fact that CRAs have a strong reputational incentive to produce accurate and independent ratings for the investor community acts as an effective counterbalance to

[3] For more details see BMA's response to CESR's call for evidence on Possible Measures Concerning Credit Rating Agencies, available on CESR's website at http://www.cesr-eu.org/.

concerns about possible CRA and issuer collusion.

We believe that the IOSCO Code, in particular Provisions 2.3 (a credit rating should be influenced only by factors relevant to the credit assessment) and 2.8 (requiring disclosure of a CRA compensation arrangement with rated issuers), provide adequate checks and balances to ensure that any perceived risk of issuer influence is properly managed.

We do not think it appropriate to require CRAs to disclose that such scheme has been applied for each rating. Many transactions of the same type will have their own intricacies and specificities, requiring more or less analyst involvement; CRAs, issuers and their advisers need to be able to discuss the most appropriate fee in each case, within the parameters set by the scheme.

Unsolicited credit ratings

Q6. In order to deal with issues related to unsolicited ratings, to what extent do you agree that it is sufficient to have the CRA (i) introduce and disclose policies and measures with regard to issuing unsolicited credit ratings and (ii) disclose when a particular rating has been unsolicited?

Please see our response to Q3 on page 2. We believe that our approach would go a long way towards addressing the issues related to unsolicited ratings and that it should be adopted by CRAs in their implementation of the IOSCO Code. In particular, a CRA should explicitly prohibit its analysts from attending marketing meetings with an issuer that may follow from the issue by such CRA of an unsolicited rating on such issuer where the purpose of the meeting is to discuss possible conversion of the unsolicited rating to a solicited rating, as this may involve discussion of CRA fees.

Capital or other interest links

Q7. To what extent do you agree that in order to adequately address the risk that any financial or other link between a CRA and an issuer might influence the credit ratings process it is sufficient to have the CRA (i) introduce policies and measures managing and disclosing financial links or other interests between a CRA and issuers or its affiliates or investments in general and the issuer or its affiliates or investments being rated in particular, (ii) disclose the said policies and procedures and (iii) disclose whether the said policies and procedures have been applied in each credit rating?

We believe that the IOSCO Code addresses the key situations where the market would expect conflicts to be disclosed and we note that some CRAs, in their own codes, are already going beyond IOSCO's requirements in certain respects. This is another area where the IOSCO Code, having laid strong foundations, can allow competition between CRAs to develop and let the CRAs themselves, conscious of their reputation, set the highest standards for the benefit of the entire market place.

It is unnecessarily cumbersome to require the CRA to disclose that the policies and procedures have been observed for each rating; however, each rating opinion should contain an internet hyperlink, displayed prominently, to such policies and procedures in question that users can access.

<u>Fair Presentation</u>

Levels of skills of CRA's staff

Q1. To what extent do you agree that in order to adequately address the risk that lack of sufficient or inappropriate skills might lead to poor quality credit ratings it is sufficient to have the CRA (i) introduce policies and measures managing and disclosing levels of skills of staff, (ii) disclose the said policies and measures and (iii) disclose whether the said policies and measures have been applied in each credit rating?

We agree with CESR that CRAs should devote and be seen to devote the necessary resources to provide for adequately skilled staff and ensure that all staff involved is and remains qualified to do so in terms of training, expertise and experience. Provisions 1.4 and 1.7 of the IOSCO Code require CRAs to have and disclose policies to that effect. We believe these provisions to be sufficient to address the risk highlighted by CESR. Any further requirement may interfere with CRAs' internal Human Resources management.

We do not believe it is useful for CRAs to disclose the skills of their staff for each rating. We are concerned that this would allow the rated company to challenge a rating based on the qualifications of a single analyst. It is important to remember (which is a requirement of IOSCO Code Provision 1.4) that the ratings process at a CRA is a collaborative one. Thus, a final rating is not the product of a single analyst, but of a committee.

As with any company, a CRA franchise and reputation is a function of the quality of its personnel. CRAs therefore have strong commercial incentives to ensure that specific qualifications are met as they relate to staff skills.

Q2. Do you have any alternative approaches to address the actual or potential risk that lack of sufficient or inappropriate skills might lead to poor quality credit rating assessments?

CRAs should undertake and publish studies on rating default and trends in a more systematic and more user-friendly manner.

Methodologies used for building credit ratings

Q3. Do you think that undisclosed methodologies could lead to biased credit ratings or to biased interpretation of credit ratings?

In theory, yes. However, see our response to Q5 below.

Q4. Do you see more advantages or disadvantages in the regulation of CRAs methodologies by securities regulators? Please describe the advantages and disadvantages that you consider and which is the best way of dealing with them. Do you believe that this regulation would contribute in some ways to lead to common global standards for CRAs?

A CRA should have written methodologies that are rigorous, systematic, adequately disclosed and consistently applied. However, a CRA should also be able to elaborate appropriately on the application of and or deviations from such methodologies as it relates to individual ratings.

We see no benefit whatsoever for the issuer or investor community in regulators regulating CRA methodologies.

First, methodologies alone do not drive credit ratings, they are applied to each particular transaction. They are then subjected to the collective analysis by the CRAs. This is where judgment comes into play and why credit ratings are opinions. Second, there are a variety of subjective factors about the management of an issuer that are crucial to the rating process. Such factors are not conducive to quantification by a regulator. Third, users of ratings benefit from seeing differing analyses of the same issuer, which might be less likely to occur if the regulators have mandated a particular methodology. Fourth, in the fixed income area, there is a substantial amount of innovation in terms of new products and variations on existing products. If a CRA could not rate a new product until a regulator approved a rating methodology for the product, it might add a substantial amount of time to the rating process, and windows of opportunity created by a particular interest rate environment might be lost. Finally, as CESR points out, regulation could give the market the wrong impression that regulators are able in some ways to guarantee a certain level of quality of rating, which could in effect make regulators accountable for rating outcomes.

We believe that common global standards have already been set by the international regulatory community through the IOSCO Code and that this provides the best way to ensure that global standards are achieved in a flexible and competitive manner.

Q5. Do you believe provisions of the IOSCO Code are sufficient, in terms of rules on CRAs' methodologies and the corresponding disclosure? Do you believe that CRAs should disclose to issuers changes in methodologies before starting to use new methodologies?

We support the ten IOSCO Code Provisions that deal with or refer to CRA methodologies and believe them to be sufficient, in particular Provisions 1.2 (CRA rating methodologies should be rigorous and systematic and ratings should be subjected to validation based on historical experience), 1.3 (analysts should use methodologies established by a CRA in a consistent manner), 1.4 (ratings should reflect all public and non-public information known and believed to be relevant to the CRA), 3.5 (a CRA should publish sufficient information about its procedure, methodologies and assumptions so that outside parties can understand how a rating was arrived at), and 3.10 (CRAs should fully and publicly disclose material modifications to their methodologies prior to them going into effect).

Regarding the latter, we believe that both issuers and investors would benefit from advance notice of changes to methodologies and of the timetable for implementation of such changes. This is an area, however, in which flexibility is required. Pre-disclosure is critical to issuers and their advisors who need to know in advance the methodologies that will be applied to the issuer's creditworthiness and/or debt securities. This is especially important because securities may need to be sold quickly to take advantage of short market windows, or because a change in methodology may alter ratings or delay transactions, thus impacting on the issuer's ability to fund itself. However, it is also essential for the protection of investors and the integrity of the rating process that CRAs may freely alter their views of the criteria to obtain a particular rating and the best methodology for assessing creditworthiness. Only then can they adapt to fast changing circumstances and product developments. CRAs should not therefore as a rule be prevented from effecting changes to their rating methodologies simply because they have not yet disclosed such changes to issuers and investors (provided that such changes are then applied consistently).

We believe IOSCO Code Provision 3.10 now achieves the desired compromise.

Q6. Do you believe that regulation should concern all aspects of CRAS' methodologies? How appropriate is the choice of explicitly regulating the four proposed issues (disclosure and explanation of the key elements and assumptions of a rating, indication of some forms of risk warning, rules on updating of ratings and the inclusion of some market indicators within a rating opinion)? Would you deal with these issues by self-regulation?

As per our response to Q4 above, we see no benefit in regulating all or, for this matter, part only, of CRAs' methodologies. It should be left to the CRAs to compete for the most appropriate, most attractive and most reliable methodologies, with the market as arbiter.

<u>Relationship between issuers and rating agencies</u>

Access to inside information by CRAs

Q1. Do you consider that the combination of the requirements of the Market Abuse Directive in this area and the requirements of the current version of the IOSCO Code adequately address the issue of access to inside information by CRAs?

Yes. We thank CESR for its helpful analysis. This no doubt contributed to the deletion of the old IOSCO Code Provision 3.11 which market participants had requested.

Q2. What is your view on requiring an issuer to itself disclose an imminent rating change where it has been advised of this by a CRA and where the rating announcement may itself amount to inside information in relation to the issuers' financial instruments? Q3. Do you consider that the requirements of the Market Abuse Directive in this area sufficiently address the risks that inside information might be disseminated, disclosed, or otherwise

misused?

Again, we thank CESR for its helpful analysis and, although outside its mandate, we consider that it is appropriate for CESR to focus not just on access to inside information held by an issuer, but also on inside information generated by a CRA given that a rating action may indeed amount to inside information.

This issue arises because CRAs usually give issuers an opportunity to correct any factual inaccuracies that have been relied on in determining the rating before the issuer agrees to make it publicly available. Although we believe that it is essential that issuers, their advisors and CRAs may preserve such practice, it is equally important to ensure that the risks of inadvertent dissemination, selective disclosure or other misuse of inside information are subject to adequate controls.

We believe that such controls exist within issuers and their advisors. Rating advisors typically work for regulated investment firms supervised by multiple regulators. Further, the way the current practice is structured severely limits the risks just highlighted. CRAs only give issuers a few hours to check imminent releases for factual incorrectness and /or removal of confidential information. This, together with the threat of market abuse under MAD, provides, in our opinion, for sufficient safeguards for the market. This would also explain why, to our knowledge, there have only been exceptional cases of inadvertent dissemination by issuers. These exceptional cases do not outweigh the overwhelming positives of ensuring that the market gets accurate information and, as CESR points out, there would be no or little incentive for a CRA to give an issuer advanced notice of a rating if the issuer was then going to itself publish it.

It is therefore our view that issuers should not be required to disclose imminent rating changes and that MAD sufficiently addresses the risks highlighted above. CRAs should make it clear in their codes that the sharing of rating reports with issuers or their advisors prior to publication is limited both in scope (to correct factual inaccuracies and remove any non-public information) and in time, although, in some instances, issuers and their advisors may identify reasonable grounds on which to challenge a ratings outcome (see Q8 below).

We do not believe that preventing the communication of any information to subscribers of CRA services that is not also made public will provide any additional meaningful safeguard. Our understanding is that CRAs do not provide information of a confidential or price sensitive nature selectively to subscribers.

Q4. Are there any other issues concerning access to inside information which CESR should consider from the perspective of establishing a level playing field between CRAs?

No. The combination of MAD, the Prospectus and Transparency of Obligations Directives and the International Financial Reporting Standards will generate additional available information to the marketplace as a whole. In addition, see our comments under Q11 below.

Q5. Are there any other issues concerning the Market Abuse Directive's provision concerning inside information that you consider to be of relevance to CRAs and their activities which need to be considered?

No.

Q6. Do you consider that it would be helpful to have a dedicated regime governing CRAs and their access to inside information?

No. We believe that existing EU legislation (and for that matter, US legislation as well) and the IOSCO Code Section 3(B) dedicated to the protection of confidential information provide sufficient tools to deal with issues relating to CRAs' access to inside information.

Other issues concerning the relationship between issuers and CRAs

Q7. Is this provision sufficient to ensure that issuers have an opportunity to discuss and understand the underlying basis for any rating decision? If not, what other measures do you consider should be introduced?

This question goes to the transparency of the rating process. We consider that IOSCO Code Provisions 3.5 (a CRA should publish sufficient information about its procedures, methodologies and assumptions so that outside parties can understand how a rating was arrived at), 3.6 (CRAs should explain in their press releases/ reports the key elements underlying their rating decision), 3.7 (Prior to issuing/revising a rating, CRAs should advise issuers of the critical information and principal considerations upon which a rating will be based and afford issuers the opportunity to clarify factual misperceptions), and 3.8 (CRAs should publish sufficient information about the historical default rates of CRA rating categories and whether the default rates of these categories have changed over time, so that interested parties can understand the historical performance of each category and if/how ratings categories have changed) provide significant practical steps to enhance rating users' understanding and benchmarking ability.

We believe that these written measures, now also supplemented by IOSCO Code Provisions 4.2, are indeed sufficient. The rest is down to further education efforts by CRAs. We believe that CRAs should organise periodic meetings with special interest groups (e.g., an issuer group, an investment banker group and an investor group) to discuss the needs and issues of these groups.

Q8. In addition to being able to discuss the basis for a rating, should an issuer have a "right of appeal" where they disagree with the CRA's opinion?

As mentioned above, in some instances issuers and their advisors may identify reasonable grounds on which to challenge a ratings outcome, at which time a formal appeal process may be launched at the request of the issuer. This would typically happen where new material information regarding the issuer becomes available. CRAs generally have internal guidelines related to such appeals, S&P's code of conduct contains specific provisions relating to appeals. We would welcome all CRAs to explicitly provide for and describe in their codes the appeal process that is afforded to issuers and their advisors to appeal rating decisions, it being understood that such process should carefully balance issuers' rights and CRAs independence.

Q9. Do you consider the provisions of the current draft IOSCO Code and the Market Abuse Directive to be sufficient to ensure that information published by CRAs is accurate?

In our view, the combination of (i) the importance for CRAs' to build or protect a credible franchise, (ii) IOSCO Code Provisions 1.1 to 1.8 (relating to the quality of the rating process), in particular Provision 1.6 (The CRA and its analysts should 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), (iii) the offence under MAD (relating to dissemination of false or misleading information), and (iv) the fact that issuers are under similar obligations under MAD, provide ample safeguards to ensure that the information published by CRAs is as accurate as it can be.

Q10. Given the lack of specificity in the current draft IOSCO Code to maintain internal records for any particular time period, do you think more specific measures would be appropriate, requiring for example all the information received by a CRA to be kept, along with records supporting its credit opinions, for a minimum of 5 years?

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

Q11. Do you consider that it would be appropriate to introduce measures requiring the establishment of a rating agency data room to ensure that all CRAs had access to the same information concerning a particular issuer?

We believe that it is entirely inappropriate for regulation to introduce measures to ensure a level playing field in terms of access to information for CRAs, irrespective of whether ratings are solicited or not. There should be no obligation on an issuer to provide information to CRAs that have not been appointed by such issuer. In addition, although, as a general principle, an issuer should give equal information access to all of its appointed CRAs, if an issuer decides it is not in its best interest to provide nonpublic information to a particular CRA, measures should be limited to requiring disclosure that the CRA's rating reports are based solely on publicly available information.

Measures should further ensure that the information provided is not false or misleading. Both such measures already exist by virtue of MAD and the IOSCO Code. No additional measures should be introduced that would have the effect of forcing issuers to speak with all (or all of their appointed) CRAs. As CESR points out it could also have the pernicious opposite effect of forcing the issuer to only speak to one.

Regulation should not intrude unnecessarily into economic, strategic or relationship decisions made by issuers.

IV. REGULATORY OPTIONS CONCERNING REGISTRATION AND RULES OF CONDUCT FOR CREDIT RATING AGENCIES

Q1. Could you assess the policy options concerning the need for regulation or other measures, with particular reference to the practical implications for competition in the rating market and for the quality of ratings and of information to the market? Q2. Could you please indicate your preferred option and highlight pros and cons that you see with regard to each policy option?

For the reasons set-out below, we believe that Option 6 is the only viable option.

A OUR STRONG PREFERENCE

Option 6: Monitoring the market developments

We strongly believe that enforcement of the IOSCO Code by the market offers the strongest, most cost-efficient and most immediate answer to current regulatory concerns. The market does and will react to a CRA losing or gaining credibility in the eyes of the investor community (as evidenced by Fitch's increasing market penetration). We disagree with CESR that this amounts to "do nothing" because it fails to recognise the work that has already been done by the regulators with Basel II and the publication of the IOSCO Code. The latter represents a significant development in terms of investor protection.

We also disagree with CESR that there would be an uncontrollable shift of power to the CRAs, away from investors and issuers. We believe that CRAs have done a very good job of predicting credit quality over time and they have made much progress improving their methodologies, rigor and transparency since the recent economic downturn as a result of market forces (i.e. investor demands). CRAs are responding to public scrutiny and media focus. In recent years, they have been responsive to the market through more active disclosure of changes in methodologies and publication or preparation of codes of conduct. CRAs should therefore be given the opportunity to respond more fully, in a positive and proactive manner, to the IOSCO Code. They have a strong economic and reputational incentive not only to strive to comply, but to be seen to be embracing the new framework constructed by IOSCO.

For this reason, we also disagree that the IOSCO Code could become toothless. Users and investors are engaged. They will observe how CRAs implement the IOSCO Code and will react to the way CRAs "comply or explain". We have recommended to CRAs some practical steps for putting the IOSCO framework on a concrete footing, e.g. regular reporting on various IOSCO requirements and setting-up forums for specific user groups and have made further practical suggestions in this letter. There is no substitute for market acceptance of the value and credibility of ratings from a certain CRA. This is not something that can be bestowed upon a CRA by regulation, registration, or arbitration. Market sanctions can be as effective as regulatory sanctions in a reputations-based industry.

We believe, therefore, that the only sensible and pragmatic next step is to allow CRAs the opportunity to implement the IOSCO Code, demonstrate compliance with it and adopt the recommendations suggested in this letter, rather than to rush into regulation or arbitration responses which will very likely adversely impact the quality and availability of ratings, without improving competition. There is no need in our view to create additional regulatory burdens in the area of credit ratings. It would be inconsistent with the current aim of the EU, which is to reduce the intervention of regulatory policy. It would also be inconsistent with the overwhelming market feedback received by CESR and IOSCO on this matter.

Any option other than Option 6 therefore only risks: (i) reducing competitive opportunities that the European market and the IOSCO Code offer; (ii) confusing the market with duplication or multiplication of EU regulatory systems; (iii) losing the international consistency and consensus offered by a self-regulatory approach towards implementation of the IOSCO Code; (iv) reducing the quality and availability of ratings because of the likely impact of regulation (or, for this matter, arbitration) on the analytical process; and (v) causing significant costs to the industry that would likely be borne by investors and issuers, all this for very unclear gains to users of ratings.

B) ALTERNATIVE OPTIONS?

Option 1: Registration/Regulation Regime (intrusive)

It is reassuring that CESR finds it difficult to list many pros in support of this option. Even the arguments in favour made by CESR seem weak. For example, advancing that this registration model could be useful for new or smaller agencies, because they would receive from it recognition of their expertise, very much depends on the registration criteria that are adopted. Under option 1, these are likely to be numerous and demanding, thereby preventing entry.

Regarding the cons, we agree with CESR that creating another regulatory system for CRAs in the EU, in addition to Basel II, could lead to duplication of the regulatory burden for CRAs and effectively increase barriers to entry, further preventing competition among CRAs. As to CESR's argument that intrusive regulation may give investors the impression of a sort of guarantee given by regulators of quality of ratings, we believe that investors should be entitled to expect near perfect reliability and quality of ratings to the extent that all aspects of a CRA's business are to be regulated in detail. This highlights the importance of determining the regulatory purpose of this option. Because of its negative impact on the analytical quality of CRA opinions (regulating an analytical process involving subjective opinions can only cause a detrimental impact on the quality and diversity of ratings information), the only sensible purpose of this option is that the CRAs' analytical processes lead to inaccurate or biased ratings. This in turn requires evidence of a systematic failure. As far as default studies go, these demonstrate a consistent and clear correlation between long-term corporate debt ratings and the probability of default. As far as Enron and Parmalat are concerned, these events involved fraud that CRAs cannot be expected to detect. Market participants accept that they cannot expect any CRA, or ratings systems, to act as a perfect evaluator of credit risk or quality because of the complexity of evaluating the various objective and subjective factors that affect creditworthiness and reflecting them in a single symbolic rating; CRAs should not and cannot be reasonably charged with uncovering and evaluating all possible undisclosed risks or liabilities that might affect credit quality, or with uncovering fraud or other misconduct by issuers. CRAs, like other market participants, must be able to rely on the integrity of the audit process to produce financial information that is accurate and complete. Although they may have access to certain information not contained in public disclosures of issuers, they lack the resources and expertise to conduct an independent audit of all the financial information produced by the issuers they rate and cannot be expected to police in any meaningful way the review conducted and decisions made by accounting professionals.

Also, intrusive regulation will inevitably have a detrimental impact on CRAs' ability to be responsive to market developments. This is particularly relevant to methodologies where regulation may prevent CRAs from quickly adjusting to market developments or innovation, which would, in turn, reduce the quality and availability of information. Finally, it is important to remember that there are many other compelling counterbalancing market-driven "checks" in place, for example: CRAs' own reputation (including default studies), investment firms' and banks' own research departments, other research providers, investors' and issuers' own risk management functions, and other available market information. Looking at research for a moment, it is important that certain lessons are learned from the detailed regulatory disclosure requirements in MAD which, as can already be seen, are causing less and less research to be published, in particular in the bond markets.

Option 2: Registration/Regulation Regime (light)

We acknowledge that there are more "pros" and less "cons" under this option than under Option 1. In concept, we believe that having 1 registration system for the whole EU market would require that process to be managed in a consistent manner across the EU (and also between the EU and the US).

Still, we would have the same concerns as those raised under Option 1 above. In addition, as CESR points out, it would require the modification of CESR's legal profile through EU legislation. The practicalities, time and politics involved in the process being likely to be significant, we do not see this as an immediate option.

The implementation details of Option 2 would need much greater clarification and a thorough cost/benefit analysis should be carried out before we can begin to consider it.

Option 3: Including the IOSCO Code within Basel II recognition procedure

Although we can see the attraction in this approach in terms of trying to promote a consistent European regulatory system for the use of credit ratings, we do not believe that this overly complicated multi-layered option is appropriate. Leaving aside the difficulty we have in working out how it would be practically implemented, we believe that it risks bringing two different regulatory purposes into one to the detriment of competition.

Again, we question what underlies the regulatory purpose of this option. It seems to us that, in the context of Basel II, regulation of ECAIs aims at ensuring safe risk management by banks of their capital reserves through, among other things, holdings of instruments that are rated following, understandably, a strict and demanding process designed to achieve that purpose and therefore focused more on aspects of CRA market experience, credibility, independence, international access and resources, less so on competition, conduct and issuer/CRA relationships; as such a large number of the criteria for eligibility of ECAIs will not be suited to smaller CRAs and new entrants and codes of conduct are of lesser relevance.

In addition, as CESR points out, following the Basel II infrastructure would leave it open to member states to implement IOSCO Code in different ways and the international consensus that the Code has achieved could be lost.

Further, as CESR also points out, Basel II will only cover those CRAs that want to be recognised for external ratings and it being not obvious that all CRAs will have an interest in becoming recognized in this respect, Basell II criteria are not necessarily much stronger than market-based enforcement.

Option 4: Third party's certification or enforcement of the IOSCO Code

We believe that a CRA, not a third party, is in the best position to certify compliance or indicate and explain areas of non-compliance with the IOSCO Code; CRAs should carry out this exercise and the market can assess the consequences. This approach is now embedded into the "comply or explain" IOSCO Code Provision 4.1 and supplemented by Provision 4.2 which requires CRAs to set-up internal compliance functions that may received concerns and complaints. CRAs will be motivated to regularly carefully review their operations by interest in preserving their franchise. Further, we do not think that CESR has given the cons of arbitration a fair assessment. The issue is not so much the difficulty in identifying a really independent third party, but rather, like option 1, that this option may lead to annihilate the subjective component of rating opinions.[4]

Option 5: Relying on rules covering only specific aspects of CRAs' activity

Although this option seems more attractive because of its stronger self-regulatory focus than any option other than Option 6, we are not clear, from CESR's explanation, how the self-regulatory aspects would interact with the Basel II requirements. We are also uncertain as to whether the "two ways" described by CESR are cumulative or exclusive.

As for Option 2, the details of the implementation of Option 5 would require much greater clarification and a thorough cost/benefit analysis should be carried out before we can

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[4] For further details see BMA's response to the Report of the Chairman's Task Force of the Technical Committee of the IOSCO regarding a *Code of Conduct Fundamentals for Credit Rating Agencies* available on IOSCO's website at http://www.iosco.org/pudocs/pdf/IOSCOPD177.pdf.

consider it more fully.

Q3. Do you think the IOSCO Code is conducive to reducing or increasing competition?

We believe that the IOSCO Code is conducive to increasing competition, so long as it remains enshrined in a self-regulatory environment and is not transformed into a set of regulatory requirements. Throughout this letter, we have highlighted several areas where the IOSCO Code provides all types of CRAs with the opportunity to gain competitive advantages in the way the implement the IOSCO Code, for the further benefit of users of ratings.

Q4. Are there any areas where any European rules of conduct should be extended beyond the IOSCO Code?
No.

CONCLUSION

The only plausible rationale for the adoption of any option other than Option 6 must be that the regulators have no confidence in the CRAs implementing the IOSCO Code or in the market policing implementation.

We do not believe that CESR necessarily lacks that confidence and recognise that CESR may be under some pressure to propose regulatory-based options. While we acknowledge that these pressures exist, we stress that any proposed regulatory oversight should achieve all of the following objectives:

It should give primary reliance to self-regulation within the parameters of the IOSCO Code

It should avoid a fragmented “market-by-market” approach which would be onerous and costly for the market as a whole.

It should be designed and applied in a coordinated fashion, both across the EU and with the U.S.

It should be principles-based.

We would like to thank CESR for their thorough review of the CRA topic. We remain at your disposal for any further assistance that CESR may wish to draw from our Working Group.

Yours faithfully,

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THE BOND MARKET ASSOCIATION

6 November, 2004

<u>Public Comment on *Code of Conduct Fundamentals for Credit Rating Agencies*</u>

The Bond Market Association (the "Association")[1] welcomes this opportunity to comment on the Report of the Chairmen's Task Force of the Technical Committee of the International Organisation of Securities Commissions ("IOSCO") regarding a *Code of Conduct Fundamentals for Credit Rating Agencies* (the "Code Fundamentals"). This letter has been prepared by the Association in coordination with its Credit Rating Agencies Working Group.

The Association has been and continues to be an active participant in the debate concerning Credit Rating Agencies ("CRAs")[2]. We support code of conduct based approaches to issues with CRAs and therefore commend IOSCO for its initiative to provide consistent guidance and set clear expectations for all participants in the market.

Our response is structured as follows: in Section I, we respond to the three questions posed in the Preamble to the Code Fundamentals; in Section II, we comment on some of the specific provisions of the Code Fundamentals.

<u>SECTION I – RESPONSE TO IOSCO'S THREE QUESTIONS</u>

1 How do the provisions of the code advance the goals of investor protection, fairness, efficiency and transparency in securities markets, and the reduction of systemic risk?

We believe that, in recommending that CRAs include, in their codes of conduct, provisions which flexibly meet the objectives of (i) ensuring the quality and integrity of the rating process, (ii) ensuring the independence of CRAs and the avoidance of conflicts of interest, and (iii) specifying the responsibilities of CRAs to the investing public and issuers, the Code Fundamentals, if implemented by CRAs, will go a long way towards advancing the goals of investor protection, fairness, efficiency and transparency and the reduction of any perceived systemic risk.

We applaud IOSCO for its statement that the Code Fundamentals is not intended to be rigid or formulistic, given our preference for a principles-based approach to the review of CRAs' activities. Flexibility will be required for CRAs (in particular new entrants and specialised CRAs) to be able to adjust the provisions to their own business models, in addition to complying with different legal and market circumstances.

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[1] The Bond Market Association is an international trade association representing approximately 200 securities firms and banks that underwrite, distribute and trade in fixed income securities internationally. More information about the BMA and its members and activities is available on its website www.bondmarkets.com.

[2] See BMA's response to CESR's call for evidence on Possible Measures Concerning Credit rating Agencies, available on CESR's website at http://www.cesr-eu.org/ (under "Consultations") and BMA's response to SEC's June 2003 Concept Paper on Rating Agencies and the Use of Credit Ratings, available on the SEC's website at http://www.sec.gov/rules/concept/s71203/bondmarket072803.htm

We therefore fully support IOSCO's proposed Code Fundamentals, subject to the comments and recommendations made in this letter.

2. Is it advisable to require that CRAs disclose to issuers beforehand changes to their rating methodologies and rating criteria and would such requirement enhance or undermine investor protection? (Code Fundamentals Provision 3.9)

We believe that both issuers and investors would benefit from advance notice of changes to rating methodologies and rating criteria, as well as the timetable for implementation of such changes. This is one area, however, in which flexibility is required.

Pre-disclosure is of great relevance to issuers and their advisors who need to know in advance the methodologies and criteria that will be applied to the issuer's creditworthiness and/or debt securities. This is especially important because securities may need to be sold quickly to take advantage of short market windows, or because a change in methodology or criteria may alter ratings or delay transactions, thus impacting on the issuer's ability to fund itself. Unannounced last minutes changes in rating requirements or criteria do happen and can therefore cause significant problems to issuers and their advisors. For example, this has been the case, over the last year or so, in the context of structured finance transactions.

However, it is also essential for the protection of investors and the integrity of the rating process that CRAs may freely alter their views of the criteria to obtain a particular rating and the best methodology for assessing creditworthiness. Only then can they adapt to fast changing circumstances and product developments. CRAs should not therefore as a rule be prevented from effecting changes to their rating methodologies and/or criteria simply because they have not yet disclosed such changes to issuers and investors.

We therefore recommend that the Code Fundamentals require, as a basic principle, that CRAs: (i) give issuers, their advisors and the public advanced notice of upcoming changes to rating methodologies and/or ratings criteria; (ii) inform the public, including affected issuers, of such changes at the same time, to ensure that the new methodologies or criteria are uniformly applied; and (iii) promptly implement such changes so as to reduce market uncertainty between notice and implementation.

However, in order to allow for the necessary flexibility, this basic principle should not apply (i) in exceptional circumstances where it is impossible or impractical to inform issuers and the public before the changes are implemented, or (ii) to changes to CRAs' "practices, procedures and processes" that are of an administrative, cosmetic or other trivial nature.

3. How should compliance with the Code be best enforced? Current proposals include direct regulatory oversight, an outside arbitration body (e.g. ICC) and market mechanisms.

This is a difficult question which our Working Group has spent a lot of time debating. We note with interest, and some sympathy, that IOSCO itself, in its introduction, is rather vague about what "enforcement" means. We are however concerned by the statement, on page 2, in the carryover paragraph, that "the elements contained in the CRA Code Fundamentals should . . . be backed by thorough compliance and enforcement mechanisms". This seems to imply that regulators could force CRAs to comply with their own policies in each instance, no matter what the circumstances, or that issuers or investors could legally enforce the statements in the Code Fundamentals against a CRA.

We start by emphasising that no "enforcement" mechanism should be used as a back-door way to interfere with, challenge or overturn a particular credit assessment.

We also repeat, as mentioned in paragraph 1 above (and as acknowledged by IOSCO itself in its Introduction paragraph), that flexibility will be required for CRAs to adjust the Provisions to their own business models and also to deal with different legal and market circumstances. It is important therefore that the requirements of the Code Fundamentals are not implemented by being turned into rigid word-for-word regulatory requirements.

We are concerned that an "enforcement" mechanism in which issuers or investors could bring direct legal actions (or arbitration proceedings) against a CRA would risk expending substantial market participants' time and costs in litigation/arbitration proceedings that ultimately involve dissatisfaction with a particular rating. We would therefore recommend an approach, based on market mechanisms, that motivates CRAs to protect the reputation on which their franchise relies.

3.1 Market Mechanisms

We believe that market mechanisms offer the strongest way to ensure appropriate adherence by CRAs with the Code Fundamentals. The market does and will react to a CRA losing or gaining credibility in the eyes of the investor community (as evidenced by Fitch's increasing market penetration).

In requiring CRAs to demonstrate how they comply with the Code Fundamentals, Provision 4.1 provides the market with an additional tool to assess a CRA's credibility. We believe, however, that for this provision to constitute a meaningful "comply or explain" mechanism, it should require CRAs to describe areas of non-compliance, rather than areas of compliance, and to periodically re-certify compliance or highlight non-compliance (see our further comments in Section II under Provision 4.1).

We would, in addition, recommend that the Code Fundamentals require CRAs to provide for (i) a grievance procedure where an individual user, who believes that a CRA is not adhering to its code or to the Code Fundamentals, can initiate direct discussions with the CRA in appropriate circumstances and be guaranteed speedy attention, and (ii) a procedure that provides for periodic meetings with special interest groups (e.g., an issuer group, and investment banker group and an investor group) to discuss the needs and issues of that group.

3.2 Arbitration

We believe that arbitration is an entirely inappropriate dispute resolution tool for the enforcement of CRA codes of conduct. The purpose of any arbitration court is to settle commercial disputes that are borne out of private contractual arrangements. Envisaging arbitration as an enforcement mechanism for compliance with codes of conduct suggests that such codes are legally binding on CRAs, or that there is an implied promise by CRAs that they are. This is not the nature of codes of conducts in any industry or profession. We do not believe that CRA codes should be legally binding instruments, but rather they should be seen as persuasive guiding principles that should be applied flexibly as circumstances warrant.

Even if CRA codes were viewed as being legally binding, we believe arbitration would be an inappropriate enforcement mechanism, since the cost of arbitration and the length of time it takes to complete an arbitration are prohibitive. Following ICC's procedures in its Rules of Arbitration, it can take up to four months for the Arbitral Tribunal to be set-up and "establish…a provisional timetable that it intends to follow for the conduct of the arbitration..." (Article 18.4). The Arbitral Tribunal must then render its final award with six months (Article 24). As to costs, these can reach, under ICC's Rules of Arbitration, up to half a million dollars in administrative and arbitrators' fees alone (recovery of which is unpredictable as the norm is for arbitrators to have complete discretion over the apportionment of costs between the parties), depending on the sum involved.

We believe the goal of "enforcement" of CRA codes should be to ensure compliance with the Code Fundamentals – not to exact monetary penalties for non-compliance. It would be difficult to quantify the value of the "sum involved", i.e. the value of future compliance.

We further believe that the purpose of any "enforcement" should be to ensure proper adherence by CRAs to best practice in arriving at a rating decision, not to introduce adversarial dispute resolution mechanisms (such as arbitration), that will inevitably lead to the overturning or second-guessing of opinions arrived at in good faith and according to proper procedures.

For these reasons, we are of the strong opinion that arbitration is a wholly inappropriate solution for the assessment of compliance with codes of conduct. We would, however, recommend that the Code Fundamentals require CRAs to explicitly provide for and describe, in their own codes, (i) the appeal process that is afforded to issuers and their advisors to appeal rating decisions, as well as (ii) the person, at the relevant CRA, to whom individual grievances for alleged non-compliance with that CRA code should be addressed.

3.3 Regulatory oversight

As mentioned in paragraph 1 above, we are strongly opposed to the Code Fundamentals being transposed into a detailed set of regulations. Detailed regulation of CRAs is, in our view, inappropriate for the following reasons:

- Impact on analytical quality: it would be hard to regulate an analytical process involving subjective opinions. This would have a detrimental impact on the quality and diversity of ratings information.

- No evidence of systematic failure: Enron and Parmalat involved fraud that CRAs cannot be expected to detect. Although individual "mistakes" will occur, studies show a strong correlation between ratings and the likelihood of default.

- Other compelling counter-balancing market-driven "checks" exist, for example: CRAs' own reputation (including default studies), other research providers, investors' and issuers' own risk management functions, and other available market information.

- Detrimental impact on CRAs' ability to react to market developments: regulation may prevent CRAs from quickly adjusting to market developments/innovation, which would, in turn, have the unintended consequence of reducing the quality and availability of information.

- Finally, regulation may act to further raise barriers to entry for the CRA industry.

Any regulatory oversight should only focus on ratings "processes" and not on ratings "outcomes".

We would support, and have suggestions for, a regulatory framework which would be set-up to determine, and supervise compliance with, broad eligibility criteria, and which would take account of compliance by CRAs with the Codes Fundamentals. However, this is not the subject-matter of IOSCO's present consultation.

Conclusion and recommendation

As we hope to have demonstrated, arbitration, by its very nature, is a wholly inappropriate way of attempting to provide a mechanism for monitoring and sanctioning CRAs' compliance with the Code Fundamentals.

As we also hope to have demonstrated, turning the Provisions of the Code Fundamentals into a detailed set of regulatory requirements in order to ensure maximum compliance is entirely inappropriate too.

We believe that the strongest way to ensure adherence to the Code Fundamentals in a manner that meets all of the goals listed in IOSCO's first question, is through self-regulatory measures and market forces. This can be achieved by requiring CRAs to:

(i) certify and periodically re-certify compliance with the Code Fundamentals (or explain non-compliance);
(ii) provide clear procedures where users of ratings can, individually and collectively, raise and address concerns about non-adherence by CRAs to the Code Fundamentals; and
(iii) provide for a transparent process where issuers and their advisers can appeal rating decisions in appropriate circumstances.

We believe, therefore, that the more useful and pragmatic next step is to allow CRAs the opportunity to implement the Code Fundamentals, demonstrate compliance with it and establish the procedures suggested above, rather than to rush into regulation or arbitration responses which will very likely impact on the quality and availability of ratings.

SECTION II – PROVISION BY PROVISION COMMENTARY

The Code Fundamentals Provisions on which we have comments are repeated below in *italics*.

1. QUALITY AND INTEGRITY OF THE RATING PROCESS

A. Quality of the Rating Process

1.1 The CRA should adopt, implement and enforce written procedures and methodologies to ensure that the opinions it disseminates are based on a thorough analysis of all relevant information available to the CRA.

The words "…based on a thorough analysis of all relevant information" may suggest a more scientific approach than rating opinions can be. There are a lot of subjective decisions that go into a rating. In addition, ratings include the CRAs' assessment of what may happen in the future, and not only the objective facts from the past.

We question therefore whether the Provision as drafted could be used by users to challenge ratings retrospectively, on the basis of a subjective assertion that the opinion was not "based on a thorough analysis of all relevant information available to the CRA."

1.3 In assessing an issuer's creditworthiness, analysts involved in the preparation or review of any rating action should use methodologies established by the CRA.

In order to reduce the risk of different approaches being adopted on a particular issue within the same CRA, depending on the CRA analyst involved, it is important that such methodologies are also applied in a consistent manner.

B. Monitoring and Updating

1.9 Except for "point in time" ratings that clearly indicate they do not entail ongoing surveillance, once a rating is published, the CRA should monitor on an ongoing basis and update the rating by:

a. regularly reviewing the issuer's creditworthiness;

b. initiating a review of the status of the rating upon receipt of any information that might reasonably be expected to result in a rating action (including termination of a rating); and,

c. updating on a timely basis the rating, as appropriate, based on the results of such review.

Sub-paragraph (b): "receipt" seems to imply that the onus is always on issuers to provide information before rating status reviews may be initiated by CRAs. Such reviews should be expected from CRAs on the basis of publicly available information that might impact on a rating. We believe therefore that "receipt" should be replaced with, or mentioned alongside, "becoming aware".

In addition, we believe that ongoing surveillance should include the publication by CRAs of research reports of sufficient quality on a timely basis and the periodic (at least annual) publication of status updates on all rating names.

1.10 Where a CRA makes its ratings available to the public, the CRA should publicly announce if it discontinues rating an issuer or obligation. Continuing publications by the CRA of the discontinued rating should indicate the date the rating was last updated and the fact that the rating is no longer being updated. Where a CRA's ratings are provided only to its subscribers, the CRA should announce to its subscribers if it discontinues rating an issuer or obligation. Continuing publications by the CRA of the discontinued rating should indicate the date the rating was last updated and the fact that the rating is no longer being updated.

When making the announcement to discontinue a rating or continuing publication of the discontinued rating, a CRA should also provide a link (via its website or otherwise) to where the rating history may be accessed free of charge.

C. Integrity of the Rating Process

1.13 The CRA's analysts should be held to high standards of integrity, and the CRA will not employ individuals with demonstrably compromised integrity.

We note that the Code Fundamentals uses "should" throughout, but states here that the CRA "will" not employ individuals with demonstrably compromised integrity. It is unclear what "demonstrably" means. Does it require evidence of criminal activity?

1.14 The CRA and its employees should not, either implicitly or explicitly, give issuers any assurance or guarantee of a particular rating prior to a rating assessment.

CRAs should also clarify to potential issuers that CRAs' marketers have no input into the rating decision.

THE BOND MARKET ASSOCIATION

1.16 Upon becoming aware that another employee or entity associated with the CRA is or has engaged in conduct that is illegal, unethical or contrary to the CRA's code of conduct, a CRA employee should report such information immediately to the individual in charge of compliance or an officer of the CRA, as appropriate, so proper action may be taken. Its employees are not necessarily expected to be experts in the law. Nonetheless, its employees are expected to report the activities that a reasonable person would question. Any CRA officer who receives such a report from a CRA employee is obligated to take appropriate action, as determined by the laws and regulations of the jurisdiction and the rules and guidelines set forth by the CRA.

It should also be made clear that the CRA should protect whistle-blowers from retaliation, and that the penalty for failure to report questionable conduct is termination of employment and not personal liability to third parties.

2. CRA INDEPENDENCE AND AVOIDANCE OF CONFLICTS OF INTEREST

A. General

2.3 The CRA should not forbear or refrain from taking a rating action based on the potential effect (economic, political, or otherwise) of the action on the CRA, an issuer, an investor, or other market participant.

We support this Provision; however we think that it would be sensible to add a proviso that the CRA needs to be reasonably certain of the reliability of the information on which the action is based.

2.5 *The CRA should separate its credit rating business and CRA analysts from any other businesses of the CRA, including consulting businesses, that may present a conflict of interest.*

CRAs provide a service to issuers known as a Rating Advisory (or Evaluation) Service ("RAS"or "RES"), which involves advising an issuer on the rating impact of one or more theoretical scenarios backed by a formal committee-based process. We believe that CRAs consider this service to be an integral part of their ratings business (and not "consulting business"), and we do not believe that rating analysts should be prohibited from both participating in RAS/RES activities and performing work on a rating for the same issuer. The analysis involved in the two activities is the same, and having a single analyst performing the work for both is cost effective and results in a higher quality of service to issuers and of ratings generally. Furthermore, we do not believe that performing one activity affects the judgment of an analyst in performing the other. We believe, however, that analysts should be prohibited from soliciting RAS/RES work from issuers or from knowing which issuers have been solicited for RAS/RES work, since such involvement or knowledge might exert subtle pressure on issuers to purchase RAS/RES services.

Similarly, issuers being solicited for RAS/RES work should be informed that refusal of the service will in no way be disclosed to the rating team and will have no effect on a rating.

B. CRA Procedures and Policies

2.6 The CRA should adopt written internal procedures and mechanisms to (1) identify, and (2) eliminate, or manage and disclose, as appropriate, any actual or potential conflicts of interest that may influence the opinions and analyses CRAs make or the judgment and analyses of the individuals the CRAs employ who have an influence on ratings decisions. The CRA's code of conduct should also state that the CRA will disclose such conflict avoidance and management measures.

CRA codes should also clarify how this disclosure is to be made, or clarify that the CRA may determine how it will be made, e.g. on the CRA's website and not necessarily on the rating report.

2.7 The CRA's disclosures of actual and potential conflicts of interest should be complete, timely, clear, concise, specific and prominent.

As above

C. CRA Analyst and Employee Independence

2.12 The CRA should not have analysts initiate, or participate in, discussions regarding fees or payments with any entity they rate

"Analysts" may not be broad enough to capture all CRA conflicted personnel susceptible of becoming involved in fees discussions. We would suggest therefore that the prohibition applies to any CRA personnel involved in the analytical process.

2.13 No CRA employee should participate in or otherwise influence the determination of the CRA's rating of any particular entity or obligation if the employee:

a. Owns securities or derivatives of the rated entity or any related entity thereof;

b. Has had an employment or other significant business relationship with the rated entity within the previous six months;

c. Has an immediate relation (i.e., spouse, partner, parent, child, sibling) who currently works for the rated entity; or

d. Has, or had, any other relationship with the rated entity or any agent of the rated entity that may be perceived as presenting a conflict of interest.

We note that the concept of "related entity" may be difficult to establish in certain situations and that a negative rating action with respect to a related entity of the rated issuer may sometimes have very little effect on the issuer, depending on the definition of "related entity". We are also curious to know what the basis for the 6 months period in (b) is and why there is no time limit in (d). Finally, we are unsure about the practical meaning of "that may be perceived" in (d). We would suggest that there should be an objective test, i.e. that a reasonable person would believe could have an effect on the objectivity or independence of the rating.

2.14 The CRA's analysts and anyone involved in the rating process (or members of their immediate household) should not buy or sell or engage in any transaction in any security or derivative based on a security issued, guaranteed, or otherwise supported by any entity within such analyst's area of primary analytical responsibility, other than holdings in diversified mutual funds.

We believe that "any security or derivative" may be overly broad. In addition to the "holdings in diversified mutual funds" exemption, it would seem reasonable to exempt government and government agency securities of the country in which the analyst is a citizen or resides (at least if those securities are denominated in the currency of the issuer), even if the analyst rates those securities.

2.15 CRA employees should be prohibited from soliciting money, gifts or favors from anyone with whom the CRA does business and should be prohibited from accepting gifts offered in the form of cash or any gifts exceeding a minimal monetary value.

"Favors" seems rather intangible. The other issues not addressed here are entertainment and the treatment of conference/speaking engagement expenses. The Code Fundamentals should require CRAs to set-out in their codes what the CRAs' policies are in these areas and what procedures are in place to preserve the independence of analysts. If this is what is meant to be captured under "favors" then it would be best to set-out clearly what the intention is.

3. CRA Responsibilities to the Investing Public and Issuers

A. Transparency and Timeliness of Ratings Disclosure

3.2 The CRA should publicly disclose its policies for distributing ratings and reports.

This requirement should apply to the distribution of ratings and reports as well as updates thereof.

3.3 Except for "private ratings" provided only to the issuer, the CRA should disclose to the public, on a non-selective basis and free of charge, any rating regarding publicly issued securities, or public issuers themselves, as well as any subsequent decisions to discontinue such a rating, if the rating action is based in whole or in part on material non-public information.

It is important to clarify that issuers and CRAs may preserve their current practice of keeping a first time solicited rating confidential until the issuer has confirmed that it wishes to go public with the rating, regardless of whether or not the rating is based on material non-public information.

3.5 When issuing a rating, CRAs should explain in their press releases and reports the key elements underlying their rating decision.

The Code Fundamentals should require CRAs to provide this explanation for all rating issues and updates, and in respect of all rating actions of the CRAs.

3.7 *In order to promote transparency and to enable the market to best judge the performance of the ratings, the CRA, where possible, should publish sufficient information about the historical default rates of CRA rating categories and whether the default rates of these categories have changed over time, so that interested parties can understand the historical performance of each category and if and how ratings categories have changed, and be able to draw quality comparisons among ratings given by different CRAs. If the nature of the rating or other circumstances make a historical default rate inappropriate, statistically invalid, or otherwise likely to mislead the users of the rating, the CRA should explain this.*

We strongly support this provision. However, it should be clarified that CRAs need to retain ultimate editorial control over their reports/actions/analyses, retention of which (including the decision on whether to disseminate or not) is important to the actual and perceived independence of CRAs.

3.8 *The CRA should disclose when its ratings are not initiated at the request of the issuer and whether the issuer participated in the rating process.*

The CRA should make this disclosure on a continuous basis for so long as it continues to publish a rating, and prominently on all of its research and analysis reports as applicable.

The issue, however, is not so much in respect of the disclosure by CRAs of unsolicited ratings (they generally disclose this); it is rather in respect of the dissemination of such information by market data providers (e.g., Bloomberg, Reuters) who do not "carry" the information to the market. The Code Fundamentals should therefore also require CRAs to adopt, as is already the practice in certain sectors, subscript markers, or symbols, that are part of the rating itself and can be detected by the market as unsolicited ratings.

3.9 *Because users of credit ratings rely on an existing awareness of CRA practices, procedures and processes, the CRA should fully and publicly disclose modification of these practices, procedures and processes. The CRA should carefully consider the various uses of credit ratings before modifying its practices, procedures and processes.*

See our comments in Section I, paragraph 2, in response to IOSCO's second question.

B. The Treatment of Confidential Information

3.10 *The CRA should adopt procedures and mechanisms to protect the confidential nature of information shared with them by issuers under the terms of a confidentiality agreement or otherwise under a mutual understanding that the information is shared confidentially. Unless otherwise permitted by the confidentiality agreement or required by applicable laws or regulations, the CRA and its employees should not disclose confidential information in press releases, through research conferences, to future employers, or conversations with investors, other issuers, or other persons, or otherwise.*

We believe that not all CRAs enter into confidentiality agreements. The Code Fundamentals should encourage this practice more explicitly so as to avoid the uncertainties of arrangements based on a "mutual understanding".

3.11 *Where a CRA is made aware of non-public information of the kind required to be disclosed under applicable laws and regulations, depending on the jurisdiction, the CRA* *may be obligated to make this information available to the public. However, prior to doing so, the CRA should indicate to the issuer its intent to release this information and permit the issuer to immediately disclose this information itself. The timeframe a CRA should provide an issuer to make this disclosure should be limited.*

We wonder which "applicable laws and regulations" IOSCO think currently obligate CRAs to disclose non-public information "of the kind required to be disclosed" under such laws and regulations. In the US, the obligation to disclose falls on the issuer and anyone who possesses material non-public information and who proposes to trade on it. Similarly in the EU pursuant to the Market Abuse Directive ("MAD"). MAD allows an issuer to delay public disclosure of price sensitive information where disclosure would prejudice its legitimate interests, so long as the issuer can ensure the confidentiality of the information (Article 6(2)). MAD also allows an issuer to disclose such information privately to a third party, such as a CRA, where the recipient is under a duty of confidentiality, regardless of whether such duty is based on laws, regulations, articles of association or on contract (Article 6(3)). It is important to preserve the flow of information between issuers and CRAs and the ability of CRAs to use that information, including of a non-public nature, in achieving and maintaining fair and objective ratings. MAD does not prohibit the use of non-public information for that purpose.

We therefore recommend that this Provision be deleted from the Code Fundamentals.

3.16 CRA employees should not selectively disclose any non-public information about rating opinions or possible future rating actions of the CRA.

We highlight the importance of ensuring that CRAs remain able to allow issuers <u>and their advisors</u> a short period of time to review CRA documentation (in particular press releases) for factual accuracy and inadvertent disclosure of non-public information, before such documentation is made public.

4. Disclosure of the Code of Conduct

4.1 The CRA should disclose to the public its code of conduct and describe how the provisions of its code of conduct are consistent with the provisions of the IOSCO Principles Regarding the Activities of Credit Rating Agencies and the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies. The CRA should also describe generally how it intends to implement and enforce its code of conduct and disclose on a timely basis any changes to its code of conduct or how it is implemented and enforced.

It will be more convenient to the public if CRAs describe how their codes of conduct are inconsistent with the provisions of the Code Fundamentals than if they describe how their codes are consistent.

Further, this form of self-certification should be repeated periodically by CRAs, for example via a status report.

Yours faithfully,

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