# Final Report

Guidelines on the application of the endorsement regime under Article 4 (3) of the Credit Rating Agencies Regulation No 1060/2009

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European Securities and Markets Authority

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## I- Background

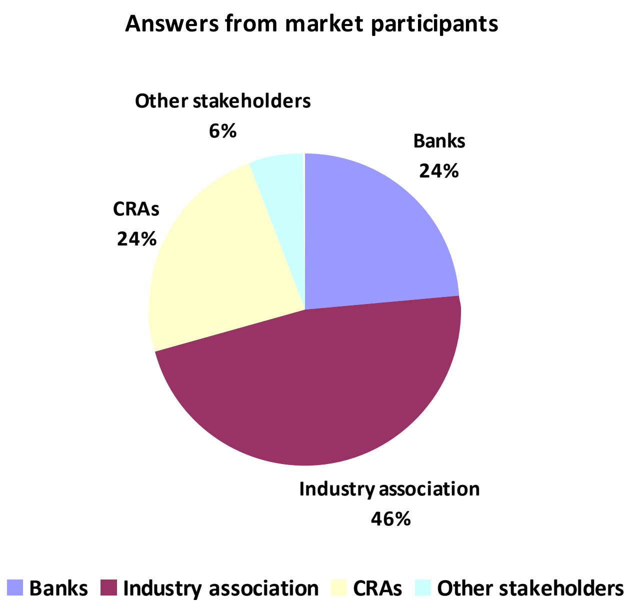
1. In June 2010 CESR published guidance on the registration process and related issues (CESR/Ref. 10-347), as required by Article 21 (2) of Regulation (EC) No 1060/2009. CESR's Guidance (the "CESR Guidance") also dealt with the endorsement regime allowing the distribution and the use for regulatory purposes in the Community of credit ratings issued in third countries.

2. Article 21 (3) of the revised Regulation on Credit Rating Agencies (CRAs) modifying EU Regulation 1060/2009 on CRA gave ESMA the power, in cooperation with EBA and EIOPA, to issue and update guidelines on the application of the endorsement regime under Article 4.(3) by 7 June 2011.

3. Accordingly, on 18 March 2011 ESMA released a Consultation Paper asking stakeholders to provide comments on these Guidelines

4. The consultation closed on 31 March 2011 and ESMA received 17 responses from a wide range of stakeholders including 4 CRAs, 4 banks, 8 industry associations and one advisory committee of a regulator. All responses received, with the exception of those treated as confidential, are available on the ESMA website at http://www.esma.europa.eu/index.php?page=responses&id=179.

5. The final version of the guidelines contained in Annex 1 will be translated into all European Union languages and will be available at a later stage on the ESMA website.




## II- Results of the consultation

6. Whilst respondents agreed that high quality of ratings would contribute to the efficiency of capital markets and therefore welcomed the overarching objective of improving transparency and competition, a majority of respondents expressed concerns about ESMA's legal interpretation of the application of the endorsement procedure. Respondents unequivocally called for ESMA to adopt a more flexible approach, recognising self-regulatory measures, for the application of the endorsement

regime, on the basis of conclusions inferred from their interpretation of Article 4 (3) of the Regulation.

7. Estimates of the likely impact on capital requirements provided by the banks indicate potentially significant effects after 7 June 2011, mostly derived from rated securitisation exposure originating in the US. Furthermore, respondents from the banking sector favoured an approach where the implementation of the endorsement standards was on a phased basis to avoid unnecessary market disruption after 7 June 2011.

8. ESMA reiterates its position already contained in its Guidance issued in June 2010 that the requirements set out in Article 4 (3) (b) – to be as stringent as those applicable in the EU- will have to be established by law or regulation in the third countries where the endorsed ratings are issued. With regard to market participants' concerns that markets will be disrupted post 7 June 2011, Article 40 third sub paragraph and Article 24 (2), the Regulation enables ESMA to mitigate and minimize undesirable disruption of the use of credit ratings (as described in paragraphs 35 to 37 of ESMA Guidance on endorsement which is enclosed in Annex I to this Report).

9. Set out below is a summary of the feedback ESMA received on its consultation proposals followed by its responses.

### *1. Issues*

#### *a) The assessment of requirements "at least as stringent as" those set out in Articles 6 to 12 of the Regulation*

10. A majority of respondents argued that the CRA Regulation does not state that endorsement should depend on the equivalence of the third country regime. Consequently, one respondent expressed concerns regarding ESMA's interpretation of Article 4 (3) considering it too stringent and maintaining that it would have the effect of increasing the regulatory burden.

11. Most respondents expressed the view that the endorsement procedure should take account of the extent to which the "conduct of credit rating activities" complied with EU requirements rather than by assessing the equivalence of the supervisory regime in the third countries concerned with EU requirements. In support of this view, some respondents cited that in contrast to Article 5 (6) regarding the equivalence decision, there is no reference to a non-EU regulatory regime in Article 4 (3) (b).

12. Supporting this view, one respondent made reference to the conclusion of ECON rapporteur Klinz that the "*Regulation devises two systems to deal with external credit ratings from third countries and that the intention behind the endorsement regime was to allow external credit ratings deemed non-equivalent to be used in the European Union if clear responsibilities was attached to an endorsing CRA*".

13. One respondent also argued that Recital 13 of the CRA Regulation provided for the situation where the endorsing CRA could assess and monitor on an on-going basis whether the credit rating activities resulting in the rating being issued complied with requirements as stringent as the Regulation. This provision supports the interpretation of Article 4 (3) (b) that it is the activities of the CRA and not the regulatory regime of the third country that should be assessed.

14. Several respondents expressed the view that the endorsing CRA is fully responsible for the endorsed ratings as set out in Article 4 (5) and Recital 18 of the Regulation. This would be in line with the interpretation that the Regulation permits a third country CRA to follow standards of conduct "as stringent as" through its own policies and procedures.

15. One respondent stated that under the endorsement regime the endorsing CRA is "fully and unconditionally responsible" (Recital 18) for endorsed ratings. EU competent authorities would be able to supervise the endorsing CRA and therefore effectively oversee compliance with the Regulation. This answer supports the view that Article 4(3) (b) should not be interpreted as requiring the third country regime to be equivalent, as is the case for the certification regime, if a third country CRA has no supervisory association with the EU other than through cooperation arrangements.

16. Agreeing with this view, some respondents argued that the endorsement process was meant to be a flexible mechanism allowing the use of ratings issued by the largest CRAs irrespective of the country where those ratings were issued or where the analyst was located. In this instance, a CRA seeking endorsement would only need to verify and demonstrate to ESMA that the conduct of the CRA established outside the EU which issues the relevant credit ratings is subject to voluntary rules that are as stringent as the requirements set out by law in the EU. The regulation in the country of incorporation, outside of the European Union, of the CRA which issues the ratings to be endorsed would only need to follow the EU regulatory requirements to the extent expressly provided for in Article 4 (3) (a) to (h).

17. In support of this view, another respondent stated that there was inconsistency in the way ratings of different CRAs at subsidiary level were derived. Ratings for different affiliates belonging to the same group should be treated in the same fashion.

18. Some respondents pointed out that ESMA's assumption that the rules applied in the EU should be adopted in other jurisdictions went significantly beyond the agreement reached in IOSCO. Furthermore, ESMA's interpretation disregarded the Basel III requirement that national supervisors determine ECAI eligibility taking into account compliance with the IOSCO Code of Conduct Fundamentals for CRAs.

19. One respondent pointed out that Recital 2 of the Regulation states that credit ratings issued by certain central banks are exempt from the Regulation provided they fulfil conditions which were as stringent as the requirements of the Regulation. Article 2 (2) provides an explanation of what this exemption means: "[ratings] are issued in accordance with the principles, standards and procedures which ensure the adequate integrity and independence of credit rating activities as provided for by this Regulation". This article refers to the nature of internal policies rather than to regulatory requirements. Therefore, the same interpretation should be allowed for CRAs.

20. There was however also some support for ESMA's interpretation. Respondents supporting ESMA's view essentially argued that ESMA's interpretation would improve the quality and standard of ratings and make them more meaningful, whilst reducing the risk of non-compliance with the substance of the EU Regulation. Moreover, these respondents argued that there did not seem to be any objective reason to introduce different requirements for third country CRAs depending on the mechanism used, as the requirements according to which the ratings are to be produced should pursue the same objectives.

21. However, these respondents suggested a longer transition period for the introduction of this regime (see also subsequent Section 1.c), in order to avoid or minimize any possible market disruption and to ensure that smaller and medium sized financial institutions in particular were able to adjust to the new framework without being placed at a competitive disadvantage.

### *b) The certification and the endorsement regime*

22. Most respondents expressed that if there was no difference between the "as stringent as" test and the ""equivalent to" test; the Regulation would not have adopted two different approaches. If the

requirements in Article 4 (3) (b) are interpreted as requiring local regulations to be equivalent, this would mean that the endorsement regime duplicated the equivalence regime except for the fact that the competent authorities and/or ESMA made the equivalence decision instead of the Commission.

23. Hence, one respondent highlighted that a consequence of ESMA's interpretation was that the third country CRA was subject to the direct supervision of its domestic regulator and to the indirect supervision of the ESMA as a result of cooperation arrangements.

24. Some respondents pointed out that Article 4 (6) of the Regulation stated that when the European Commission had recognised the regulatory regime of a third country as equivalent, then the condition set out in Article 4 (3) (g) was met. This "exemption" did not apply to the rest of conditions laid down in Article 4 (3), in particular in sub-paragraph (b). This is interpreted to mean that a CRA established outside the EU is permitted to set standards, policies and procedures which, in addition to the local regulatory regime, achieve the same outcomes as Articles 6 to 12 of the Regulation.

25. According to these respondents, Article 4 (3) (b) should only focus on the conduct of the third country CRA, not on the regulatory regime, otherwise, the conditions set out in sub-paragraph (b) would have been included in the exemption laid down in Article 4 (6). There would be no point in requiring an endorsing CRA to evaluate whether the as stringent as requirements are met under letter (b) if the Commission had already done this assessment in an equivalence decision.

### *c) The application of the transitional regime to the endorsement procedure and the deadline of 7 June 2011*

26. In respect of the application of the transitional regime, one respondent argued that the transitional regime established in Article 41 for sub-paragraphs (f), (g) and (h) of Article 4 (.3) does not extend to sub-paragraph (b), which in the view of another respondent supported an interpretation that its requirements could be self-imposed.

27. Regarding the 7 June 2011 deadline, some respondents expressed concern about the practical implications of applying the endorsement process as of 7 June 2011 e.g. the lead analyst criterion as well as the setting up of formal cooperation arrangements.

28. Some respondents called on ESMA to consider extending this tight deadline as CRAs may not be able to put in place the necessary arrangements before 7 June 2011. Other respondents were of the view that a phase in approach to implementation should have been taken in order to prevent major unintended disruption that would increase banks' capital requirements. One respondent argued that the application of the endorsement regime should only start from 31 December 2012; one respondent suggested postponing the application of the endorsement regime to the end of 2011.

29. Some respondents, who shared ESMA's interpretation, suggested a longer transition period for the application of the proposed regime of at least one year in order to avoid or minimize any possible market disruption and ensure that smaller and medium sized financial institutions were able to adjust to the new framework and avoid being placed at a competitive disadvantage.

30. One respondent proposed a grandfathering clause for existing investments so that institutions that had made investment decisions in the past on the basis of a rating, could continue using that rating for prudential purposes. Thus, the costs of the new regulation will only be felt when an investment in the old portfolio was replaced.

### d) Cost benefit methodology

31. In respect to the methodology used for the Cost Benefit Analysis (CBA), a significant number of respondents expressed the view that there was insufficient empirical evidence to support the CBA and not sufficient background given regarding how the definition for the level of costs as “low”, “medium”, “high” had been made. In support of this view, several respondents argued that an alternative basis for assessing the costs might have been using the option of “self-imposed” requirements rather than assuming that the CRA in the third country was not subject to any control at all.

32. One respondent argued that ESMA’s analysis was based on two main assumptions: that other countries, such as the US, would quickly adjust their CRA Regulation in order to fulfil the “as stringent as” test, and that international CRAs would relocate analysts to the EU. The same respondent noted that the amount of ratings issued by large CRAs in the EU might not be sufficient and this increased the importance of ratings issued by lead analysts based in the US e.g. in the area of corporate ratings.

33. One respondent stressed that the underlying assumption used in the CBA is that the costs of improving the CRA legislation fall for the most part on financial institutions. Such costs should really be aimed at CRAs as they were the problem needing to be addressed.

34. Some respondents expressed doubts that there really was a risk that the relocation of analysts to countries with regulations “as stringent as” or the appointment of new analysts in these countries, with an associated loss of expertise, would separate analysts from investors and lead to a loss of local sector and market expertise on the rated entities which in turn would have led to a reduction in the quality of the ratings.

35. Most respondents expressed concerns about the impact of ESMA’s interpretation on financial stability, i.e. that significant market disruption would be precluded. One respondent highlighted that the short term costs could be of such magnitude that the medium to long term benefits identified by ESMA might never materialise.

### e) Capital requirements impacts

36. Several respondents raised concerns that ESMA had underestimated some of the costs implied by the ESMA interpretation. In assessing possible increases in capital requirements (especially for securitisation positions), the CBA should have been taken into account the following elements:

   i. The trading book implications including the effects on qualifying debt items and securitisations, the eligibility of collateral and guarantees and the potential follow-on implications for large exposure issues and exemptions which rely on external ratings;

   ii. The expected impact of CRD 3 on securitisation exposure;

   iii. The potential valuation decreases and the impact on return on capital caused by a reduction in market interest in securities (securitisation exposures);

   iv. The costs associated with developing internal ratings system (IRB approach) in a short space of time. Hence one respondent considered the IRB approach was not an appropriate solution for all portfolios especially in the field of securitisation exposure;

   v. The costs to EU firms which are currently rated by a CRA based outside the EU.

37. The vast majority of respondents who gave comments and figures on capital requirements stressed that the endorsement of ratings being issued by lead analysts based in the US was essential. In support of this approach, a significant number of respondents noted that exposures related to the US were

significant within the EU banking system and that if credit ratings issued in the US were not to be endorsed in the EU, the consequent costs in terms of increased capital requirements would be potentially higher than expected.

38. Some respondents also expressed concerns about the CBA's overall conclusion that the "as stringent as" regime may deliver high costs in the low/medium term for banks which would never be offset by future benefits.

39. Finally, one respondent called on ESMA to conduct a second assessment on the prudential impact of the implementation of the proposed endorsement regime together with the European Banking Authority (EBA).

### *2. ESMA responses*

40. ESMA acknowledges the concerns raised by the markets participants in respect of the application of the endorsement regime. However, ESMA points out that the requirements of Article 4 (3) have not been modified by the amendment of the Regulation and that the entry into force of sub-paragraphs (f), (g) and (h) of Article 4 (3) remains 7 June 2011.

41. As a consequence, ESMA confirms the application of Article 4 (3) (b) requiring that the local legal and regulatory systems in third countries be "as stringent as" those set out in Articles 6 to 12 of the EU Regulation. This interpretation was initially adopted by CESR in its June 2010 Guidance, and is now reiterated by ESMA, after taking into consideration the views expressed on this subject by stakeholders and by the Services of the European Commission.

42. Finally, as stated in its Guidance on endorsement, ESMA is of the view that compliance with Article 4 (3) should be at the date of registration of any CRA which applied before 7 September 2010.

43. If at the date of registration, any credit ratings issued outside the EU cannot be endorsed for use in the EU, then the use of those ratings for regulatory purposes by financial intermediaries will still be allowed for up to three months from that. . In addition, if after the expiry of those three months, exceptional circumstances occur which might lead to potential market disruption or financial instability linked to the non-endorsement of those credit ratings, ESMA will still be in the position to allow the use of those credit ratings for regulatory purposes in the EU for a further three months.

44. In respect of the Cost-Benefit Analysis, ESMA acknowledges market participants' concerns about some of the assumptions made by ESMA. However, in connection with paragraphs 42 and 43, ESMA confirms that there has been no material change to the Cost-Benefit Analysis included in the Consultation Paper (ESMA/2011/97).

## Annex I - Guidelines on the application of the endorsement regime under Article 4 (3)

### I- Scope

**Who?**

1. The present Guidelines are relevant to all credit rating agencies established in the EU which intend to endorse credit ratings issued by a third country CRA in accordance with Article 4(3) of Regulation No. 1060/2009.

2. These Guidelines should also be considered by those jurisdictions that are or may in the future be in the process of changing their existing or creating a regulatory framework in respect of credit rating agencies in order to adopt requirements that are as stringent as those set out in the EU by the Regulation No. 1060/2009.

**What?**

3. The Guidelines apply to the endorsement regime established by Article 4(3) of Regulation No. 1060/2009 to allow the distribution and the use for regulatory purposes in the Community of credit ratings issued in third countries.

4. These Guidelines replace paragraphs 93 to 111 of CESR's Guidance published in June 2010 (Ref. CESR/10-347), with the exception of paragraphs 74 to 83 of the above CESR Guidance which will continue to apply.

### II- Background

5. The EU Regulation No. 1060/2009 on credit rating agencies (hereafter "the Regulation") was published in the Official Journal of the European Union on 17 November 2009 and came into force on 7 December 2009. The Regulation was modified by an amending regulation[1] approved by the European Parliament on 15 December 2010 and by the Council. The amendments to the Regulation empowered the European Securities and Markets Authority (ESMA) to undertake the supervision of all credit rating agencies (CRA) in Europe.

6. In June 2010 CESR issued its Guidance on the Registration Process and related issues (CESR/Ref. 10-347) (The Guidance). The Guidance dealt with the endorsement regime established to allow the distribution and the use for regulatory purposes in the Community of credit ratings issued in third countries.

7. Article 21(3) was inserted into the Regulation which requires ESMA, in cooperation with EBA and EIOPA, to issue and update guidelines on the application of the endorsement regime under Article 4(3) of the Regulation, in accordance with Article 16 of ESMA Regulation (EU) No 1095/2010, by 7 June 2011. ESMA is issuing these Guidelines to fulfil the requirements placed upon it by said article 21 (3).

[1] At the time of the publication of these Guidelines the amending Regulation has not been yet published on the EU Official Journal.

8. Indeed, according to Article 40a inserted by the amending Regulation "*all competences and duties related to the supervisory and enforcement activity in the field of credit rating agencies, which were conferred on the competent authorities of the Member States, whether acting as competent authorities of the home Member State or not, and on colleges of competent authorities where those have been established, shall be terminated on 1st July 2011*".

9. However, according to the inserted Article 40a of the Regulation, "*an application for registration received by the competent authorities of the home Member State or the relevant college by 7 September 2010 will not be transferred to ESMA, and the decision accepting or refusing registration or refusal decision will be taken by those authorities and the relevant college*".

10. Pursuant to amendments to the Regulation, ESMA replaced the national competent authorities as far as the provisions set in Article 4(3) are concerned. However, the requirements of Article 4(3) of the Regulation themselves remained unchanged and the entry into force of sub-paragraphs f, g and h of Article 4(3) remained effectively 7 June 2011.

11. ESMA has publicly consulted on these Guidelines by producing a Consultation Paper (Ref: ESMA/2011/97) which was published on 18 March 2011 and consulted on until 31 March 2011. ESMA received 17 responses of which one requested to remain confidential. A summary of the responses received is contained in the Feedback Statement published alongside these Guidelines.

**III- Relationship between equivalence and endorsement**

12. The Regulation provides for two means by which ratings issued outside the EU can be used for regulatory purposes by regulated entities in the EU:

   - Endorsement

   - Certification based on equivalence

13. One of the endorsement conditions that an EU CRA must verify in order to endorse ratings is that "*the conduct of credit rating activities by the third-country credit rating agency resulting in the issuing of the credit rating to be endorsed fulfills requirements which are at least* ***<u>as stringent as</u>*** *the requirements set out in Articles 6 to 12*".

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

15. The question that arises is whether the Regulation establishes two different tests depending on which method is followed ("at least as stringent as" versus "equivalent to").

16. The last sentence of (Recital 13) of the Regulation stipulates that the third country CRA should comply with requirements that achieve the same objective and effects in practice (as the EU Regulation). This

suggests an objective based assessment of the condition set out in Article 4 (3) (b) for endorsement and therefore a similar test to that required for equivalence.

17. Recital 14 of the Regulation clarifies that the certification regime is envisaged for smaller CRAs that are not systemically important. But the only adaptation to the endorsement mechanism that the Recital considers necessary is the requirement of physical presence in certain cases.

18. Therefore, ESMA is of the view that there are no objective reasons to set different requirements for third country CRAs depending on the mechanism used. The requirements according to which the ratings are produced should achieve the same objectives irrespective of the route the foreign CRA has to follow. This would ensure a level playing field for all rating agencies.

19. ESMA understands that an equivalence decision from the European Commission recognising the legal and supervisory framework of the third country as equivalent to the requirements of the Regulation would certainly facilitate an ability to assess whether the requirements in that third-country CRA are as stringent as those set out in Articles 6 to 12 of the Regulation (assuming that no material change to the framework of the third-country has occurred since the date of the Commission's decision).

## IV- The assessment of the conditions set out in Article 4 (3) (b) for endorsement

20. ESMA will apply Article 4 (3) (b) by requiring that the local legal and regulatory system imposes requirements as stringent as those found in Articles 6 to 12 of the EU Regulation. This interpretation is adopted by ESMA taking into account the European Commission Service's view on this subject that it has been communicated.

21. ESMA shall assess[2] and monitor compliance of a CRA with the requirements of the EU Regulation according to Article 4 (3). However, as stated in Article 40a (1) inserted by the amending Regulation, competent authorities of the home Member State or the relevant college shall finalise all applications for registration received before 7 September 2010. In cases where the third-country CRA is not subject (or ceases to be subject) to requirements as stringent as those set out in Articles 6 to 12 of the Regulation under local legal and regulatory requirements, the relevant authority should not authorise the endorsement, or withdraw[3] the authorisation to endorse.

22. ESMA is of the view that Article 4 (3) (f) requires the CRA to be authorised or registered, and subject to supervision, in the third country, therefore the requirements "as stringent as the requirements set out in Articles 6 to 12" of the Regulation must be established by law or regulation, and not on a self-imposed basis. In fact, it seems inconsistent to require a third country to have a regulatory system which provides for authorisation/registration and supervision of the CRAs, when the requirements "as stringent as" could be met on a self-imposed basis.

23. Sub-paragraph (g) also refers to a "regulatory regime in that third country", which could be interpreted as clearly indicating rules established by Law or Regulation.

24. The Regulation does not envisage admissibility of a dual system of compliance with its requirements, whereby local legal/regulatory duties in a third country would be "topped up" by policies and

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[2] National competent authorities, individually or within the relevant colleges, will remain responsible for assessing the applications for registration submitted by existing CRAs before 7 September 2010, in accordance to the inserted Article 40 a(1) of the amending Regulation.

[3] The decision on the authorisation withdrawal for registered CRAs shall be the responsibility of the home Member State until 1 July 2011, according to inserted Article 40a(1) of the Regulation.

procedures voluntarily followed by the third country CRA or the EU-registered, endorsing CRA. Therefore, the requirements as stringent as those set out in Articles 6 to 12 may only be established in law or regulation of that third-country in order to satisfy the condition laid down in Article 4 (3) (b).

25. Moreover, the absence of an equivalence decision of the European Commission does not prevent the use of endorsement as ESMA[4] can verify directly the presence, within the local laws and regulations, of the requirements set out in Article 4(3) (b), (f) and (g), on the basis of the information provided by the CRAs to comply with the demonstration required in accordance to Article 4 (3) (b).

## V- Assessment of the credit rating agency's ability to endorse ratings from third countries at the point of the credit rating agency's initial registration

26. ESMA[5] will consider all relevant information concerning the regulatory system of the third country and other information required by the Regulation in order to assess compliance with the requirements provided in Article 4(3).All relevant information will be considered by ESMA until the moment of the registration decision.

27. The conditions set out in Article 4(3) (b) will be evaluated via an objective based assessment. This means that ESMA[6] will assess whether or not the core aspects of the EU Regulation are fulfilled and met by law or regulation in the third country, taking into account that an exact replication of all the EU requirements will not be necessary.

28. This assessment will be based on the methodology developed and applied by CESR for the purposes of assessing equivalence, which is enclosed in Annex II of this Report.

29. In addition, the EU endorsing CRA will need to be able to demonstrate, with regard to the ratings issued in a third country, that the requirements 'as stringent as' are "de-facto" fulfilled by the third-country CRA..

## VI- Assessment of the credit rating agency's ability to endorse ratings from third countries after the credit rating agency's initial registration decision

30. In case a CRA that has already been registered in the EU decides later on that it would like to endorse ratings from a third country, for which the endorsement was not envisaged at the time of registration, CRAs will notify their intention to endorse, on the basis of Article 14 of the Regulation, and will provide the information necessary to enable the assessment of requirements of Article 4(3).

31. ESMA will subsequently assess whether the requirements for endorsement are met and, if this assessment is negative, endorsement of the ratings issued by these third countries will not be possible after this decision.

32. Where the regulatory framework of the third country had already been assessed as fulfilling the conditions in article 4(3) (b), ESMA will assess whether some changes of the regime in the third

[4] Or the EU national competent authorities for the applications for registration submitted by existing CRAs before 7 September 2010, in accordance to Article 40a(1) inserted by the amending Regulation.
[5] Confront footnote no. 2.
[6] Confront footnote no. 2.

country has occurred so that it may not be considered any-more as including “as stringent as” requirements or fulfilling the other conditions established in Article 4(3). Moreover, the fulfilment of the other conditions established in art 4(3), which refer specifically to the CRA, will also be assessed

## VII-Ongoing obligations of endorsing CRAs

33. According to Article 14 (3) of the Regulation, an EU-registered CRA shall comply at all times with the conditions for initial registration. Article 14 (3) also requires CRAs to notify ESMA without undue delay of any material changes to the conditions for initial registration. ESMA understands that Article 14 (3) also applies to the conditions for endorsement.

34. The EU endorsing CRA should provide information concerning any possible breach of the “as stringent as” requirements from the third country CRA which the EU endorsing CRA notices as a result of its monitoring of the activities of the third country CRA. ESMA should also be able to collect information concerning the conduct of the third country CRA from the relevant supervisory authority, in the framework of the cooperation arrangements provided for by Article 4 (3) (h).

35. The EU endorsing CRA should provide information on the procedures put in place to monitor the fulfilment of the “as stringent as” requirements by the third country CRA whose ratings are to be endorsed.

## VIII. Transitional measures in respect of existing CRAs who applied for registration before the 7th of September 2010.

36. According to Article 40 of the amended Regulation, “*existing credit rating agencies may continue issuing credit ratings which may be used for regulatory purposes by the financial institutions and other entities referred to in Article 4(1) unless registration is refused*.” It is ESMA’s understanding that this measure applies also to ratings that are to be endorsed, which implies that until the moment of registration all new information regarding endorsements may be considered.

37. If registration is refused, or the endorsement of the ratings issued in a country is not permitted as the conditions set out in Article 4(3) are not met at the time of the registration, the mechanism provided for in Article 24(2)[7] shall apply, thus enabling the continued use of those ratings for regulatory purposes.

38. The use for regulatory purposes of credit ratings that are assessed as non-endorsable can continue for a period of three months commencing from the date of the refusal of their endorsement; the application of this three months period is automatic. Existing CRAs shall indicate to the public which credit ratings issued in third countries are not endorsable in the EU, clarifying that these ratings can still be used for regulatory purposes for the mentioned three months period. ESMA will provide relevant information concerning these circumstances to the public.

39. ESMA may extend the period during which non-endorsable ratings can still be used for regulatory purposes of a further three months following the expiry of this first three month period, “in exceptional circumstances relating to the potential for market disruption or financial instability”.

[7] Article 24(4) of the amended Regulation.

**Annex II - Methodological elements for assessing fulfilment of the requirements set out in Article 4 (3) (b) of the Regulation:**

**Excerpt from CESR's Technical Advice to the European Commission "*on the Equivalence between the Japanese Regulatory and Supervisory Framework and the EU Regulatory Regime for Credit Rating Agencies*" (CESR/10- 333).**

### Section III – CESR's Approach To Assessing Equivalence

22. The EU Regulation has established a prescriptive and strict EU legal and supervisory framework for credit rating agencies in order to ensure that credit ratings are independent, objective, and of adequate quality in order to underpin confidence and stability in the financial markets and contribute to the protection of investors.

23. CESR recognises that, in contrast to legal and supervisory frameworks in some third countries, the EU regulatory framework for credit rating agencies is very prescriptive and detailed.

24. The philosophy and approach of the EU Regulation is front loaded and rigorous. The EU Regulation prescribes in great detail:

    a) how a credit rating agency should organise itself and the types of procedures and processes it needs to have in place,
    b) what corporate governance needs to be in place,
    c) the skills and knowledge base of the people it should employ,
    d) the presentation and method of publishing its ratings,
    e) information about the credit rating agency and its activities, in order for such credit rating agency to be eligible for consideration of suitability for issuing ratings for use in the EU.

25. The EU Regulation is directly applicable in Member States. This means that the ability of Member States at a national level to exercise individual decisions is limited. For example, competent authorities cannot impose requirements regarding registration which are not imposed in the EU Regulation, however each Member State can establish the penalties and registration and or supervisory fees that will be applied by each competent authority.

26. The EU Regulation also seeks to ensure that all Member States adopt the same supervisory approach in respect of credit rating agencies. It has introduced a concept of group decision making in the form of colleges of competent authorities.

27. Applications for registration are to be examined by the home Member State competent authority jointly with the other authorities that are members of the college.

28. In addition, where the home Member State competent authority has established that a credit rating agency breaches the obligations arising from the EU Regulation, such competent authority is expected to consult the members of the relevant college before taking supervisory measures against

the credit rating agencies. It is only in respect of the supervisory measures that can be imposed on a credit rating agency for breaching the obligations arising from the EU Regulation, that decisions at a national level can be taken in the absence of agreement with either the college or CESR and even then these require initial consultation with the college, and then with CESR in the absence of agreement with the college.

29. The unified approach to supervision will be reinforced once CESR becomes a European agency and is formally empowered to take over the supervisory responsibility for credit rating agencies.

30. Against this background, CESR has been tasked with assessing the equivalence of legal and supervisory frameworks – where the philosophy of how best to regulate and supervise these entities may be very different, against that of the EU Regulation.

31. As such, CESR's approach to assessing equivalence is not to expect the EU regime to be adopted in an identical manner – this is clearly unrealistic and does not reflect the principle that the same outcome can be achieved through different means.

32. The approach adopted is to take a high level and overall look at the legal and supervisory framework that is in place, the powers of those entrusted to enforce it, and their overall approach to supervision.

33. CESR has also taken into account a number of objectives that the European Commission set out in section 2.3 of its mandate. The most notable of these being, that when assessing the equivalence of the legally binding requirements that a credit rating agency in a third country has to comply with, and the nature of the effectiveness of the supervision and enforcement to which it may be subjected to:

***"the priority should lie in assuring that users of ratings in the EU would benefit from equivalent protections in terms of CRA's integrity, transparency, good governance and reliability of the credit rating activities."***

34. This principle has driven the method that CESR has used in assessing overall equivalence, where CESR has asked itself – **does the third country legal and supervisory framework being assessed achieve this objective?**

35. In addition, when assessing the details of any provisions – CESR has asked itself – **does the requirement that is in place achieve the same objective of the EU requirement?**

36. The European Commission's mandate also included an indicative list of areas that CESR needs to consider in its assessment as well as the regulatory principles that need to be respected in the third country regime being assessed, CESR makes reference to these in Section IV.

37. The mandate also made it clear that CESR should:

a) conduct a technical "*global and holistic*" assessment of the regulatory framework based on "*the entirety of the third country regulatory framework in that country*";
b) "*not be limited to just assessing a commitment to any international convergence initiatives"* – such as the IOSCO code of conduct;

c) *"focus on the differences between the regulatory regime established at EU level and the third country framework",* and *"evaluate and give its judgment on the material importance of such differences.*"

38. In light of the instructions set out in paragraph **37** above, in conducting its assessment CESR has not just looked at the relevant legal provisions that have been introduced for the purposes of regulating and supervising credit rating agencies in a third country, but has also looked at other areas, such as existing securities law or corporate law that may also be applicable.

39. As the assessment is global in nature and not limited to the legal requirements that may be in place, CESR has in accordance with the mandate also assessed the nature of supervision and enforcement to which a credit rating agency may be subjected to.

40. CESR also points out for completeness that the European Commission's mandate also made it clear that:

a) *"the regulatory framework of the third country must include mandatory requirements for the registered CRA's";* and
b) *"voluntary regimes are not to be considered equivalent to the regulatory and supervisory framework introduced by the CRA Regulation."*

### *III.1 The steps adopted by CESR in assessing equivalence*

41. Having discussed in detail above the approach that CESR has adopted in carrying out its assessment of the equivalence between a third country's legal and supervisory framework and the EU regulatory regime for credit rating agencies, this part of the advice explains the steps taken by CESR in assessing equivalence.

42. In light of the fact that the assessment is technical in nature, its scope is global, and the comparison is between prescriptive detailed provisions in a regulation and a whole regulatory and supervisory framework, CESR decided to undertake a detailed analysis ensuring that it is able to exercise its judgment objectively and that the information, it used in doing so, was fully comprehensive.

43. To do this, CESR used a step by step approach as set out below.

#### Step 1 – Drafting a questionnaire for self assessment

44. The first step was to find out what the third country's framework is, and how it compares to the EU one.

45. CESR considered the EU Regulation and in light of its prescriptiveness and the global nature of the assessment that needs to be undertaken, drafted a questionnaire that covered all aspects of the EU Regulation, including those relating to supervision and enforcement.

46. As the third country authority responsible for the registration and supervision of credit rating agencies is clearly best placed to explain its legal and supervisory framework, the objective of the questionnaire was to enable the third country authority to assess itself against the requirements of the EU Regulation, and explain how it considers it meets the same objectives of the EU requirements in light of the inevitable differences in philosophy and approach that may be in place.

47. For full details of the staff of the JFSA's answers to the questionnaire – see Annex II and Annex IIA.

### Step 2 – Establishing conditions for objectively assessing equivalence

48. In order to ensure that CESR adopted an objective approach to its assessment, it needed to establish a number of conditions that it considers have to be met by third country regulators and their regulatory and supervisory regimes:

a) Pure self regulatory regimes are insufficient for an equivalence assessment. Any assessment on the equivalence of a third country regulatory regime must be based on laws, draft laws and regulations that either are currently or will be legally binding;

b) For the successful assessment of a third country's regulatory regime it is not sufficient that the relevant rules are described in the abstract. CESR therefore required that the third country regulator provided it not only with the relevant rules and regulations itself, but also with accompanying translations into English as the functional language of CESR;

c) Unconditional assessments can only be made with regard to laws and regulations already in force. Where only draft regulations and laws exist an equivalence assessment can only be made under the condition that the draft regulations and laws will come into force as proposed. No assessment is possible until a legislative stage is reached in which, according to the third country regulator, the proposed legal texts that are being assessed will more likely than not come into force as proposed, before an equivalent decision by the European Commission is taken. If significant changes occur, the assessment will need to be revised;

d) There needs to be legal clarity regarding what a credit rating agency is, or the activities that it conducts are, and these need to broadly cover what the EU Regulation covers, including those areas where exemptions are permissible according to the third country laws and regulations. Such exemptions need to be considered in order to verify that they do not hamper the compliance with the objectives of the EU Regulation.

49. In addition to the conditions set out in paragraph **48** above, CESR also needed to take into account what the EU Regulation states regarding the assessment of equivalence, and look at what, from a legal perspective, the text of the EU Regulation sets out.

50. Article 5(6) of the EU Regulation sets out the following requirements that need to be met cumulatively by a third country regulatory system in order for it to be able to be considered as equivalent:

a) credit rating agencies in the third country are subject to authorisation or registration;
b) the regulatory regime in the third country prevents interference with the content of credit ratings and methodologies by the supervisory authorities and other public authorities of that third country;
c) credit rating agencies in the third country are subject to legally binding rules which are equivalent to those set out in Articles 6 to 12 and Annex I of the EU Regulation;
d) credit rating agencies in the third country are subject to effective supervision and enforcement on an ongoing basis.

51. The conditions listed in paragraphs **50 a), b),** and **d)** above are narrowly defined in the EU Regulation itself and as such can be assessed with relative ease. If these conditions are not met by a third country regulatory system, CESR considers that such a system **cannot be considered as equivalent**.

52. This means that if:

a) in terms of scope there is no legal clarity regarding what a credit rating agency is, or the activities that it conducts are, and the scope of coverage is not broadly speaking what is covered by the EU Regulation;

b) credit rating agencies in third countries are not subject to authorisation or registration;

c) the regulatory regime in the third country does not prevent interference by the supervisory authorities and other public authorities of that third country with the content of credit ratings and methodologies;

53. **Then CESR will not consider the third country regulatory regime to be equivalent**.

54. Having established the core fundamental conditions that need to be satisfied, the next step was to consider what needs to be in place in order to assess the requirements of the condition set out in paragraph **50 c)** above.

55. CESR considers that this condition requires that the third country regulatory regime is **equivalent with regard to the core substantive provisions of the EU Regulation** concerning independence and the avoidance of conflicts of interest, rating analysts, employees and other persons involved in the issuing of credit ratings, methodologies, models and key rating assumptions, outsourcing, disclosure and presentation of credit ratings, general and periodic disclosures, and transparency reports.

56. This means that the third country regulatory systems that do not take the same kind of regulatory approach and do not have the same detailed requirements set out in their legal system as those set out in the EU Regulation with regard to these issues may nevertheless be considered as equivalent if the regulatory system achieves similar adequate regulatory effects.

57. In order to ensure an objective, fair and transparent process in assessing equivalence, CESR went through those provisions considered relevant for assessing equivalence as set out in the questionnaire created under step 1.

58. As explained in paragraph **35** above, when assessing the equivalence of these provisions, CESR asked itself – **does the requirement that is in place achieve the same objective of the EU requirement?**

59. This assessment is reflected in detail in Section IV below of this advice.

### Step 3 – Assessing the third country's regulatory and supervisory framework against the conditions

60. Having established the conditions for assessing equivalence, CESR reviewed the responses to the questionnaire, ensuring that it fully understood the responses and how the relevant authority had explained its framework. A number of meetings and conference calls were held, with many additional questions, which were not set out in the original questionnaire, being asked.

61. Since the responses to the questionnaire are to be made public in order to ensure that there is complete transparency regarding the assessment that CESR has conducted, the relevant authority was given the opportunity to update its responses to the questionnaire, following further discussion and clarification regarding either the objective of what the EU regulatory requirement was, or what the requirement meant in practice.

62. An assessment table was created in order to compare each of the third country's requirements against:

a) the conditions for assessing equivalence;
b) the requirements as set out in the EU Regulation; and
c) the relevant legal provisions that had been provided by the authority.

63. This enabled CESR to do a detailed assessment of the framework in question, identifying the similarities and differences on a provision by provision basis, establishing how the objective of the provision was covered either by law or through supervisory practice or a combination of the two; and ensuring that where requirements were stated as being embedded in legislation, that the legislation in question covered the provision.

64. Once completed, the assessment of equivalence of each provision was established, with CESR asking itself the question as explained in paragraph **35** above- **does the requirement that is in place achieve the same objective of the EU requirement?** And thereby establishing the basis of its conclusion in respect of each provision.

65. CESR then grouped the provisions into core areas establishing overall objectives for each area and then assessed whether or not the overall objectives of each of these areas were met.

66. In relation to those areas where CESR considers that there is no equivalence, CESR will highlight the differences and make suggestions regarding how the gap between these differences can be bridged.

67. For completeness, although it is not possible for the purposes of assessing the equivalence of an existing regime to take recent proposals that may or may not be adopted in the future into account, where such developments may shed light on the direction in which an existing framework may be going, reference to this will also be made.

68. For the detailed CESR assessment of the Japanese regulatory and supervisory framework please see Section IV of this advice.

69. Although CESR has left it to each authority to check the accuracy of its response to the questionnaire which is annexed to this advice, CESR has ensured that both it and the third country authority have fully understood each other's framework and its requirements. Therefore, this advice

is based on additional explanations and clarifications that have been provided to CESR by the staff of the JFSA in addition to the information set out in the answer.

### Step 4 – Establishing the global assessment of the equivalence between the third country's legal and supervisory framework and the EU Regulatory regime for credit rating agencies

70. Once the assessment of the regulatory and supervisory framework was completed, the framework was looked at as a whole and CESR made a global assessment of the equivalence between the third country's legal and supervisory framework and the EU Regulatory regime for credit rating agencies on that basis, asking itself the question whether the framework overall enables assurance that:

***"users of ratings in the EU would benefit from equivalent protections in terms of CRA's integrity, transparency, good governance and reliability of the credit rating activities."***

71. For CESR's global assessment of the equivalence between the Japanese legal and supervisory framework and the EU Regulatory regime for credit rating agencies see paragraphs 1399 To 1443 and **Box 72** paragraphs 1400 To 1403 Of Section V below.

## III.2 The conditions that CESR has established for each provision of the EU Regulation in order to assess equivalence

72. In establishing its advice, CESR has divided the EU Regulation into a number of different sections, based on the overall objective that the provision is seeking to address.

73. These sections are discussed below and the same sub divisioning is used in the discussion of the assessment of Japan set out in the next Section IV of this advice.

74. The sections are as follows:

A) Scope of the regulatory and supervisory framework
B) Corporate governance
C) Conflicts of interest management
D) Organisational requirements
General organisational requirements
Outsourcing
Confidentiality
Record Keeping
E) Quality of methodologies and quality of ratings
Reviewing credit ratings, methodologies, models and assumptions and information used in issuing ratings
Knowledge and experience of employees directly involved in credit rating activities
Quality of credit ratings and analysis of information used in assigning credit ratings
Quality of methodologies and changes to them
Competition
F) Disclosure
Presentation and disclosure of credit ratings
General and periodic disclosure about the credit rating agency
G) Effective supervision and enforcement

Divisions and offices of the JFSA responsible for the oversight and supervision of credit rating agencies
JFSA's personnel
Prohibition to influence the content of ratings and credit rating agencies' methodologies
Powers of the JFSA
Sanctions

### A.) *Scope of the Regulatory and supervisory framework*

75. In assessing equivalence, as can be seen from Questions 1-8 and Questions 40-41 of the CESR questionnaire set out in Annex II and as discussed in paragraphs **48** to **53** above, ensuring that the nature of the legal and supervisory framework that is in place is able to meet the same overall objectives of the EU regulatory regime is key.

76. If CESR is not satisfied that the framework is able to do this, **then a positive equivalence recommendation cannot be made.**

77. As such, the following needs to be in place:

a) there has to be some form of legally binding regulatory and supervisory framework for credit rating agencies in place (Articles 4.3.f and 5.6.a of the EU Regulation);
b) credit rating agencies have to be subject to what CESR considers to be effective ongoing supervision and enforcement (for what CESR considers this to be see sub-section (G) effective supervision and enforcement paragraphs 200 to 220 below (Articles 4.3.f and 5.6.a of the EU Regulation);
c) credit rating agencies are subject to some form of registration or authorisation process (Articles 4.3.f and 5.6.a of the EU Regulation);
d) the scope of the activities of a credit rating agency that are subject to the third country legal and supervisory framework includes the scope of activities that is included in the EU regime (Article 3.1(a)(b) of the EU Regulation);
e) the relevant authority is prohibited from influencing the content of ratings and methodologies (Article 23.1 of the EU Regulation).

78. In respect of the points above, see paragraphs 200 to 220 below regarding what CESR considers needs to be in place for effective ongoing supervision and enforcement.

79. Of the other requirements, set out in paragraph **77** above, it is point **d)** that needs further elaboration. As explained in paragraphs **48 d)** and **52 a)** above, there needs to be legal clarity regarding what a credit rating agency is, or the activities that it conducts are, and these need to broadly cover what the EU Regulation covers.

80. Where exemptions are permissible according to the third country laws and regulations, such exemptions need to be considered in order to verify that they do not hamper the compliance with the objectives of the EU Regulation.

81. Looking at the requirements of the EU Regulation, this means that the definition of credit rating agency or the activities that it conducts **do not need to be identical**, but it needs to cover the same scope of what is covered by the EU Regulation, ensuring that the credit ratings that are subject to

the oversight of the third country framework in question and that could be used in the EU are covered.

82. In assessing equivalence of this aspect, CESR looked at the legal definition of what a credit rating agency is, what activities of the agency are covered and also at the nature of the exemptions that can be applied.

83. In looking at the definition of a credit rating agency, CESR considered whether or not the definition meant that individuals as opposed to legal entities could be credit rating agencies, as this could have implications for the recourse of those relying on those ratings.

84. If for example the definition of credit rating agencies is broader in scope than the EU definition, then clearly there is equivalence in relation to this aspect.

85. CESR points out that a third country regulatory and supervisory framework may not require all credit rating agencies to be registered or authorised with the relevant authority, but only those who want to enable their ratings to be used for what CESR considers to be those circumstances covered by Article 4.1 of the EU Regulation (referred to as "use for regulatory purposes" in this advice) need to be registered or authorised.

86. CESR highlights that Articles 4 and 5 of the EU Regulation make specific reference to the use of credit ratings issued in a third country for regulatory purposes in the EU and require the credit rating agency in question to be registered or authorised in that third country.

87. In addition, CESR highlights that it does not expect the concept of "use for regulatory purposes" in a third country's legal and supervisory framework to be the same.

88. In cases where the third country and supervisory and regulatory framework is broad, although CESR has been mandated to assess the third country framework as a whole, for the purposes of assessing equivalence, CESR is only focusing on those aspects of the third country framework that relate to the use of credit ratings for "regulatory purposes".

*Exemptions*

89. In terms of assessing the exemptions that can be applied and how the authority in question exercises its discretion in respect of these exemptions, any exemptions need to be assessed for the reasons set out below in paragraph **91** below.

90. If there are no exemptions set out in the third courtly legal and regulatory framework, then this is acceptable for the purposes of assessing equivalence because, the exemptions allowed under the EU Regulation exist in order to facilitate competition, recognising that the nature, scale, and complexity of a credit rating agency's business and the nature and range of its credit ratings, may in certain circumstances warrant that the agency can be exempted from complying with some of the EU Regulation's requirements.

91. Where exemptions are allowed, CESR has looked at what the nature of these exemptions are or can be, looking at whether or not other requirements of what CESR considers to be required of a credit rating agency are in place in order to ensure that:

***"users of ratings in the EU would benefit from equivalent protections in terms of CRA's integrity, transparency, good governance and reliability of the credit rating activities."***

92. Only where CESR is satisfied that the exemptions do not prevent the achievement of this objective in practice, and there is legal clarity as to how the authority will exercise its discretion in respect of applying exemptions for attaining registered or authorisation status, is equivalence said to be in place.

93. For a discussion regarding how the Japanese framework compares to these general and periodic disclosure requirements about credit rating agencies, see paragraphs 369 to 490 below.

### *(B) Corporate governance*

94. Corporate governance is a core aspect of the EU Regulation, and its ability to achieve the objective set out in paragraph **22** above, and as such sets out a large number of detailed and prescriptive requirements in Annex I section A.

95. CESR considers that the key objectives of the EU Regulation's requirements with respect to corporate governance are to ensure that senior management is responsible and legally accountable for ensuring:

a) that credit ratings activities are independent;
b) that there is proper management of conflicts of interest; and
c) compliance with the legal requirements of the regulatory framework.

96. CESR points out that, as set out in recitals 28, 29 and 30 of the EU Regulation, corporate governance arrangements are necessary to ensure that credit ratings are independent, objective, and of adequate quality.

97. The EU Regulation sets out a number of corporate governance requirements that need to be in place in order to ensure that a credit rating agency is able to demonstrate its ability to meet these objectives, and its compliance with them.

98. In assessing the equivalence of a third country's legal and supervisory framework, CESR asked a number of questions in order to establish whether the requirements set out in Article 6.2 and Annex I Section A of the EU Regulation were in place.

99. These requirements involve the need for a credit rating agency to have:

a) an administrative or supervisory board ("board");
b) at least 2 independent members of the board tasked with monitoring the:
   I) credit rating policy;
   II) effectiveness of the internal quality control system;
   III) internal controls and measures established to deal with conflicts of interest.

100. These requirements also involve the need for a credit rating agency to ensure that:

a) the compensation of the independent members of the board is not linked to the business performance of the credit rating agency, and that their judgment can be exercised in an independent manner;
b) the term of office of the independent members of the administrative or supervisory board is for a pre-agreed fixed period and is not renewable;
c) a term limit for the independent member of the board is defined;
d) the majority of members of the board, including independent members have sufficient expertise in financial services;
e) if the credit rating agency issues credit ratings of structured finance instruments, at least one independent member and one other member of the board has in-depth knowledge and experience at a senior level of the markets in structured finance instruments;
f) in addition to the overall responsibility of the board, the independent members of the administrative or supervisory board have the specific task of monitoring:
   I) development of credit rating policy;
   II) development of the methodologies the credit rating agency uses in credit rating activities;
   III) effectiveness of internal control mechanisms in relation to credit rating activities;
   IV) effectiveness of measures and procedures instituted to ensure that any conflicts of interest are identified, eliminated or adequately managed and disclosed;
   V) compliance and governance processes including the efficiency of the review function.

101. CESR anticipates that there may be significant differences in the corporate governance requirements in a third country, and as such is not expecting all of the above requirements to be in place.

102. However, CESR considers that for the purposes of assessing equivalence, there needs to be some form of requirement that a corporate governance structure is in place to ensure that senior management is accountable.

103. In respect of the requirements relating to the independent directors that are tasked with monitoring certain activities, CESR considers that what is important and needs as a minimum to be in place is that there is a clear allocation of the following monitoring tasks in terms of overall responsibility to the senior management:

a) the development of credit rating policy and of the methodologies used by the credit rating agency in its credit rating activities;
b) effectiveness of the internal quality control system;
c) effectiveness of measures and procedures instituted to ensure that any conflicts of interest are identified, eliminated or managed and disclosed;
d) compliance and governance processes.

104. CESR points out that it considers that these monitoring tasks do not need to be carried out by senior management per se, but in order for the objective of the EU requirement to be met, what is important is that these monitoring tasks are carried out by someone independent, who is not involved in credit rating activities, and whose compensation is arranged in such a way to ensure the independence of their judgment and the absence of links to the business performance of the credit rating agency.

105. Considering the importance of the specific monitoring tasks and the overall responsibilities of senior management, these tasks and functions are to be ideally carried out by those who have sufficient expertise in financial services and, where relevant for the business of the credit rating agency, an appropriate in-depth knowledge and experience of the markets in structured finance instruments.

106. For a discussion regarding how the Japanese framework compares to these requirements see paragraphs 491 to 553 below.

### *(C) Conflicts of interest management*

107. CESR points out that conflicts of interest management is a core requirement of the EU Regulation in order to ensure that it meets the overall objective as set out in paragraph **22** above.

108. CESR considers the objectives of the conflicts of interest management requirements of the EU Regulation are to ensure:

a) objectivity, independence, integrity, and quality of the credit ratings;
b) transparency about the credit ratings; and
c) to contribute to the protection of investors and financial markets.

109. The EU Regulation sets out a number of detailed requirements that have to be met by credit rating agencies in order to ensure that these objectives are achieved.

110. In assessing the equivalence of a third country's legal and supervisory framework, CESR asked a number of questions in order to establish whether the requirements set out in Article 6, Article 7 paragraphs 2-5, Annex I Sections A, B, and C of the EU Regulation were in place in addition to those aspects of conflicts of interest covered in the corporate governance section above.

111. These requirements involve the need for credit rating agencies to:

a) identify and eliminate or alternatively manage and disclose conflicts of interest;
b) be organised in a manner that ensures that its business interest does not impair the independence and accuracy of its credit rating activities;
c) establish appropriate and effective organisational and administrative arrangements to prevent, identify, eliminate, or manage and disclose any conflicts of interest;
d) identify, eliminate, or manage and disclose clearly and prominently any actual or potential conflicts of interest that may influence the analyses and judgment of its ratings analysts, employees, and other natural persons whose services are placed at the disposal or under the control of the credit rating agency and who are directly involved in the issuance of credit ratings and persons approving credit ratings;
e) publicly disclose the names of the rated entities or related 3rd parties from which it receives more than 5% of its annual revenue;
f) not issue a credit rating or in the case of an existing credit rating, immediately disclose that the credit rating is potentially affected in the circumstances set out in Annex 1 Section B paragraph 3 of the EU Regulation;
g) ensure that the provision of ancillary services does not present conflicts of interest with its credit rating activity, and disclose in final rating reports any ancillary services provided for the rated entity or any related third party;

h) design its reporting and communication channels so as to ensure independence of related persons from the other activities of the credit rating agency carried out on a commercial basis;
i) ensure that compensation and performance evaluation of the rating analysts and persons approving the credit ratings are not linked to the amount of revenue they generate;
j) disclose any actual and potential conflicts of interest;
k) have requirements whereby those who know of illegal conduct by others report it to the compliance officer without negative consequences;
l) require that where a rating analyst terminates his or her employment and joins a rated entity, in the credit rating of which the analyst has been involved, or a financial firm, with which the rating analyst has had dealings as part of his or her duties at the credit rating agency, the credit rating agency is required to review the relevant work of the analyst preceding his departure;
m) establish an appropriate gradual rotation mechanism with regard to rating analysts and persons approving credit ratings.

112. In addition to the above:

a) a credit rating agency is prohibited from providing consultancy or advisory services;
b) credit rating analysts or persons approving ratings are prohibited from making proposals or recommendations on the design of structured finance products about which the credit rating agency is expected to issue a rating; and
c) credit rating analysts are prohibited from being involved in the negotiation of fees or payments with any rated entity, related third party or any person directly or indirectly linked to the rated entity by control.

113. In addition those persons referred to in Annex 1 Section C point 1 of the EU Regulation are prohibited from:

a) engaging in transactions in financial instruments issued, guaranteed or otherwise supported by the rated entity;
b) participating in or otherwise influencing the determination of a credit rating if those persons own financial instruments of the rated entity or any entity related to a rated entity or have had a recent employment or other business relationship with the rated entity that may cause a conflict of interest;
c) soliciting or accepting monies, gifts or favours from anyone with whom the credit rating agency does business;
d) taking key management positions with the rated entity or its related third party within 6 months after the rating.

114. Overall, as can be seen from the above requirements the EU approach to conflicts of interest management is a combination of requirements relating to how:

- the credit rating agency needs to be organised so that conflicts of interest are managed,
- to disclose certain interests which are considered to be a potential conflict,
- to prohibit the credit rating agency itself and those who are involved in the credit rating process from conducting certain activities,
- to ensure that those who are key to determining the credit rating of credit rated entities and their instruments do not establish working relationships that may result in conflict, and
- to ensure that the compensation of those involved in credit rating activities ensures the independence of their judgment.

115. This is another area where CESR recognises that the approach to this may differ in a third country for example by setting out in the law a list of prohibited activities that are considered *de facto* to be conflicts of interest and are prohibited irrespective of the procedures and processes that a credit rating agency may have in place.

116. CESR recognises that the third country laws and regulations in this area may not be as detailed or specific as those set out in the EU Regulation.

117. However, CESR points out that conflicts of interest management is fundamental to the ability of the EU Regulation to achieve its objectives and does expect, for the purposes of making an equivalence assessment, that there are robust provisions embedded into the law that cover actual or potential conflicts of interest management and disclosure.

118. As such, CESR considers that, in addition to those aspects of corporate governance set out in paragraphs **102** to **105** above, overall, the objectives of each individual conflict of interest management requirement described in paragraphs **111** to **113** above should be met through provisions embedded in the third country legal and regulatory framework, together with proper and effective supervision and enforcement.

119. However, CESR can accept the following differences:

a) disclosure regarding the names of clients from whom the credit rating agency receives more than 5% of its annual revenue can be made only to the regulator so that it can monitor and supervise how the credit rating agency is managing the conflicts that may arise in respect of these clients;
b) requirements that relate to the need to review the work of the rating analyst prior to its departure to a rated entity do not need to be in place because this duplicates other requirements that would pick this issue up;
c) requirements prohibiting certain individuals from taking key management positions with the rated entity or its related third party within 6 months after the rating – do not need to be in place because the conflict that is being addressed would be captured by other requirements;
d) requirements relating to rotation of certain individuals.

120. CESR recognises that the requirements relating to the gradual rotation of rating analysts and persons approving credit ratings is one of a number of ways in which a credit rating agency can achieve the objectives of the management of conflicts of interest requirements as set out in paragraph **108** above and the independence of rating analysts and persons approving ratings.

121. CESR also recognises that these requirements are controversial in that sense that some market players consider such requirements as having the effect of potentially damaging the quality of ratings by diluting expertise, as well as being in contradiction to those requirements relating to knowledge and experience.

122. Others, on the other hand, welcome it as they consider it a good discipline to have to ensure that knowledge and expertise is shared as well as the ensuring that the nature of the working relationship between the credit rating analysts and the rated entity remains impartial.

123. For the purposes of assessing equivalence, CESR does not consider it necessary that rotation requirements are in place in order to achieve the objective, but where there are no such requirements will expect for example the legal requirements relating to conflicts of interest management to be very robust.

124. For a discussion regarding how the Japanese framework compares to the conflicts of interest requirements see paragraphs 560 to 760 below.

### *(D) Organisational requirements*

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

126. The EU Regulation sets out a number of organisational requirements that credit rating agencies need to have in place in order to be able to demonstrate its ability to meet these objectives and compliance with them.

127. These requirements can be divided as follows:

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

#### D.I) General organisational requirements

128. Article 6.2 and Annex I Section A paragraph 3-6, 8, 10 of the EU Regulation requires the credit rating agency to:

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

129. In respect of the above requirements, CESR considers that these are necessary to facilitate the credit rating agency's ability to achieve the objectives set out in paragraph **125** above, although it does not expect the identical requirements to be hard wired into a third country's regulatory framework.

130. CESR needs to take an in depth look at what organisational requirements are in place as a package, and in addition consider the nature and extent of the supervisory and enforcement powers and practices that are in place, as discussed in Section G below.

131. Having assessed what is in place as a package, CESR considers that the overall organisational requirements must objectively achieve the purposes discussed above in order to be assessed equivalent to the EU requirements.

132. As such, for example CESR can accept that there may not be an identical requirement set out in the law to have a permanent and effective compliance function which operates independently, but it does expect the objective of this requirement to be somehow in place.

133. For an explanation of CESR's view regarding how and if the Japanese framework meets these requirements please see paragraphs 765 to 825 below.

### D.II) Outsourcing

134. Article 9 of the EU Regulation prohibits outsourcing of important operational functions in such a way so as to impair materially the quality of the credit rating agency's internal control and the ability of the authorities to supervise the credit ratings agency's compliance under the EU Regulation.

135. In assessing the equivalence of this prohibition, CESR asked a number of questions to establish:

a) if any outsourcing of important operational functions is allowed;
b) if any restrictions in respect of outsourcing exist;
c) whether or not the regulatory framework ensures that:

    I) none of the outsourced functions impair the quality of the credit rating agency's internal controls; and
    II) that the outsourcing does not impair the ability of the relevant authority to supervise the credit rating agency's compliance with its regulatory obligations.

136. In respect of these requirements, CESR considers that, where outsourcing is allowed in the third country, for the purposes of a positive assessment of the equivalence, the third-country regulatory framework shall set out conditions for outsourcing aimed at ensuring that the following objectives are achieved:

a) none of the outsourced functions impair the quality of the credit rating agency's internal controls, and

b) the ability of the authority to supervise the credit rating agency's compliance with its legal obligations is not impaired.

137. In addition, CESR expects that if outsourcing is allowed:

a) there needs to be legal clarity regarding what can be outsourced; and
b) the legal responsibility for what is being outsourced shall remain with the credit rating agency.

138. For a discussion about what the Japanese outsourcing requirements are, please see paragraphs 826 to 837 Below.

### D.III) Confidentiality

139. Requirements relating to confidentiality are important because of the nature of the information that the credit agency and its employees have access to. There is a need to ensure that confidential information is only used for purposes related to credit rating activities and is protected from fraud, theft or misuse.

140. The EU Regulation imposes a number of confidentiality obligations on rating analysts, employees of the credit rating agency as well individuals whose services are placed at the disposal or under the control of the credit rating agency and who are directly involved in credit rating activities as well as individuals closely associated with them as set out in Article 7.3 and Annex I Section C paragraph 3 of the EU Regulation as follows:

a) to take all reasonable measures to protect property and records in possession of the credit rating agency from fraud, theft or misuse;
b) to not disclose any information about credit ratings or future ones other than to the rated entity or its related third party;
c) to keep information entrusted to the credit rating agency confidential;
d) to not use or share confidential information for trading purposes or any other purpose other than credit rating activities;

141. CESR considers these requirements to be very important for the reasons set out above, and it expects the objectives of these requirements to be met for the purposes of assessing equivalence.

142. For a discussion regarding how the Japanese framework compares to these confidentiality requirements see paragraphs 838 to 844.

### D.IV) Record Keeping

143. Effective record keeping enables a credit rating agency to document the manner in which it meets its legal obligations, as well as allowing its regulator to supervise that this is being done.

144. Article 6.2 and Annex I Section B paragraphs 7 to 9 of the EU Regulation require credit rating agencies to keep adequate records and, where appropriate, audit trails of their credit rating activities for at least five years and make them available upon request to the competent authority.

145. CESR considers this requirement to be crucial for the purposes of establishing equivalence, but can accept that the period of time for which records need to be kept may differ from jurisdiction to jurisdiction, but whatever is in place has to be reasonable.

146. For a discussion regarding how the Japanese framework compares to these record keeping requirements see paragraphs 845 to 853 below.

### *(E) Quality of Methodologies and Quality of Ratings*

147. In addition to the general organisational requirements referred to above, the EU Regulation sets out a number of requirements aimed at ensuring the following objectives:

a) that the methodologies, models and key rating assumptions that are used in credit rating activities are rigorous, continuous and thorough;
b) the adequate quality, integrity and thoroughness of the credit rating activities;
c) as set out in recital 7 of the EU Regulation the protection of the stability of financial markets and of investors; and
d) that ratings and methodologies are subject to validation as well as the adequate quality and thoroughness of ratings.

148. These requirements are set out in Article 6.2 – Annex I Section A paragraph 9, Article 7.1, Articles 8.2, 8.3, 8.4, 8.5, 8.6, Article 10.2 Annex I Section D.1 of the EU Regulation, and can be divided into the following areas:

I) Reviewing credit ratings, methodologies, models and assumptions and information used in issuing ratings;
II) Knowledge and experience of employees directly involved in credit rating activities;
III) Quality of credit ratings and analysis of information used in assigning credit ratings;
IV) Quality of methodologies and changes to them; and
V) Competition.

#### E.I) Reviewing credit ratings, methodologies, models and assumptions and information used in issuing ratings

149. The EU Regulation sets out a number of requirements dealing with the review of credit ratings, methodologies, models and assumptions as well as the need to review the information used in issuing ratings in Article 8.2, Article 8.5, Article 8.6 and Annex I Section A paragraph 9.

150. These requirements require a credit rating agency to:

a) have a review function devoted to the periodical review of methodologies, models, key rating assumptions;
b) monitor its ratings and methodologies on an on-going basis and at least annually; and
c) review the affected credit ratings as soon as possible and not later than within 6 months after the change, and in the meantime place those ratings under observation.

151. For the purposes of assessing equivalence CESR considers it important that methodologies are up-to-date and subject to a comprehensive review on a periodic basis.

152. CESR does not consider it necessary for there to be a separate review function per se for the purposes of equivalence, but that whatever requirements are in place, that these achieve a periodic review of methodologies, models, and key rating assumptions by those who are independent from those that are responsible for the development and use of these models, key rating assumptions, and models.

## E.II) Knowledge and experience of employees directly involved in credit rating activities

153. The EU Regulation sets out requirements relating to the nature of the knowledge and experience of credit rating agency's employees directly involved in credit rating activities in Article 7.1.

154. This requirement is that the credit rating agency ensures that rating analysts, employees of the credit rating agency, and any other natural person directly involved in credit rating activities have appropriate knowledge and experience for the duties assigned.

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

156. CESR recognises that the EU requirement has embedded a test of appropriateness, which is subjective and is something that will need to be assessed on a case-by-case basis.

157. The question for the purposes of equivalence is therefore whether embedding the "appropriateness" requirement in law means that in practice those doing the job are appropriately qualified, and who is best placed to assess this?

158. CESR considers that for the purposes of assessing equivalence, the lack of an appropriateness test in a requirement can still result in the objective of the provision being met, provided there is disclosure regarding those individuals doing the job, and the ability to take legal action where it is clear in practice that those doing it are not appropriate.

## E.III) Quality of credit ratings and analysis of information used in assigning credit ratings

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

160. These requirements are set out in Articles 8.2, 8.5, 10.2, and Annex I.DI. of the EU Regulation.

161. These requirements are:

a) to adopt, implement and enforce adequate measures to ensure that the credit ratings they issue are based on a thorough analysis of all the information that is available to them and that is relevant to their analysis according to their rating methodologies;
b) to adopt all necessary measures so that the information they use in assigning a credit rating is of sufficient quality and from reliable sources;
c) to establish internal arrangements to monitor the impact of changes in macroeconomic or financial market conditions on credit ratings;
d) to inform the entity subject to the rating at least 12 hours before publication of the credit rating and of the principal grounds on which the rating is based in order to give the entity an opportunity to draw attention of the credit rating agency to any factual errors;

e) to refrain from issuing a credit rating or withdraw an existing rating if they do not have sufficient quality information to base their ratings on; and
f) to establish an appropriate gradual rotation mechanism with regard to rating analysts and persons approving credit ratings.

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

163. In establishing the equivalence of these requirements with a third country's legal and supervisory framework, CESR would not expect to see identical requirements however it would expect to see requirements that are able to achieve this objective.

164. In respect of the requirement set out in paragraph **161** c) above CESR does not consider that this needs to be addressed by a separate requirement as is the case in the EU Regulation because it expects this to be covered in the obligation to ensure that ratings are based on accurate and up to date information.

165. In respect of the requirement set out in paragraph **161** f) above, and as discussed in paragraphs **120** to **123** above, CESR does not consider it necessary that there is a specific requirement that the credit rating agency establishes a gradual rotation mechanism.

### E.IV) Quality of methodologies and changes to them

166. The EU Regulation sets out a number of requirements relating to the quality of methodologies and what needs to be done when methodologies, models or key rating assumptions used in credit rating activities are changed, as set out in Article 8.3 and 8.6 (a-c) of the EU Regulation.

167. These requirements impose an obligation on credit rating agencies to:

a) use rating methodologies that are rigorous, systematic, continuous and subject to validation based on historical experience, including back-testing;
b) apply the changes in methodologies and models consistently to existing ratings; and
c) immediately disclose the likely scope of credit ratings to be affected by using the same means of communication as was used for the distributions of the affected credit ratings.

168. CESR considers that these requirements are significant in ensuring that the credit rating agency is able to achieve the overall objective of these requirements.

### E.V) Competition

169. The EU Regulation has a number of requirements relating to the rating of structured finance products where the rating agency has not rated the underlying assets of the product.

170. These requirements are set out in Article 8.4 of the EU Regulation and they impose a prohibition on the credit rating agency to refuse:

a) to issue a credit rating of an entity or a financial instrument because a portion of the entity or the financial instrument had been previously rated by another credit rating agency, where a credit rating agency is using an existing credit rating prepared by another credit rating agency with respect to underlying assets or structured finance instruments;
b) to record all instances where in its credit rating process it departs from existing credit ratings prepared by another credit rating agency with respect to underlying assets or structured finance instruments providing a justification for the differing assessment.

171. CESR does not consider that these requirements need to be in place for the purposes of assessing equivalence.

172. For an explanation of CESR's view regarding how and if the Japanese framework meets the objectives of the quality of methodologies and quality of ratings requirements, please see paragraphs 867 to 1032 below.

### *(F) Disclosure*

173. The information that has to be disclosed either to the public or the regulator in respect of credit ratings and the credit rating agency and its activities forms another set of core prescriptive requirements.

174. For the purposes of assessing equivalence, CESR has subdivided the EU Regulations disclosure requirements as follows:

I) Presentation and disclosure of credit ratings;
II) General and periodic disclosure about the credit rating agency.

#### F.I) Presentation and disclosure of credit ratings

175. In light of the number of presentation and disclosure of ratings requirements, for the purposes of this advice, CESR has further categorized these requirements into:

a) General provisions on the presentation and disclosure of any credit ratings; and
b) Additional requirements in respect of the presentation and disclosure of credit ratings for structured finance products.

#### F.I) A) General provisions on the presentation and disclosure of any credit ratings

176. The EU Regulation sets out a number of detailed requirements relating to the disclosure and presentation of ratings. CESR considers that the objectives of these requirements aim at ensuring that ratings are disclosed in a timely manner and in a non-selective basis, and that adequate information is provided to the users of credit ratings in order to allow them to conduct their own due diligence when assessing whether or not to rely on those credit ratings.

177. Namely, pursuant to Article 10.1,4,5,6, Article 11.2, and Annex I, Section D, paragraph 5, of the EU Regulation, credit rating agencies are required to:

a) disclose any credit rating, as well as any decisions to discontinue a credit rating, on a non-selective basis and in a timely manner;
b) refrain from using the name of the competent authority in such a way that would indicate endorsement or approval by that authority of the credit rating or any credit rating activities of the credit rating agency;
c) disclose its policies and procedures regarding unsolicited credit ratings and ensure that unsolicited credit ratings are identified as such;
d) in the case of an unsolicited credit rating, information on whether or not the rated entity or related third party participated in the credit rating process and whether the credit rating agency had access to the accounts and other relevant internal documents of the rated entity or its related third party;
e) when announcing a credit rating, to explain in their press releases or reports the key elements underlying the credit rating; and
f) make available information on its historical performance data, including the rating transition frequency and information about credit ratings issued in the past and their changes.

178. In addition, according to Article 10.2 and Annex I, Section D, paragraphs 1, 2, 4 of the EU Regulation, credit rating agencies are required to ensure that the following information is indicated in the credit ratings:

a) the name and job title of the lead rating analysts as well as the name and the position of the person primarily responsible for approving the rating;
b) all substantially material sources used to prepare the credit rating, with an indication of whether the credit rating has been disclosed to that rated entity or its related third party and amended following that disclosure;
c) the principal methodology or methodology version that was used in determining the rating, with a reference to its comprehensive description;
d) the meaning of each rating category, the definition of default or recovery and any appropriate risk warning, including a sensitive analysis of the relevant key rating assumptions, accompanied by an explanation of the worst-case and best-case scenario credit ratings;
e) the date of first release of the credit rating for publication as well as of its last update;
f) information on whether the credit rating concerns a new financial instrument and whether the credit rating agency is rating it for the first time; and
g) any attributes and limitations of a credit rating, and in particular to what extent the credit rating agency has examined the quality of information used in the rating process and whether it is satisfied with the quality of information it bases its rating on.

179. CESR considers that, for the purposes of assessing equivalence, overall, the objectives of each individual requirement described in paragraphs **177** to **178** above should be met through provisions embedded in the third country legal and regulatory framework, together with proper and effective supervision and enforcement.

180. However, CESR can accept the following differences:

a) decisions to discontinue a credit rating are to be disclosed, but there is no requirement to indicate the reasons for such a decision;

b) the requirement, when announcing a credit rating, for press releases or reports to indicate the key elements underlying the credit rating, provided that it is ensured that such key elements are provided to investors when ratings are announced;
c) the name and job title of the lead rating analysts as well as the name and the position of the person primarily responsible for approving the rating are not to be disclosed in the credit rating, provided that record of this information is kept;
d) credit ratings are not required to indicate whether the credit rating concerns a new financial instrument and whether the credit rating agency is rating it for the first time, since it expects this requirement to be covered through the requirement to indicate the attributes and limitations of the credit ratings that are disclosed.

**F.I)B Additional requirements in respect of the presentation and disclosure of credit ratings for structured finance instruments**

181. The EU Regulation imposes additional requirements in respect of the presentation and disclosure of ratings related to structured financial instruments.

182. The aim of these requirements is to ensure that ratings for structured financial instruments are clearly identifiable as such, and that investors receive appropriate information to deal with the additional complexity of these products.

183. Namely, Article 10.3 and Annex I, Section D.II, paragraphs 3, 4 of the EU Regulation require credit rating agencies that rate structured finance instruments:

a) to ensure that credit categories attributed to those structured finance instruments are clearly differentiated by the use of a specific symbol;
b) to accompany the disclosure of methodologies, models and key rating assumptions with guidance explaining the assumptions, parameters, limits and uncertainties surrounding the models and methodologies used in such credit ratings;
c) to disclose on an on-going basis information about all structured finance products submitted to them for initial review or preliminary rating, regardless of whether a final rating has been issued.

184. In addition, credit rating agencies that rate structured financial instruments are required to provide in the relevant credit ratings the additional information set out in Annex I, Section D.II, paragraphs 1, 2 of the EU Regulation, as detailed below:

a) all information about loss and cash-flows analysis performed or relied upon by the credit rating agency as well as about expected changes in the credit rating;
b) information on whether the credit rating agency has performed any assessment concerning the due diligence processes carried out at the level of underlying financial instruments or other assets of structured finance instruments (specifying what level of assessment) or whether the credit rating agency has relied on a third party assessment.

185. Taking into account the complexity of structured finance products, CESR considers it important, for the purposes of assessing equivalence that additional requirements are in place for the presentation and disclosure of credit ratings related to these types of products.

186. Out of the requirements set out in paragraphs **183** to **184** above, CESR considers that it shall be, as a minimum, ensured that information is disclosed about the level of assessment, if any, conducted by the credit rating agency on the due diligence processes carried out at the level of underlying financial instruments or other assets of structured finance instruments.

187. For a discussion regarding how the Japanese framework compares to these presentation and disclosure of credit ratings requirements see paragraphs 1039 to 1189 below.

### F.II) General and periodic disclosure about the credit rating agency

188. In addition to the requirements on disclosure and presentation of credit ratings, the EU Regulation imposes a number of prescriptive disclosure requirements on credit rating agencies in relation to their organization and their activities, including the methodologies they use for determining and publishing credit ratings.

189. CESR considers that the objectives of the general and periodic disclosure requirements of the EU Regulation are aimed at ensuring transparency about credit rating activities, at making information available to the public to allow it to perform an assessment on whether to rely on certain credit ratings as well as at providing information to competent authorities for the purposes of on-going supervision.

190. For the purpose of this paper, a distinction is made between:

a) General additional disclosure requirements; and
b) Periodic additional disclosure requirements, which include the information expected to be provided in the transparency reports.

#### F.II) A) General additional disclosure requirements

191. According to Article 11.1 and Annex I, Section E.I of the EU Regulation, a credit rating agency is required to generally disclose to the public the following information:

a) the fact that it is registered;
b) a list of ancillary services;
c) the policy of the credit rating agency concerning the publication of credit ratings and other related communications;
d) the general nature of its compensation arrangements;
e) the methodologies, and descriptions of models and key rating assumptions as well as their material changes;
f) any material modification to its systems, resources or procedures; and
g) where relevant, its code of conduct.

192. CESR recognises the importance of the disclosure of such information for the purposes of achieving the objectives referred to in paragraph **189** above. CESR considers that, for the purposes of an equivalence assessment, it is necessary to assess, whether or not as a minimum, the information referred to under letters **a)**, **b)**, **c)**, **e)**, **g)** of paragraph **191** above is disclosed to the public. CESR

can accept for the purposes of equivalence that the information referred to under letters **d)** and **f)** of paragraph **191** above is provided only to the competent authority.

**F.II.B) Periodic Additional disclosure requirements**

193. Article 11.3 and Annex I, Section E.II paragraph 2 of the EU Regulation require credit rating agencies to provide, on an annual basis, to the competent authority:

a) a list of the 20 largest clients by revenue generated by them; and
b) a list of the clients whose contribution to the growth rate in the generation of the credit rating agency's revenue in the previous financial year exceeded the growth rate in the total revenue of the credit rating agency in that year by a factor of 1.5 times.

194. For the purposes of assessing equivalence, CESR expects the third country regulatory framework to impose some form of disclosure requirement regarding revenue generation on the credit rating agency. However, for the purposes of assessing equivalence, CESR can accept that the requirement in paragraph **193 a)** above does not need to be identical to the one set out under the EU Regulation (e.g. not covering the 20 largest clients), and that the requirement in paragraph **193 b)** above does not need to be in place in the third country.

195. In addition to these requirements, the EU Regulation (Article 11.2 and Annex I, Section E.II paragraph 1) requires credit rating agencies to make available to the public, on a half-yearly basis, data about the historical default rates of their rating categories, distinguishing between geographical areas of the issuers and whether these default rates have changed over time.

196. CESR considers that, for the purposes of an equivalence assessment, the third country legal and regulatory framework shall require credit rating agencies to disclose to the public data about historical default rates of rating categories and their changes over time. However, CESR can accept that the frequency for publication may be different, as well as that no distinction is made between the geographical areas of the issuer.

197. In addition, under Article 12 and Annex I, Section E.III of the EU Regulation, credit rating agencies are required to make the following information available to the public on an annual basis in an annual report on their Internet website:

a) a detailed description of their legal structure, ownership and revenue streams;
b) a description of the internal control mechanisms ensuring quality of their credit rating activities;
c) a description of their record keeping policy;
d) a description of their management and rotation policy;
e) statistics on the allocation of their staff to new credit ratings, credit rating reviews, methodologies or model appraisals and senior management; and
f) the outcome of the annual internal review of their independent compliance function.

198. Whilst according to the EU Regulation these requirements need to be disclosed to the public, CESR considers disclosure to the authority is adequate for the purposes of establishing equivalence. In addition, CESR considers that it can accept that credit rating agencies are not required to disclose the statistics referred to under letter e) in paragraph 197 above.

199. For a discussion regarding how the Japanese framework compares to these general and periodic disclosure about the credit rating agencies requirements see paragraphs 1193 to 1270.

### *(G) Effective supervision and enforcement*

200. Article 4.3(f) and 5.6 of the EU Regulation include as preconditions for ratings issued outside the EU to be endorsable or certifiable that:

a) credit rating agencies in the third country are subject to effective supervision and enforcement on an ongoing basis (Article 5.6); and
b) the credit rating agency established in the third country is authorised or registered, and is subject to supervision in that third country (Article 4.3(f)).

201. In addition, the coordination arrangements that need to be in place in accordance with Articles 4.3(h) and 5.1I have to include provisions relating to the *"coordination of supervisory activities…"*

202. As explained in paragraph **51** above, CESR has established a number of preconditions for the purposes of establishing whether or not equivalence exists, and in the event that it does not consider the objectives of these requirements to be met, then such a system cannot be considered to be equivalent.

203. In assessing the nature of equivalence in this area, CESR divided these requirements into the following areas:

I) the methods that the authority has in place to ensure that it is adequately staffed;
II) the powers of the relevant authority; and
III) the nature of the penalties that can be imposed.

204. CESR points out that it is not, for the purposes of assessing equivalence, making any judgments regarding the approach that the third country regulator adopts in relation to on-going supervision, for example, whether a risk based approach is or is not a good or bad thing, but is overall looking to get comfort that the supervision that will or is being done can be or is in practice effective.

### G.I) The methods that the Authority has in place to ensure that it is adequately staffed

205. The nature of supervision and enforcement that takes place in respect of monitoring and supervising the credit rating agencies' adherence to their obligations and taking action where they do not, is heavily dependent upon the number of staff that the relevant authority charged with the legal responsibility of supervising these entities has in place.

206. Article 22.2 of the EU Regulation requires that competent authorities in the EU to be adequately staffed, with regard to capacity and expertise, in order to able to apply the EU Regulation.

207. In assessing equivalence in this area, CESR does not expect to find a similar legal provision but that there will be enough staff.

208. Even at an EU level there is no standardisation between Member States in terms of what "adequate" means and the minimum number of staff or their expertise for the purposes of applying the EU Regulation, as such there is no benchmark against which CESR can assess equivalence in this area.

209. However, without the necessary staff there cannot said to be "effective supervision", as such, CESR has, in assessing equivalence, sought to understand how the regulator in question either already does, or will, in the future be organising itself, and how many staff it has or will have.

210. CESR is conscious of the fact that this is an area that may change in respect of the third country that it is assessing, but clearly if there is no thought to how supervision will in practice be carried out – then irrespective of the powers that the supervisors may have at its disposable to use, CESR cannot say that the supervision is or will be effective.

### G.II) The powers of the relevant authority

211. Article 23 of the EU Regulation sets out the details of the powers that the EU competent authorities need to have in order to be able to discharge their legal duties under Article 23.3 of the EU Regulation, as well as a description of how these powers are to be exercised (Article 23.2).

212. The necessary powers that the authority need to have are the power to:

a) access to any document in any form and to receive or take a copy thereof;
b) demand information from any person and if necessary to summon and question a person with a view to obtaining information;
c) carry out on-site inspections with or without announcement;
d) require records of telephone and data traffic.

213. In addition, as set out in Article 24 of the EU Regulation, the authority in question has to be able to take the following measures against a credit rating agency following the establishment of a breach by it in respect of its obligations under the EU Regulation:

a) to withdraw the credit rating agency's registration or authorisation;
b) to prohibit the credit rating agency from temporarily issuing credit ratings;
c) to suspend the use of credit ratings issued by the credit rating agency for regulatory purposes;
d) to take appropriate measures to ensure that the credit rating agency continues to comply with its legal requirements;
e) to issue public notices where the credit rating agency is in breach of its obligations arising from the relevant regulatory framework in your jurisdiction; and
f) to refer matters for criminal prosecution to the relevant national authorities.

214. For the purposes of assessing equivalence, CESR considers that all the above powers need to be firmly embedded in the relevant law in order to be able to classify the third country regime as having effective supervision which it considers to be equivalent to that of the EU's.

215. In addition, as set out in the final paragraph of Article 23.3 of the EU Regulation the authority needs to be able to exercise these powers in respect of:

*"credit rating agencies, persons involved in credit rating activities, rated entities and related third parties, third parties to whom the credit rating agencies have outsourced certain functions or activities; and person otherwise related or connected to credit rating agencies or credit rating activities.*"

216. As such, when assessing equivalence in this area, CESR needs to assess not only the nature of the powers that can be exercised, but also against whom these powers can be exercised in assessing whether or not the supervision is or can be “effective.”

### G.III) Penalties

217. Article 36 of the EU Regulation sets out that the penalties that can be imposed by each national authority need to be: “effective, proportionate and dissuasive” – but leaves it to each authority to determine what these should be.

218. In addition, the EU Regulation imposes an obligation on the national authorities to disclose to the public every penalty being imposed for infringements of the EU Regulation, unless such disclosure would seriously jeopardise the financial markets or cause disproportionate damage to the parties involved.

219. For the purposes of assessing equivalence, CESR expects that the relevant third country framework has legal provisions setting out what the penalties that can be imposed for breaches of the relevant requirements are, but does not expect these penalties to be publishable for the purposes of equivalence.