

**Important note:**

***This document is a working document of the Commission services for consultation.***

***It does not purport to represent or pre-judge the formal proposals of the Commission.***

You are invited to comment on the proposals in this paper. The proposals are only an indication of the approach the European Commission may take and are not its final policy position.

As well as responding to the specific proposals and questions, we also ask you to describe any alternative approaches you think would achieve our objectives.

We are keen to fully understand and assess the financial and other impacts of our proposals and any alternative approaches. Therefore, we ask you to comment on:

- the likely compliance costs;
- the likely effect on competition; and
- other impacts, costs and benefits.

Where possible, we are seeking both quantitative and qualitative information.

We are also keen to hear from you on any other issues you consider important.

Your comments will help us develop our proposals to refine and develop our policies on the use of credit ratings in the regulatory context. In particular, any information about compliance costs, impacts on competition and other impacts, costs and benefits will be taken into account when we prepare our final policy position.

# **DG MARKT SERVICES DOCUMENT**

## **Tackling the problem of excessive reliance on ratings**

### **I. Subprime lessons on the use of ratings**

The excessive reliance of investors on credit ratings is consistently pointed out as one of the triggers of the recent troubles in credit markets. In its report of April 2008<sup>1</sup>, the Financial Stability Forum noted that *some institutional investors have relied too heavily on ratings in their investment guidelines and choices, in some cases fully substituting ratings for independent risk assessment and due diligence. Some also relied exclusively on ratings for valuation purposes.* Similar observations were also included in the recent reports of the Committee of European Securities Regulators and the European Securities Markets Expert group<sup>2</sup>.

Consequently, arguments have been raised that greater demand and reliance on ratings by investors has come as a result of the increasing number of references to credit ratings in regulatory requirements. Based on that premise, policy recommendations have been formulated<sup>3</sup> that it is necessary to reconsider the existing ties between ratings and regulatory duties on the financial industry: investors should not be obliged or even encouraged to refer to ratings as the sole or ultimate benchmark for assessing asset quality, because it discourages their own consideration and due assessment of the risks involved.

Credit rating agencies (CRAs) provide a service that when done well represents a clear value to the markets: they help address the information asymmetry existing between those issuing debt instruments and those investing in these instruments. Whatever policy is eventually pursued with respect to the problem of excessive reliance, CRA ratings are likely to remain a significant reference point for in-house due diligence performed by investors on the financial assets they hold.

This document identifies in broad terms the references made to ratings in the existing EU legislation and looks at possible approaches to the problem of possible excessive reliance on ratings.

Comments of all interested parties are invited on the identified options.

Deadline for comments: 5<sup>th</sup> September 2008

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<sup>1</sup> *Enhancing Market and Institutional Resilience*, Financial Stability Forum, April 2008, p.37-38.

<sup>2</sup> Second Report to the European Commission on the compliance of credit rating agencies with the IOSCO Code and the role of credit rating agencies in structured finance. May 2008. (CESR/08-277); ESME's Report to the European Commission on the Role of Credit Rating Agencies, 4 June 2008.

<sup>3</sup> FSF in its report recommends: *Authorities should check that the roles that they have assigned to ratings in regulations and supervisory rules are consistent with the objectives of having investors make independent judgment of risks and perform their own due diligence, and that they do not induce uncritical reliance on credit ratings as a substitute for that independent evaluation.*, *Enhancing...*, Financial Stability Forum, April 2008, p.37-38.

## II. References to ratings in the EU financial *acquis* and in industry practices

### 1) *Banking*

The Capital Requirements Directive (CRD)<sup>4</sup> requires banks to have their own sound credit granting criteria and credit decision processes in place. This applies irrespective of whether banks grant loans to customers or whether they incur *securitisation exposures*. Basing credit decisions solely on external credit rating agency ratings does not fulfil this requirement under EU-banking legislation (or the G-10 'Basel 2' requirements for Bank Regulatory Capital).

For the specific purposes of calculating regulatory bank capital requirements, rating agency assessments are, in certain instances, applied as a basis for differentiating capital requirements according to risks, and not for determining the minimum required quantum of capital itself. The CRD framework as a whole provides banks with deliberate and clear incentives to use *internal* rather than external credit ratings even for purposes of calculating regulatory capital requirements. In the specific case of *securitisation exposures* and due to a lack of sufficiently objective internal methodologies within banks, most of them would be expected to calculate their regulatory capital requirements by reference to external ratings.

### 2) *Central banking*

Several central banks take securities as collateral against their lending as part of their Open Market Operations, in the standing lending facility and for intra-day liquidity in their Real Time Gross Settlement systems. The definition of eligible securities includes the requirement that they are issued by an issuer with a satisfactory credit rating(s) from two or more of the leading rating agencies.

### 3) *Insurance*

The existing Insurance and Reinsurance Directives do not contain any provisions which place reliance on credit rating agencies. There is actually no credit risk charge for the solvency margin in the Solvency I framework. However, a number of Member States' national laws implementing the investment rules of the current Solvency I Directives do refer to, or place reliance on, ratings in order to decide whether a certain asset is authorised or eligible to cover technical provisions. Moreover, in a number of Member States (re)insurance undertakings are required, as part of their internal reinsurance policy, to pay special attention to the financial strength of their reinsurers using ratings as a proxy.

The Solvency II Framework Directive proposal<sup>5</sup>, which introduces risk-oriented solvency requirements, addresses credit risk but it does not contain any provisions referring to or placing reliance on credit rating agencies. The precise design of capital requirements, including the counterparty default risk capital charge, will be set out in the future level 2 implementing measures to be developed by end 2010. In the 4<sup>th</sup> Quantitative Impact Study (QIS4) credit ratings have been tentatively used as a proxy for financial strength, but this does not prejudice any final decision as regards the detailed design of capital requirements, which clearly remains an area for further work and consideration.

### 4) *Pensions*

The Institutions for occupational retirement provision (IORP) Directive<sup>6</sup> does not contain any provisions referring or placing reliance on credit rating agencies. A few Members States'

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<sup>4</sup> Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast) (Official Journal L 177, 30.6.2006, p. 1–200).

<sup>5</sup> Amended Proposal for a Directive of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (SOLVENCY II) (recast), COM(2008) 119.

<sup>6</sup> Directive 2003/41/EC of the European Parliament and of the Council of 3 June 2003 on the activities and supervision of institutions for occupational retirement provision

rules and supervisory practices regarding IORPs do make use of credit ratings, for example with respect to investment rules and determination of an appropriate discount rate.

### **5) *Investment funds***

The UCITS Directive (85/611/EEC<sup>7</sup> as amended by Directives 2001/107/EC and 2001/108/EC) does not contain provisions which make reference to credit ratings. However, Commission Directive (2007/16/EC)<sup>8</sup> which clarifies certain definitions used in the UCITS Directive contains 2 references:

1) Article 6 clarifies criteria which can be used to assess the eligibility of non-listed money market instruments which are issued by an "establishment which is subject to, and complies with, prudential rules considered by competent authorities to be as stringent as those laid down by Community law. This provision identifies 4 non-cumulative criteria for concluding that the relevant money market instruments would be eligible for acquisition by a UCITS fund. The third criterion identified is that the issuer of the instrument in question has 'at least investment grade rating.'

2) Article 10 refers to credit ratings in the context of determining whether transferable securities or money market instruments embed a derivative component. This provision is modelled on the definition of an embedded derivative incorporated in International Accounting Standard No. 39. One of several non-cumulative criteria to be used in assessing whether the host security (or money market instrument) embeds a derivative is whether performance of the security (MMI) is sensitive to changes in credit rating of the underlying index or asset.

### **6) *Investment firms***

For the purposes of defining high quality money market instruments that must be held by qualifying money market funds (which are allowed – at par with credit institutions and other eligible entities – to receive on a temporary basis clients funds from an investment firm), Article 18 of the MiFID Implementing Directive<sup>9</sup> makes reference to ratings of these instruments issued by competent CRAs<sup>10</sup>. It requires that these instruments should have been awarded the highest available credit rating by each competent rating agency which has rated that instrument. An instrument that is not rated by any competent rating agency shall not be considered to be of high quality.

### **7) *Private contracts***

Credit ratings are very often referred to in private contracts (e.g. loan contracts, where they are used as a trigger to mandatory debt repayment in case the borrower's creditworthiness deteriorates below a stipulated level) or other arrangements between private parties (e.g. investment mandates to be respected by fund managers, which define the minimum quality of expected investments or collaterals using ratings as a benchmark).

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<sup>7</sup> Council Directive 85/611/EEC of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) OJ L 375, 31.12.1985, p. 3–18.

<sup>8</sup> Commission Directive 2007/16/EC of 19 March 2007 implementing Council Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) as regards the clarification of certain definitions (Official Journal L 79, 20.3.2007, p. 11–19, Official Journal L 56 M, 29.2.2008, p. 134–142).

<sup>9</sup> Commission Directive 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive (Official Journal L 241, 02/09/2006 P. 0026 - 0058)

<sup>10</sup> According to the same article, a rating agency shall be considered to be competent if it issues credit ratings in respect of money market funds regularly and on a professional basis and is an eligible external credit assessment institution (ECAI) within the meaning of Article 81(1) of Directive 2006/48/EC.

### III. What could be the way forward?

Commission services wish to consult on three proposals, which are not necessarily mutually exclusive:

**1) Require regulated and sophisticated investors to rely more on own risk analysis, especially for (relatively) large investments.**

The upcoming COM proposal on CRAs will create the necessary conditions for investors to carry out their own risk assessments. In that regard, CRAs would be required to make public information about their methodologies and models.

In the banking field, the CRD places particular importance on external credit ratings in the context of *securitisation exposures* as outlined above. Therefore, the Commission is already developing concrete measures to make sure that banks look 'beyond' the ratings. If banks fail to do so, they would not be allowed to use the external ratings for regulatory capital calculations and would have to deduct the full securitisation exposure from regulatory capital. Such requirements can be implemented as a comitology measure early next year.

**2) Require that all published ratings include 'health-warnings' informing of the specific risks associated with investments in these assets.**

**3) Examine the regulatory references to CRA ratings and revisit them as necessary.**

This examination would cover the different areas where regulatory references to ratings have been identified in EU financial regulation. As a result, changes would be proposed where these references effectively trigger undue reliance of investors on the ratings (or have the potential to do so). At this point, DG MARKT services are of the view that a one-size-fits-all approach need not necessarily be followed, as ratings are used in different contexts, with varying intensity and for different purposes.

Inasmuch as specific regulatory references to ratings exist at national level, DG MARKT services would also encourage the Member States concerned to take the opportunity of reconsidering their usefulness, in an effort to eliminate instances of unnecessary reliance on the opinions of CRAs.

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## **DG MARKT SERVICES DOCUMENT**

### **I. Introductory remarks**

The purpose of this document is to seek views and useful input from all interested parties on a Directive / Regulation that the European Commission (Commission) intends to propose with respect to the authorisation, operation and supervision of credit rating agencies (CRAs).

CRAs were close to the origin of the problems that have arisen in the professional structured credit markets, notably with respect to the rating of structured instruments in which subprime mortgages were embedded. They gave generally favourable opinions on the creditworthiness of instruments that were financially engineered to offer high confidence to investors. Many investors in these highly sophisticated instruments relied predominantly on the CRAs' expertise and judgements and took little interest in the risk characteristics of these instruments, the performance of the underlying assets or the general market outlook. As massive losses have been announced at large institutions and smaller players alike, and as the credit markets are suffering from a prolonged confidence deficit, with likely negative effects on the real economy and risks for financial stability, it has become imperative to address with due care all aspects of this crisis, including the role played by CRAs.

The policy response currently being developed by the Commission is likely to involve regulatory measures; this follows the manifest failure of self-regulatory efforts, both formal and informal, to ensure high standards of independence, integrity and professional diligence. The ECOFIN Council in July 2008 supported the overall objective of introducing a strengthened oversight regime as well as the principle, envisaged by the Commission, that CRAs should be subject to registration in the EU. In its current work, the Commission aims to ensure, as far as possible, close alignment with international regulatory standards, but where necessary it will consider specific solutions that reflect the particular concerns of European financial markets.

The document consists of two main building blocks:

- substantive requirements to be respected by CRAs; and
- authorisation, supervision and enforcement provisions.

#### *1. Substantive requirements to be respected by CRAs*

Accurate and independent ratings are essential for the proper functioning of the financial markets. CRAs contributed to the recent market turmoil by underestimating the credit risk of structured credit products. Even as the situation in the credit markets started to deteriorate, they failed to reflect early enough in their ratings the worsening of market conditions. The subprime debacle demonstrated that the existing framework for the operation of CRAs needs to be significantly reinforced.

The main objective of the Commission proposal is to ensure that ratings are reliable and accurate pieces of information. It is of the utmost importance to mitigate any negative influence on the ratings resulting from conflicts of interest within CRAs, low standards of quality in the ratings and lack of transparency of the agencies. The objective is to address

systematically the risks arising from these three areas. Thus, the objectives of the proposal from the Commission are the following:

- ensure that CRAs avoid and manage appropriately any conflict of interest.
- ensure that CRAs apply a high standard for the quality of the rating methodology and the ratings.
- increase the transparency of the CRAs.

This consultation paper suggests the adoption of a set of rules introducing a number of substantive requirements that CRAs will need to respect for the authorisation and exercise of rating activity. These substantive requirements cover issues related to the organisational structure and internal governance of credit rating agencies, the avoidance and management of conflicts of interest, the quality of ratings and transparency obligations. They do not interfere with the content of ratings, for which the CRAs retain full responsibility.

These draft provisions take due consideration of discussions that have taken place since September 2007 in a number of fora. More specifically, the Commission requested last year the advice of the Committee of European Securities Regulators (CESR) and the European Securities Markets Expert Group (ESME)<sup>1</sup> on the various aspects of CRAs' activity and their role in the financial markets, especially in structured finance. In addition, the reports by the International Organisation of Securities Commissions (IOSCO), the Financial Stability Forum and the Committee on the Global Financial System have been carefully considered – and to a large extent inspired these draft provisions.

## *2. Authorisation, supervision and enforcement*

Credit ratings go beyond the traditional concept of a service and the bilateral relationship between a financial institution and a client, as credit ratings are used by an indefinite number of possible addressees on the entire EU territory. In addition, the rating activity that is used for regulatory purposes e.g. risk assessment by financial institutions is concentrated among a very small number of players in the EU. The draft Directive / Regulation will need to provide for an authorisation and supervision process which is adapted to the specificities of the rating activity. The main elements of such a system could be:

- **Authorisation:** the Directive / Regulation should create a one-stop-shop system for CRAs that wish to operate within the EU. This can only be achieved if a single body is competent for the authorisation. At this stage there is no unitary supervisory structure at EU level. A central or coordinating role could be played by CESR in its present form or in the form of an Agency, or by a Community Agency. The ultimate objective of such a mechanism would be, in both cases, to avoid "forum shopping" and the creation of a level playing field among the various EU jurisdictions.

- **Supervision and enforcement:** strong coordination among national regulators will be needed to ensure an efficient supervision and sanctioning system in Europe inspired by a partnership culture between national regulators operating in a network of regulators where CESR or the Agency could play an important role. The objective is to increase the convergence of supervisory and sanctioning practices. Convergence could be enhanced

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<sup>1</sup> Delivered respectively on 13 May and 4 June.



notably through strong cooperation and information exchange mechanisms, including possibly the creation of "colleges of supervisors".

For the purposes of this consultation, DG MARKT services present two different options on both the authorisation procedure and the supervisory structure. The main content of these options is described below. The relevant Articles of the draft Directive / Regulation will be developed after having received comments on the proposals outlined hereafter. No specific draft legal provisions have yet been developed with regard to the two options. The provisions of Chapters I and III will thus need to be further modified / supplemented accordingly. Depending on the options chosen, further provisions will need to be introduced to detail respectively the role of CESR or the composition and functioning of an Agency.

## **II. Options related to the authorisation process and the supervisory architecture**

***Option 1:** National authorisation and supervision process – strong coordination through CESR with compulsory involvement of other competent authorities*

- **Authorisation process:** Option 1 would give a key role to CESR) in the authorisation procedure. A CRA would submit its application to CESR. CESR's members would agree on a national supervisor to be the home Member State competent authority responsible for deciding on the authorisation request and for supervising the applicant CRA. The designation of the home Member State competent authority would be based on certain criteria related to the particular circumstances pertaining to the applicant's actual and planned activities, including the place where the applicant credit rating agency carries out or is planning to carry out the most important part or a significant part of its rating activity inside the Community. However, other factors could also be considered for designation of the home Member State competent authority, including the place where the CRA has a registered office or a principal branch.

Strong coordination with and involvement of other competent authorities in the authorisation process, together with the consultation by CESR, would facilitate a coherent application of the common rules, a consistent treatment of CRAs within the EU and a common supervisory culture. The authorisation would be granted by the designated home Member State competent authority and would be valid for the entire territory of the Community.

- **Supervision and enforcement:** Under this option, supervisory authorities in the Member States would supervise CRAs, with strong coordination by CESR. In this framework, the home Member State competent authority would have the main responsibility in supervising a specific CRA and to take supervisory measures and apply sanctions, when necessary. The home Member State competent authority would be in charge of duly informing and consulting the other competent authorities concerned, which would assist the home Member State competent authority in carrying out supervision.

The designation of a home competent authority does not imply that the other competent authorities in other EU Member States lose their power of intervention. Taking into consideration that ratings issued by a CRA can be used by financial institutions in the entire EU territory, strong supervision and where necessary intervention by other competent authorities would remain possible to avoid any malfunctioning of the system. This would be the case notably when problems related

to the use of a rating occur in the territories of the other Member States. Also, in the case of a lack of, or ineffective, action by the home Member State competent authority, other competent authorities would retain the competence and right to take action, notably in order to protect interests on the territory of their Member State.

The convergence of supervisory and enforcement practices could be guaranteed by CESR if necessary by the establishment of a mediation mechanism. CESR would provide advice to competent authorities.

Moreover, competent authorities in the Member States should be allowed to delegate specific tasks to other competent authorities. CESR would establish an effective network between all national authorities for their supervisory co-operation in order to strengthen the day-to-day exercise of supervisory and enforcement duties across the EU.

In addition, close cooperation, possibly through the creation of colleges of supervisors, could be envisaged in case the same group comprises a number of subsidiaries located in different EU Member States.

***Option 2: Community authorisation via an Agency combined with supervision by national regulators***

- **Creation of a Community Agency:** This option would envisage the establishment of a Community Agency (CESR or a new Agency) financed from the EU budget and with its own legal personality. The Agency would be responsible for the authorisation process. Member State competent authorities would remain responsible for the supervision of the CRAs..
- **Authorisation process:** CRAs would submit their application for authorisation to the Agency. The Agency would decide, after examination of the authorisation request, on the granting of an authorisation or the refusal. The Agency would also designate the home Member State competent authority responsible for supervising the applicant CRA. In order to designate the home Member State competent authority, the Agency would take into account the particular circumstances pertaining to the applicant's actual and planned activities, including the place where the applicant CRA carries out or is planning to carry out the most important part or a significant part of its rating activity inside the Community, as well as other aspects including the place where the credit rating agency has a registered office or a principal branch. The Agency would be responsible for withdrawing authorisations granted to CRAs.
- **Supervision and enforcement:** Under this second option, the competence for supervising and sanctioning the activities of CRAs would remain with the national regulators. The same cooperation and convergence considerations detailed above under Option 1 are also valid under this option. In addition, the Community Agency responsible for authorising CRAs would coordinate the activities of competent authorities, ensure uniform application of the rules, give advice to Member States on supervisory issues and have the power to intervene if competent authorities disagree on supervisory measures.

For the sake of coherence and efficiency, the Agency would have the power to intervene in the event that national competent authorities fail to cooperate effectively or even take a

decision in case national regulators fail to adopt a decision. Moreover, taking into consideration that this Agency would have its own legal personality, certain tasks or even responsibilities could be transferred from national regulators to the Agency, through the delegation of tasks or responsibilities.

### III. Draft Directive / Regulation

Proposal for a

## **DIRECTIVE / REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL**

### **on Credit Rating Agencies**

THE EUROPEAN PARLIAMENT AND THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article [ ] thereof,

Having regard to the proposal from the Commission<sup>2</sup>,

Having regard to the opinion of the European Economic and Social Committee<sup>3</sup>,

Having regard to the opinion of the Committee of the Regions<sup>4</sup>,

Acting in accordance with the procedure laid down in Article 251 of the Treaty<sup>5</sup>,

Whereas:

- (1) Credit rating agencies play a vital role in global securities and banking markets, because their ratings are used by investors, borrowers, issuers and governments to make informed investment and financing decisions. Moreover, several Community Directives, such as the Capital Requirements Directive<sup>6</sup>, Markets in Financial Instruments Directive<sup>7</sup>, Directive on undertakings for collective investment in transferable securities (UCITS)<sup>8</sup>, Directive on institutions for occupational retirement provision<sup>9</sup>, Solvency II envisage that credit institutions, investment firms, collective investment schemes, pensions funds and insurance and assurance undertakings may use the ratings as the reference for the calculation of their capital requirements for solvency purposes

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<sup>2</sup> OJ C [...], [...], p. [...].

<sup>3</sup> OJ C [...], [...], p. [...].

<sup>4</sup> OJ C [...], [...], p. [...].

<sup>5</sup> OJ C [...], [...], p. [...].

<sup>6</sup> Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions OJ L 177, 30.6.2006, p. 1

<sup>7</sup> Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 OJ L 145, 30.4.2004, p.1, as amended

Directive 85/611/EEC of the European Council of 12 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities, OJ L375, 31.12.1985, p. 3, as amended [ new Directive 2009/XX/EC recast].

<sup>9</sup> Directive 2003/41/EC of the European Parliament and of the Council of 3 June 2003 on the activities and supervision of institutions for occupational retirement provision, OJ L 235, 23.9.2003, p. 10

or for calculating risks in their investment activity. It is essential, therefore, that credit rating agencies consistently provide ratings which are independent, objective and of the highest possible quality. Nonetheless, those using credit ratings for their investment decisions should take utmost care to perform own analysis and conduct due diligence regarding their reliance on such credit ratings.

- (2) In 2006, the European Commission issued a Communication on Credit Rating Agencies<sup>10</sup>, wherein it concluded that various financial services directives, and notably the Market Abuse<sup>11</sup> and Capital Requirements Directives, combined with self regulation by the credit rating agencies on the basis of the International Organisation of Securities Commissions (IOSCO) Code of Conduct Fundamentals for credit rating agencies, could provide an answer to the major issues of concern in relation to credit rating agencies. It was stated that this approach would require continuous monitoring of developments in this area by the European Commission. In addition, the European Commission asked the Committee of European Securities Regulators to monitor compliance with the IOSCO Code and report back on an annual basis. The annual monitoring report produced by the Committee of European Securities Regulators is presently the only mechanism available in order to control the credit rating agencies' compliance with the IOSCO Code.
- (3) The European Council of 13 and 14 March 2008 agreed to a set of conclusions to respond to the main weaknesses identified in the financial system. One of the objectives was to improve market functioning and incentive structures, including the role of credit rating agencies. The credit rating agencies are considered to have failed to reflect early enough in their credit ratings the worsening market conditions. This failure in credit rating agencies can be best corrected by measures related to conflicts of interest, the quality of the credit ratings, the transparency of the credit rating agencies, their internal governance and, finally, an effective oversight/supervision of the activities, processes and performance of the credit rating agencies. To this end, it is necessary to provide for a legal framework which ensures that credit rating agencies consistently provide ratings which are independent, objective and of the highest possible quality.
- (4) The activity of credit rating agencies whose credit ratings are to be used by credit institutions, investment firms, insurance and assurance undertakings, collective investment schemes and pension funds in order to comply with the provisions of Community legislation should be subject to prior authorisation. It is therefore necessary to lay down the conditions and the procedure for the granting of that authorisation as well as for its withdrawal.
- (5) Credit rating agencies should limit their activity to the business of credit ratings and related operations. This should not prevent a credit rating agency from carrying on ancillary services such as the provision of pricing analysis for structured finance securities that do not have a liquid market or rating

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<sup>10</sup> OJ C59, 11.3.2006, p. 2.

<sup>11</sup> Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation OJ L 96, 12.4.2003, p. 16

assessment services, where credit rating agencies provide issuers with the likely impact on a rating of hypothetical events, for instance a merger between two corporations.

- (6) A credit rating agency should not be allowed to carry out consultancy or advisory services, such as making proposals or recommendations, either formal or informal, regarding the design of a structured finance instrument.
- (7) In order for credit rating agencies to meet their commitments with regard to this Directive / Regulation, they should establish adequate internal policies and procedures to insulate those involved in the credit rating process from conflicts of interest and to ensure at all times the quality, integrity and thoroughness of the rating and review process.
- (8) It is necessary that credit rating agencies avoid situations of conflicts of interest or manage adequately these conflicts when they are unavoidable in order to ensure their independence. Credit rating agencies should disclose conflicts of interest in a complete, timely, clear, concise, specific and prominent manner. They should also keep record of all significant threats to the rating agency's independence and that of its employees involved in the credit rating process, as well as the safeguards applied to mitigate those threats.
- (9) It is necessary that a credit rating agency allocates a sufficient number of employees with appropriate knowledge and experience to its credit rating activity. In particular, the credit rating agency should ensure that adequate personnel and financial resources are allocated to monitoring and updating its ratings. The delegation of the monitoring function to non-skilled employees should not be allowed.
- (10) Appropriate rotation arrangements should be put in place for analysts and persons approving credit ratings to avoid that they develop long lasting relationships with the same rated entities, which could compromise their independence.
- (11) The compensation arrangements of employees involved in the rating process should be determined primarily by the quality, accuracy, thoroughness and integrity of their work. Compensation arrangements should be appropriate to ensure independence and avoid conflicts of interest.
- (12) It is necessary that the information a rating agency uses in assigning a rating is of appropriate quality to support a robust rating. For this purpose, a credit rating agency may envisage, among other elements, reliance on independently audited financial statements and public disclosures; verification by reputable third party services; random sampling examination by the credit rating agency of the information received; or contractual provisions clearly stipulating liability for the rated entity or its related third parties, if the information provided under the contract is knowingly materially false or misleading or if the rated entity or its related third parties fail to conduct reasonable due diligence regarding the accuracy of the information as specified under the terms of the contract. In this last case, such contractual provisions should only be relied upon where the party to the contract taking on or underwriting the

liability can demonstrate that it has the financial strength to honour the actual or contingent liabilities that may arise thereunder.

- (13) It is necessary that methodologies and models used by the credit rating agency are regularly reviewed in order to be able to properly reflect the changing conditions in the underlying asset markets. With a view to ensuring transparency, disclosure of any material modification to the credit rating agency's methodologies and significant practices, procedures and processes should be made prior to their coming into effect, unless extreme market conditions require an immediate change in the credit rating.
- (14) The credit rating agency should indicate any appropriate risk warning, including sensitivity analysis of the relevant assumptions, such as explaining how various market developments that move the parameters built into the model may influence the credit rating changes (e.g. volatility). The credit rating agency should ensure that the information on historical default rates of its rating categories is verifiable and quantifiable and provides a sufficient basis for interested parties to understand the historical performance of each rating category and if and how rating categories have changed. If the nature of the credit rating or other circumstances make a historical default rate inappropriate, statistically invalid, or otherwise likely to mislead the users of the rating, the credit rating agency should provide appropriate clarifications. This information should, to the extent possible, be comparable with any existing industry patterns in order to assist investors in drawing performance comparisons between different credit rating agencies.
- (15) It is necessary to make a clear distinction between credit ratings of structured finance instruments and other credit ratings.
- (16) For the publication of all available ratings and historical performance, guidance on common standards should be issued in order to facilitate the use of the same metrics by credit rating agencies to present data about their past performance. Those common standards should include in particular the requirement for publication of default and related grade migration statistics, which take into account defaults on issues that were rated by the rating agency but that have ceased to be so, rated prior to the originally scheduled maturity of the relevant issues, but where those previously rated issue or issues have gone into default within four years of such cessation of rating. Upon issuing a rating, a credit rating agency should have entered into contractual terms with the issuer under which the issuer is obliged, following a payment default under the terms of the issue or issues, to inform the credit rating agency of such default immediately, where such default occurs, within a four year period after the issue has ceased to be rated by that credit rating agency. Such default should be included in the biannual presentations of default and grade migration statistics.
- (17) A credit rating agency should keep and regularly update a record of the methodology of a rating and its changes and of the elements of the dialogue between the analyst and the rated entity or its related third parties, for a period of at least three years. In particular, all substantial elements of the dialogue with the client that precede the credit rating shall be recorded.

- (18) It is appropriate that a publicly available central repository of credit ratings is created in order to facilitate the comparability of the performance of the credit rating agencies.
- (19) Credit rating agencies should retain the records demanded by this Directive / Regulation in a medium that allows the storage of information in a way accessible for future reference by the competent authorities, and preferably in a durable medium, as referred in Commission Directive 2006/73/EC.
- (20) It is appropriate to create a mechanism to ensure the effective enforcement of the provisions of this Directive / Regulation. The supervisory authorities of the Member States should have at their disposal all means necessary to ensure the respect of this Directive / Regulation by credit rating agencies throughout the Community whether they carry out their activity under the right of establishment or the freedom to provide services. In order to ensure the effectiveness of the supervision all actions taken by the supervisory authorities should be proportionate to the nature and the complexity of the risks inherent to the business of a credit rating agency.
- (21) For the efficiency of supervision it is necessary to envisage close coordination between the competent authorities concerned with the activity of a credit rating agency.
- (22) In case the agreed home Member State competent authority does not take the necessary action in order to eliminate irregularities committed by a rating agency whose authorisation and supervision it has been entrusted with, other competent authorities should retain the right to intervene and take appropriate action, in case the irregularity affects entities using its ratings in their Member State.
- (23) Delegation of tasks is not intended to affect the final responsibility of the designated competent authority.
- (24) In order to limit the administrative burden and avoid duplication of tasks, supervisory authorities should cooperate and exchange information.
- (25) It is necessary to enhance convergence of powers at the disposal of competent authorities so as to pave the way towards an equivalent intensity of enforcement across the integrated financial market. A common set of powers coupled with adequate resources should guarantee supervisory effectiveness.
- (26) Competent authorities under Directive 2006/48/EC should only consider credit rating agencies authorised under this Directive / Regulation as satisfying the requirements for External Credit Assessment Institutions (ECAIs).

HAVE ADOPTED THIS DIRECTIVE / REGULATION:



## **TITLE I**

### **SUBJECT MATTER AND DEFINITIONS**

#### *Article 1*

##### **Scope**

This Directive / Regulation lays down specific rules concerning the authorisation, conduct of business and supervision of credit rating agencies providing credit ratings for the use by credit institutions as defined by Directive 2006/48/EC<sup>12</sup>, investments firms as defined by Directive 2004/39/EC<sup>13</sup>, insurance and assurance undertakings as defined by Directive 73/239/EEC<sup>14</sup> and Directive 2002/83/EC<sup>15</sup>, collective investment schemes as defined by Directive 2009/XX/EC<sup>16</sup> and pension funds as defined by Directive 2003/41/EC<sup>17</sup> in order to comply with their obligations under the relevant Community legislation.

#### *Article 2*

##### **Definitions**

1. For the purpose of this Directive / Regulation, the following definitions shall apply:
  - (1) "Credit rating" means an opinion regarding the creditworthiness of an entity, a credit commitment, a debt or debt-like financial instrument or an issuer of such obligations, issued using an established and defined ranking system of rating categories. Credit ratings shall not be considered recommendations in the meaning of Article 1 (3) of Directive 2003/125/EC.
  - (2) "Credit rating agency" means any legal person whose regular and principal occupation is the issuance of credit ratings.
  - (3) "Ancillary services" means a service other than issuance of credit ratings that may be provided by the credit rating agency, in line with a specific definition developed and made public by the credit rating agency further to Article 10(4) of this Directive / Regulation.
  - (4) "Consultancy and advisory services" means investment advice as defined by Article 4(1) point 4 of Directive 2004/39/EC and the service of making proposals on the design of a structured finance instrument.
  - (5) "Analyst" means a person who performs analytical functions that are critical for the issuance of a credit rating.

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<sup>12</sup> OJ L 177, 30.6.2006, p. 1.

<sup>13</sup> OJ L 145, 30.4.2004, p. 1.

<sup>14</sup> OJ L 228, 16.8.1973, p. 3.

<sup>15</sup> OJ L 345, 19.12.2002, p. 1.

<sup>16</sup> Recast

<sup>17</sup> OJ L 235, 23.9.2003, p. 10.

- (6) "Rated entity" means a legal person the creditworthiness of which is explicitly or implicitly being opined on in the credit rating. This person does not necessarily have to be the same person that has solicited the credit rating or is expected to provide information to the credit rating agency.
- (7) "Rating category" means a rating symbol, such as a letter symbol, a numerical symbol or appending identifying characters to ratings scales, used for identifying different credit ratings for each class of credit ratings in order to distinguish the different risk characteristics of the different types of rated entities, issuers and financial instruments.
- (8) "Persons who effectively direct the business" means the senior management as defined in Article 2(9) of Commission Directive 2006/73/EC<sup>18</sup>.
- (9) "Related third party" means, as appropriate, the originator, arranger, sponsor, servicer or any other party that may interact with a credit rating agency on behalf of or for the account of a rated entity, including any person directly or indirectly linked to it by control.
- (10) "Financial instruments" means any of the instruments listed in Section C of Annex I of Directive 2004/39/EC.
- (11) "Structured finance instrument" means an instrument resulting from a securitisation transaction or scheme referred to in Article 4 point 36 of Directive 2006/48/EC.
- (12) "Competent authority" means the authority, designated by each Member State in accordance with Article 19.
- (13) "Home Member State competent authority" means the competent authority responsible for the supervision of the credit rating agency.
- (14) "Branch" means a place of business other than the head office which is a part of a credit rating agency, which has no legal personality and which provides credit rating services; all the places of business set up in the same Member State by a credit rating agency with headquarters in another Member State or in a third country shall be regarded as a single branch.

## **TITLE II**

### **AUTHORISATION AND OPERATING CONDITIONS FOR CREDIT RATING AGENCIES**

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<sup>18</sup> OJ L 241, 2.9.2006, p.26.

## **CHAPTER I PROCEDURE FOR AUTHORISATION**

### *Article 3*

#### **Requirement for authorisation**

*(to be adapted following the option chosen with respect to the supervisory architecture)*

1. Credit rating agencies whose principal business is the issuance of credit ratings, on a professional basis, to be used for the purposes specified in Article 1, shall be subject to prior authorisation in accordance with the provisions of this Directive / Regulation. The authorisation shall be valid for the entire territory of the Community.
2. An authorised credit rating agency shall comply at all times with the conditions for initial authorisation.

Credit rating agencies shall notify the home Member State competent authority of any material changes to the conditions for initial authorisation.

3. Credit rating agencies whose headquarters are located outside the Community shall establish a subsidiary or a branch in the Community for the purposes of performing the activity referred to in paragraph 1 and ask for an authorisation to operate in the Community through the subsidiary or the branch.

### *Article 4*

#### **Freedom to provide services and establishment of branches**

Without prejudice to the measures that other competent authorities can take as referred to in Article 22, credit rating agencies authorised and supervised by the home Member State competent authority in accordance with Article 5, may freely issue credit ratings within the territory of the Community. Authorised credit rating agencies may also provide their activities within the territory of Member States, in accordance with this Directive / Regulation, through the establishment of branches. The home Member State competent authority or the other competent authorities shall not impose any additional requirements on a credit rating agency in respect of the matters covered by this Directive / Regulation.

### *Article 5*

#### **Procedure for granting and refusing requests for authorisation**

*(to be drafted following the option chosen with respect to the supervisory architecture)*

### *Article 6*

#### **Withdrawal of authorisations**

(to be drafted following the option chosen with respect to the supervisory architecture)

## **CHAPTER II**

### **ORGANISATIONAL REQUIREMENTS AND OPERATING CONDITIONS**

#### *Article 7*

##### **Persons who effectively direct the business**

1. The persons who effectively direct the business of a credit rating agency shall be of good repute and sufficiently experienced to ensure the sound and prudent management of the credit rating agency.
2. The home Member State competent authority shall verify that the non-executive members of the administrative board or the members of the supervisory board shall in their majority have sufficient experience in understanding credit risk and relevant modelling sensitivity analysis techniques across the range of investments and credit structures that fall within the scope of activity of the credit rating agency. Their remuneration shall be linked to their experience and skill and to the contribution they make and are contractually expected to make to the supervision, quality, accuracy and integrity of the rating process and activity and not to the growth in earnings or share price of the credit rating agency. Their term of office, which shall be for a pre-agreed fixed period, shall not be renewable.

#### *Article 8*

##### **Organisational requirements and internal policies**

1. A credit rating agency shall establish adequate policies and procedures sufficient to ensure compliance of the credit rating agency, including of its managers and employees with its obligations under this Directive / Regulation. A credit rating agency shall have sound administrative and accounting procedures, internal control mechanisms, effective procedures for risk assessment, and effective control and safeguard arrangements for information processing systems.
2. A credit rating agency shall maintain and operate effective organisational and administrative arrangements in order to identify, prevent or manage conflicts of interest as defined in Article 9.
3. A credit rating agency shall employ appropriate and proportionate systems, resources and procedures to ensure continuity and regularity in the performance of its credit rating activities.
4. A credit rating agency shall establish a review function responsible for periodically reviewing the methodologies, models and significant changes to methodologies and models it uses, as well as the appropriateness of those methodologies and models for the assessment of new financial instruments. This review function must be independent of the business lines which are responsible for credit rating activities

and report to the independent committee of the administrative or supervisory board referred to in paragraph 5 of this Article.

5. A credit rating agency shall have a dedicated independent committee of the administrative or supervisory board which shall monitor the development of the credit rating policy, effectiveness of the credit rating agency's internal quality control system on the credit rating process and compliance and governance processes including efficiency of the review function. This committee shall be composed exclusively of non-executive members of the administrative board or of members of the supervisory board.
6. A credit rating agency shall monitor and, on a regular basis, evaluate the adequacy and effectiveness of its systems, internal control mechanisms and arrangements established in accordance with this Directive / Regulation and to take appropriate measures to address any deficiencies.

### *Article 9*

#### **Identification, management and disclosure of conflicts of interest**

1. A credit rating agency shall take all reasonable steps, including compliance with the requirements set out in Annex II, Section A, to ensure that any credit rating it issues shall not be affected by any existing or potential conflict of interest or business relationship involving itself, its managers, employees or any person directly or indirectly linked to it by control.
2. A credit rating agency shall (i) identify, and (ii) eliminate, or manage and disclose, as appropriate, any actual or potential conflicts of interest that may influence the analyses and judgments of its analysts that participate in determining a credit rating and persons approving credit ratings.
3. A credit rating agency shall not issue a rating or shall withdraw an existing credit rating in the following situations:
  - a) the credit rating is issued or maintained in respect of an entity or any of its related third parties from which the credit rating agency receives 5 percent or more of its annual revenue from the issuance of credit ratings ,
  - b) the credit rating agency, an analyst that participated in determining a credit rating, or person approving the credit ratings, directly or indirectly owns financial instruments of, or has any other direct or indirect ownership interest in, the rated entity or any related third party,
  - c) the credit rating is issued or maintained with respect to a rated entity or any related third party directly or indirectly linked to the credit rating agency by control,
  - d) an analyst who participated in determining a credit rating, or person approving the credit rating is a member of the administrative, management or supervisory bodies of the rated entity or any related third party.
4. A credit rating agency shall not provide consultancy or advisory services.

A credit rating agency shall define what it considers services ancillary to its core credit rating activities. It shall ensure that the provision of ancillary services does not present conflicts of interest with its credit rating activity.

5. A rating agency shall have necessary procedures and mechanisms to ensure that analysts do not make proposals or recommendations, either formally or informally, regarding the design of structured finance instruments that the credit rating agency is expected to issue a credit rating on.
6. Reporting and communication channels between the analysts and persons approving the credit ratings and other parts of the credit rating agency representing the commercial interests of the entity shall be designed in a way to ensure independence of the analysts and persons approving the credit ratings.

#### *Article 10*

##### **Employees**

1. A credit rating agency shall ensure that employees directly involved in the credit rating process have appropriate knowledge and experience for the duties assigned.
2. Employees who are directly involved in the credit rating process shall not be allowed to initiate, or participate in, discussions regarding fees or payments with any rated entity or any person directly or indirectly linked to the rated entity by control.
3. A credit rating agency shall ensure that employees who are directly involved in the credit rating process meet the requirements set out in Annex II, Section A.

Annex II, Section A shall be adapted by the Commission, acting in accordance with the procedure referred to in Article 28(2), in light of technical developments and to ensure its uniform application.

4. A credit rating agency shall ensure that analysts and persons approving credit ratings shall not be involved in providing the credit rating services to the same rated entity or its related third parties for a period exceeding four years. The period after which the analysts and persons approving credit ratings may again be involved in providing the credit rating services to the same rated entity or its related third parties may not be shorter than two years.

#### *Article 11*

##### **Compensation arrangements**

A credit rating agency shall design and enact compensation policies for analysts and persons approving the credit ratings in a way that does not make their compensation or performance evaluation contingent on the amount of revenue that the credit rating agency derives from the rated entities or related third parties that the analyst or persons approving the credit ratings rates or regularly interacts with.

### **Rating methodologies**

1. A credit rating agency shall use rating methodologies that are rigorous, systematic, and continuous and result in ratings that may be subject to validation based on historical experience. Analysts shall apply those methodologies in a consistent manner.

A credit rating agency shall disclose to the public the methodologies, models and key rating assumptions it employs in the rating process.

A credit rating agency shall ensure that the credit ratings it produces and disseminates are based on an analysis of all information available to it that is of relevance according to its published rating methodologies. It shall ensure that the information it uses in assigning a credit rating is of sufficient quality to support a credible credit rating.

2. Where a credit rating agency has relied on an existing credit rating or ratings by another credit rating agency with respect to underlying assets or structured finance instruments it:
  - a) shall not refuse to issue a credit rating of a financial instrument justifying its decision on the fact that a portion of the financial instrument had been previously rated by another credit rating agency;
  - b) shall duly record all instances of downgrading these underlying credit ratings in its credit rating process together with a comprehensive justification for the downgrades effected.
3. A credit rating agency shall monitor credit ratings on an ongoing basis, except for credit ratings that clearly indicate that they do not entail ongoing surveillance, and if necessary it shall review credit ratings issued. A credit rating agency shall be responsive to changes in financial conditions.
4. A credit rating agency shall ensure that methodologies, models and key rating assumptions used for determining credit ratings are properly maintained, up-to-date and subject to a comprehensive review at least once a year, to reflect any material changes to the risk characteristics of the rated entities or of the structured finance instruments.
5. A credit rating agency shall ensure that whenever rating methodologies, models or key rating assumptions are changed they shall:
  - immediately disclose, through the same channel which was used for the distributions of those credit ratings, the likely scope of credit ratings to be affected and commit to review all these credit ratings as soon as possible, in any event not later than 6 months, and in the meantime place those ratings under observation stipulating whether the review following the observation period is likely to have positive or negative implications for the current credit rating.

- re-rate all credit ratings that have been based on these methodologies, models or assumptions.

### *Article 13*

#### **Limits to the credit rating activity**

In cases where the lack of robust data or the complexity of a structure of a new type, and notably in the case of structured finance instruments, raise serious questions as to whether the credit rating agency can produce a credible credit rating, the credit rating agency shall refrain from issuing a credit rating or withdraw an existing credit rating.

### *Article 14*

#### **Obligations in relation to the disclosure and presentation of credit ratings**

1. A credit rating agency shall disclose any credit rating, as well as any subsequent decisions to discontinue such a credit rating, on a non-selective basis and in a timely manner.
2. When presenting a credit rating, a credit rating shall meet the requirements set out in Annex II, Section B.

Annex II, Section B shall be adapted by the Commission, acting in accordance with the procedure referred to in Article 28(2), in light of technical developments and to ensure its uniform application.

3. A credit rating agency shall ensure that rating categories that may be attributed to structured finance instruments are clearly differentiated from rating categories that may be used to rate other financial instruments.

### *Article 15*

#### **General and periodic disclosures**

1. A credit rating agency shall fully and publicly disclose and update without delay whenever there is a change, the information set out in Annex II, Section C, Part I.

A credit rating agency shall periodically disclose the information set out in Annex II, Section C, Part II, points 1. and 2.

Annex II, Section C shall be adapted by the Commission, acting in accordance with the procedure referred to in Article 28(2), in light of technical developments and to ensure its uniform application.

2. Credit rating agencies shall make available in a repository open to the public all credit ratings and historical performance data.
3. A credit rating agency shall make available annually to the independent committee of the supervisory or administrative board of the credit rating agency, to the home



Member State competent authority and, when requested, to the Committee of European Securities Regulators, the information set out in Annex II, Section C, Part II, point 3. Such information shall be kept confidential by the recipients.

#### *Article 16*

##### **Transparency report**

1. A credit rating agency shall publish annually a transparency report which should include, at least, the information set out in Annex II, Section C, Part III.

The credit rating agency shall make public its annual report at the latest three months after the end of each financial year and shall ensure that it remains publicly available on the company's website for at least five years.

2. Where a credit rating agency has adhered to one or several codes of conduct establishing operational best practices, it must disclose those codes of conduct to the public.

#### *Article 17*

##### **Record-keeping obligations**

1. A credit rating agency shall arrange for adequate records to be kept of all its activities undertaken, including records of all significant elements of the dialogue with the rated entity and its related third parties, and in relation to the obligations referred to in Articles 9 and 12. Those records shall be kept internally for at least three years and where necessary be made available to the competent authority to ensure monitoring compliance with the requirements of this Directive / Regulation, and notably, to allow for inspections of the credit rating agency.

Following the termination of the authorisation of a credit rating agency, the firm shall retain records for three years or such longer period as may be required by the national legislation of the home Member State.

2. Records which set out the respective rights and obligations of the credit rating agency and the rated entity or its related third parties under an agreement to provide services shall be retained for at least the duration of the relationship with that rated entity or its related third parties.

### **TITLE III COMPETENT AUTHORITIES**

## CHAPTER I

### DESIGNATION AND POWERS OF COMPETENT AUTHORITIES

#### *Article 18*

##### **Supervisory structure**

(to be drafted following the option chosen with respect to the supervisory architecture)

#### *Article 19*

##### **Designation of competent authorities**

*(to be adapted following the option chosen with respect to the supervisory architecture)*

Each Member State shall designate a competent authority to carry out the duties provided for under the different provisions of this Directive / Regulation and notably to authorise, supervise and, if appropriate, impose sanctions on credit rating agencies according to Articles 3, 5 and 24. The competent authority shall be a single public authority adequately staffed in order to perform its duties with regard to the obligations established by this Directive / Regulation. Member States shall inform the Commission and the competent authorities of other Member States of the designation of the competent authority responsible for enforcement of those duties at the latest within six months after adoption of this Directive / Regulation.

Each Member State shall ensure that the mandates of competent authorities include a Community dimension. The mandates shall in particular include the objective to promote supervisory convergence in respect of supervisory tools and practices when complying with this Directive / Regulation. Competent authorities shall participate and work together constructively in the activities of the Committee of European Securities Regulators.

#### *Article 20*

##### **Powers to be made available to competent authorities**

*(to be adapted following the option chosen with respect to the supervisory architecture)*

1. In order to fulfil their duties competent authorities shall have all the supervisory and investigatory powers that are necessary for the exercise of their functions. Within the limits provided for in their national legal frameworks competent authorities shall exercise their powers:
  - (a) directly; or
  - (b) in collaboration with other authorities; or
  - (c) by application to the competent judicial authorities.

2. The supervisory and investigatory powers referred to in paragraph 1 shall be exercised in conformity with national law but shall include at least the rights to:
- (a) have access to any document in any form whatsoever and to receive a copy of it;
  - (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;
  - (d) require existing telephone and existing data traffic records.

#### *Article 21*

#### **Sanctions**

*(to be adapted following the option chosen with respect to the supervisory architecture)*

1. The home Member State competent authority, at its own initiative or at the request of any other competent authority, may impose sanctions where the provisions of this Directive / Regulation have not been complied with. The competent authorities shall ensure that these sanctions are effective, proportionate and dissuasive. These powers to impose sanctions shall include the right to:
- (a) impose, with effect throughout the Community, the withdrawal of the authorisation granted to a credit rating agency in accordance with the provisions of this Directive / Regulation;
  - (b) require the cessation of any practice that is contrary to the provisions of this Directive / Regulation;
  - (c) impose temporary prohibition of professional activity, with effect throughout the Community;
  - (d) impose suspension of authorisation, with effect throughout the Community;
  - (e) adopt appropriate measures to ensure that credit rating agencies continue to comply with legal requirements;
  - (f) issue public warnings when a credit rating agency or a third person breaches the obligations set out in this Directive / Regulation;
  - (g) refer matters for criminal prosecution.
2. In case of inaction or ineffective action by the home Member State competent authority, the other competent authorities may act for their territory in accordance with Article 22 and take the sanctions set out in paragraph 1 of this Article, except for letters a) and d). 3. Each Member State shall ensure that appropriate and dissuasive sanctions are put in place in national legislation in case of gross malpractice or lack of due diligence by the credit rating agencies.

## Article 22

### **Action by competent authorities other than the home Member State competent authority**

*(to be adapted following the option chosen with respect to the supervisory architecture)*

Where the competent authority of a Member State has grounds for believing that a credit rating agency acting within its territory is in breach of the obligations arising from the provisions of this Directive / Regulation, it shall inform the home Member State competent authority.

If the home Member State competent authority refuses to act or if, despite the measures taken by the home Member State competent authority, such measures prove inadequate and the credit rating agency persists in acting in a manner that is clearly prejudicial to the interests of the Member State's investors or the orderly functioning of markets, the competent authority of that Member State, after informing the home Member State competent authority may take all appropriate measures necessary in order to protect investors and the proper functioning of its markets.

## **CHAPTER II**

### **COOPERATION BETWEEN COMPETENT AUTHORITIES OF DIFFERENT MEMBER STATES**

## Article 23

### **Obligation to cooperate**

*(to be adapted following the option chosen with respect to the supervisory architecture)*

1. Competent authorities of different Member States shall cooperate with each other whenever necessary for the purpose of carrying out their duties under this Directive / Regulation, making use of their powers whether set out in this Directive / Regulation or in national law.

Competent authorities shall render assistance to competent authorities of the other Member States. In particular, they shall exchange information and cooperate in any investigation or supervisory activities.

2. Competent authorities may use their powers for the purpose of cooperation, even in cases where the conduct under investigation does not constitute an infringement of any regulation in force in their Member State.

## Article 24

### **Delegation of tasks between competent authorities**

*(to be adapted following the option chosen with respect to the supervisory architecture)*

The home Member State competent authority may delegate certain tasks to the competent authority of another Member State, subject to the agreement of that authority.

#### *Article 25*

##### **Cooperation in supervisory activities, on-site inspections or other investigations**

*(to be adapted following the option chosen with respect to the supervisory architecture)*

1. The competent authority of one Member State may request the cooperation of the competent authority of another Member State in a supervisory activity or for an on-site inspection or in an investigation.
2. Where a competent authority receives a request with respect to an on-site inspection or an investigation, it shall, within the framework of its powers:
  - (a) carry out the inspections or investigations itself with the possibility for the requesting authority to join or allow the requesting authority to carry out the inspection or investigation, under the authority of the Member State where the inspection takes place, or allow auditors or experts to carry out the inspection or investigation;
  - (b) share responsibilities with the other competent authority on the exercise of specific tasks related to supervisory activities;
  - (c) request the assistance of the other competent authorities in accordance with Article 23.

#### *Article 26*

##### **Refusal to cooperate**

*(to be adapted following the option chosen with respect to the supervisory architecture)*

A competent authority may refuse to act on a request for cooperation in carrying out an investigation, on-site inspection or supervisory activity as provided for in Article 25 or to exchange information as provided for in Article 23 only where:

- (a) such an investigation, on-site inspection, supervisory activity or exchange of information might adversely affect the sovereignty, security or public policy of the Member State addressed;
- (b) judicial proceedings have already been initiated in respect of the same actions and the same persons before the authorities of the Member State addressed;
- (c) final judgment has already been delivered in the Member State addressed in respect of the same persons and the same actions.

In the case of such a refusal, the competent authority shall notify the requesting competent authority accordingly, providing as detailed information as possible.

## *Article 27*

### **Professional secrecy**

1. The obligation of professional secrecy shall apply to all persons who work or who have worked for the competent authority or for any authority or market undertaking to whom the competent authority has delegated some functions, including auditors and experts instructed by the competent authority. Information covered by professional secrecy may not be disclosed to any other person or authority except by virtue of provisions laid down by law.
2. Competent authorities exchanging information with other competent authorities under this Directive / Regulation may indicate at the time of communication that such information must not be disclosed without their express agreement, in which case such information may be exchanged solely for the purposes for which those authorities gave their agreement.

## **TITLE IV TRANSITIONAL AND FINAL PROVISIONS**

## *Article 28*

### **Committee procedure**

1. The Commission shall be assisted by the European Securities Committee established by Commission Decision 2001/528/EC<sup>19</sup>.
2. Where reference is made to this paragraph, Article 5a(1) to (4) and Article 7 of Decision 1999/468/EC shall apply, having regard to the provisions of Article 8 thereof.

## *Article 29*

### **Review**

Three years after the entry into force of this Directive / Regulation, the Commission shall make an assessment of the application of this Directive / Regulation and present a report to the European Parliament and the Council.

## *Article 30*

### **Amendment of Directive 2006/48/EC (CRD)**

1. In Article 81 of Directive 2006/48/EC, paragraph 2 shall be replaced by the following:

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<sup>19</sup> OJ L 191, 13.7.2001, p.45

"2. Competent authorities shall recognise an ECAI as eligible for the purposes of Article 80 only if it has been authorised in accordance with Directive / Regulation (EC) No XX/2009 and the competent authorities are satisfied that its assessment methodology complies with the requirements of objectivity, independence, ongoing review and transparency, and that the resulting credit assessments meet the requirements of credibility and transparency. For those purposes, the competent authorities shall take into account the technical criteria set out in Annex VI, Part 2."

2. In Article 97 of Directive 2006/48/EC, paragraph 2 shall be replaced by the following:

"2. The competent authorities shall recognise an ECAI as eligible for the purposes of paragraph 1 only if it has been authorised in accordance with Directive / Regulation (EC) No XX/2009 and the competent authorities are satisfied as to its compliance with the requirements laid down in Article 81, taking into account the technical criteria in Annex VI, Part 2, and that it has a demonstrated ability in the area of securitisation, which may be evidenced by a strong market acceptance."

#### *Article 31*

#### **Transitional provision**

Any credit rating agency falling under the scope of this Directive / Regulation and operating in the Community before the entry into force of this Directive / Regulation shall adopt all necessary measures to comply with the provisions of this Directive / Regulation and request an authorisation within six months following the entry into force of this Directive / Regulation. The credit rating agency has the right to continue to operate under the conditions of this Directive / Regulation unless the request of authorisation has been refused.

#### *Article 32*

#### **Entry into force**

This Directive / Regulation shall enter into force on the 20<sup>th</sup> day following that of its publication in the *Official Journal of the European Union*.

It shall apply from [six months after adoption].

This Directive / Regulation shall be binding in its entirety and transposed / directly applicable in all Member States.

Done at Brussels, [...]

*For the European Parliament*  
*The President*  
[...]

*For the Council*  
*The President*  
[...]



## **ANNEX I**

### **INFORMATION TO BE PROVIDED IN THE REQUEST FOR AN AUTHORISATION**

A credit rating agency shall provide the following information when requesting an authorisation:

- (1) Full name of the credit rating agency, address of the registered or head office within the Community or for a credit rating agency without registered or head office within the Community, the address of any branch.
- (2) Name and contact details of a contact person
- (3) Legal status
- (4) Organisational structure
- (5) Class of credit ratings for which the credit rating agency is applying to be authorised
- (6) Description of the procedures and methodologies used to issue and maintain credit ratings
- (7) Policies and procedures to identify and manage conflicts of interests
- (8) Information regarding employees
- (9) Compensation arrangements
- (10) Ancillary services
- (11) Programme of operations and location of the business activity setting out the type of business envisaged

## **ANNEX II**

### **OPERATING CONDITIONS**

#### **Section A**

##### **Rules on employees**

1. Credit rating analysts and other employees directly involved in the credit rating process, as well as persons closely associated with them as defined by Article 1(2) of Directive 2004/72/EC, shall not buy or sell or engage in any transaction in any financial instrument issued, guaranteed, or otherwise supported by any rated entity within the analyst's area of primary analytical responsibility, other than holdings in diversified collective investment schemes.
2. No employee shall participate in or otherwise influence the determination of a credit rating of any particular rated entity if this employee or any person closely associated with the employee, as defined by Article 1(2) of Directive 2004/72/EC:
  - Owns financial instruments of the rated entity, other than holdings in diversified collective investment schemes;
  - Owns financial instruments of any entity related to a rated entity, the ownership of which may cause or may be perceived as causing a conflict of interest, other than holdings in diversified collective investment schemes;
  - Has had a recent employment or other significant business relationship or any other relationship with the rated entity that may cause or may be perceived as causing a conflict of interest.
3. Credit rating agencies shall ensure that employees directly involved in the credit rating process:
  - take all reasonable measures to protect all property and records belonging to or in possession of the credit rating agency from fraud, theft or misuse;
  - do not disclose any non-public information about credit ratings or possible future credit ratings of the credit rating agency, except to the rated entity or its related third party;
  - do not share confidential information entrusted to the credit rating agency with employees of any person directly or indirectly linked to it by control outside the credit rating agency;
  - do not use or share confidential information for the purpose of trading financial instruments, or for any other purpose except the conduct of the credit rating agency's business.

4. An employee directly involved in the credit rating process shall not solicit money, gifts or favours from anyone with whom the credit rating agency does business and shall be prohibited from accepting gifts.
5. Upon becoming aware that another employee or entity under common control with the credit rating agency is or has engaged in conduct that is illegal, unethical or contrary to the provisions of this Directive / Regulation, a credit rating agency employee shall report such information immediately to the individual in charge of compliance, so that proper action may be taken.
6. A credit rating agency shall review the past work of an analyst that terminates his or her employment and joins
  - a rated entity, in the rating of which the analyst has been involved, or
  - a financial firm, with which the analyst has had significant dealings as part of his or her duties at the credit rating agency.
7. Analysts and other employees directly involved in the credit rating process shall not take up a key management position with the rated entity or its related third party, unless one year has lapsed since the credit rating.

## **Section B**

### **I. Rules on the presentation of credit ratings**

1. A credit rating agency shall ensure that a credit rating states clearly and prominently the name and job title of the analyst who was primarily responsible for preparing the credit rating (lead analyst).
2. A credit rating agency shall ensure that at least:
  - (a) all substantially material sources are indicated, including the rated entity or its related third party, as appropriate, together with the fact whether the credit rating has been disclosed to that rated entity or its related third party and amended following this disclosure before its dissemination;
  - (b) the principal methodology or methodology version that was used in determining the rating is clearly indicated, with a reference to its comprehensive description; where the rating is based on more than one methodology, or where reference only to the principal methodology might cause investors to overlook other important aspects of the rating (like any significant adjustments and deviations), the credit rating agency shall explain this fact in the credit rating and indicate how the different methodologies or these other aspects are taken into account in the credit rating;
  - (c) the meaning of each rating category and the definition of default or recovery is adequately explained and any appropriate risk warning, including a sensitivity analysis of the relevant assumptions, indicated;

- (d) the date at which the credit rating was first released for distribution and when it was last updated is indicated clearly and prominently.
3. A credit rating agency shall ensure that any credit rating states clearly and prominently any attributes and limitations of the credit rating. In particular, a credit rating agency shall prominently state in any credit rating whether it considers satisfactory the quality of information available on the rated entity and to what extent it has verified information provided to it by the rated entity or its related third party. If a credit rating involves a type of financial instrument for which historical data is limited, the credit rating agency shall make clear, in a prominent place, the limitations of the credit rating.
  4. A credit rating agency shall disclose in a credit rating whether the rated entity or its related third party participated in the rating process. Any rating not initiated at the request of the rated entity or its related third party shall be identified as such. A credit rating agency shall also disclose its policies and procedures regarding unsolicited ratings.
  5. If a credit rating involves a type of financial instrument for which historical data is limited (notably in the case of some structured finance instruments), the credit rating agency shall make clear, in its credit rating, the limitations of the credit rating.
  6. When announcing a credit rating, a credit rating agency shall explain in its press releases or reports the key elements underlying the credit rating.

Where the information laid down in paragraphs 1 to 4 would be disproportionate in relation to the length of the credit rating distributed, it shall suffice to make clear and prominent reference in the credit rating itself to the place where such disclosures can be directly and easily accessed, such as a direct web link to the disclosure on an appropriate website of the credit rating agency.

## **II. Additional obligations in relation to credit ratings of structured finance instruments**

1. Where a credit rating agency rates a structured finance instrument, it shall provide in the credit rating sufficient information about loss and cash-flow analysis it has performed.
2. A credit rating agency shall state whether it has sufficient knowledge of the due diligence processes carried out at the level of underlying assets of structured finance instruments. When a credit rating agency has undertaken any assessment of such due diligence processes or relied on a third-party assessment, it shall disclose this fact in the credit rating, indicating how the outcome of such assessment impacts the rating.

## **Section C**

### **I. General disclosures**

1. Actual and potential conflicts of interest referred to in Article 10 paragraph 2;

2. Definition of what the credit rating agency considers, or does not consider to be, services ancillary to its core rating business;
3. Policy of the credit rating agency concerning the publication of credit ratings and other related communication;
4. General nature of its compensation arrangements;
5. Methodologies, models and key rating assumptions as well as their material changes.
6. Any material modification to its significant practices, procedures, and processes.

## **II. Periodic disclosures**

1. On a quarterly basis, a list of all cases where an originator, arranger, sponsor or any other relater third party involved in the issuance of a structured finance instrument provided the credit rating agency with final data and information about a proposed structure and asked it for a preliminary rating of the proposed structure, but:
  - (a) did not contract with the credit rating agency for a final rating, but contracted with another credit rating agency for a final rating of that same instrument; or
  - (b) contracted with the credit rating agency for a final rating and did not publish the credit rating agency's final rating, but published the ratings of another credit rating agency for that same instrument;
2. On a biannual basis, data about the historical default rates of its rating categories and whether the default rates of these categories have changed over time.
3. On a yearly basis the following information:
  - (a) a list of the credit rating agency's largest 25 clients by revenue.
  - (b) a list of those credit rating agency's clients whose contribution to the growth rate in the credit rating agency's revenue in the previous financial year exceeded the growth rate in the total revenues of the credit rating agency in that year by a factor of more than 1.5 times. Each such client shall only be included on this list where in that year it accounted for more than 0.25 per cent of the total revenues of the credit rating agency.

For the purposes of this clause a "client" shall mean a company, its subsidiaries, and associated companies in which it has holdings of more than 20 per cent, as well as any other entities in respect of which it has negotiated the structuring of a debt issue on behalf of a client and where a fee was paid – directly or indirectly - to the credit rating agency for the rating of such issue.

## **III. Transparency report**

1. Detailed information on legal structure and ownership, including information on significant direct and indirect shareholdings (including indirect shareholdings through pyramid structures and cross-shareholdings) within the meaning of Articles 9 and 10 of Directive 2004/109/EC;

2. Description of the internal quality control system;
3. Statistics on staff allocation to new credit ratings, credit ratings review, methodology/model appraisal and management;
4. Description of credit ratings record-keeping policy;
5. Outcome of annual internal review of independence compliance;
6. Financial information on the agency's revenue divided into fees from credit rating and non credit rating services with comprehensive description of each;
7. Description of management and analysts rotation policy;
8. A corporate governance statement within the meaning of Article 46a(1) of Directive 78/660/EEC. For the purposes of this statement, the information mentioned in Article 46a(1)(d) should be provided by the credit rating agency irrespective of whether it is subject to Directive 2004/25/EC.