Comments on behalf of

Association Française des Trésoriers d'Entreprise The Association of Corporate Treasurers

in response to CESR/04-394,

Call for Evidence: Call to CESR for Technical Advice on **Possible Measures Concerning Credit Rating agencies**

(The Committee of European Securities Regulators, 28 July 2004)

The Call for Evidence quotes from the draft code for participants in the rating industry (including issuers) produced by the ACT, AFP and AFTE, and supported by the Eurozone and International treasury associations[1]. That embodies our collective views.

The draft code[2] has been drafted with the intention of being as practicable as possible. The idea of sticking to a code rather than to a regulatory basis to govern the relationship between issuers and rating agencies is because we recognise that such provisions have to be developed on a global basis. Regulation is best restricted to provision of a general framework.

The draft code was developed for the corporate (non-financial) sector – and includes a section applicable to such issuers as well as a section for rating agencies. CESR and CEBR's scope is wider – embracing structured finance, financial sector and sovereign ratings as well. However, few changes would be needed in the wider application.

We are also aware of the IOSCO work in this area to produce the essentials of a code of conduct and we hope, after their paper is published, to amend the code produced by the treasury associations to be complementary in the corporate ratings field to the IOSCO document.

The four key issues identified by the Commission and quoted in the Call for Evidence are of course addressed in the treasury associations' draft.

We welcome that the Commission has invited CESR to take account of developments elsewhere including with the SEC and IOSCO. It has been a major concern of the ACT that, should regulation of rating agencies be applied in new jurisdictions, then international collaboration will ensure that no new factors are introduced and that such regulation embodies mutual recognition of like regulation so that both double regulation of agencies and conflict of regulation can be avoided.

We recognise that implementation of Basel II and, in the EU context, CAD III will require a definition of rating agencies for those purposes. However, we continue to hold the view that the market for ratings is the best regulator of the agencies. An agency without credibility will not survive.

[1] Available in English and French at www.treasurers.org
[2] Which will be revised to take account of comments received in the consultation process

Accordingly we believe that while clear definitions – which avoid creating further barriers to entry – will be necessary, substantive regulation can best be avoided. The treasury associations' draft provided suggestions for regulation where regulation exists, and urged "light handed" regulation (and comments about the US situation are in the context of existing regulation). But the draft incorporated similar provisions to the regulatory recommendations into the section of the code for agencies as the paper did not recommend extension of regulation to new jurisdictions.

As far as the structure of the industry is concerned, we understand that it is not CESR's role to deal with the oligopoly nature of the rating industry. However, consequences of this ''de facto'' oligopoly are important for market participants: fee levels and limited fee negotiation capacity, quasi impossibility to end a rating relationship with one a major agency in the case where quality of services or cost will is judged inadequate or where a fundamental misunderstanding between an issuer and a rating agency arises. Rating agency relations can from time to time raise strong feelings among issuers.

We look forward to the CESR consultation paper and to providing input and comment in response to it. We are available to assist in any other way.

In the meantime, supplementary to the treasury associations' draft code, we attach:

- very brief notes on
    - conflicts of interest arising from advisory services;
    - payment for solicited ratings by issuers and agency access to inside information;
    - "the need to provide a level playing field" between credit rating agencies;
    - certain issues relating to the relationship between issuers and rating agencies;
    - distinguishing in any framework of regulation or code of practice between purely statistical ratings and those based on access to confidential information.

and, for background information we draw attention to the paper *Private Ordering of Public Markets: The Rating Agency Paradox*[3], by Steven L. Schwarcz of Duke Law School in the USA which addresses the question of whether light regulation of rating agencies as in the USA is appropriate.

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[3] University of Illinois Law Review, Vol. 2002, No. 2, February 2002 and which may be downloaded free of charge from the Social Science Research Network Electronic Paper Collection: http://papers.ssrn.com/paper.taf?abstract_id=267273

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Brief note (1): Provision of advisory services by credit rating agencies

This has been an area of some controversy in some markets. We can see the potential for conflict to arise under this heading.

The relevant area is that of solicited ratings with disclosure of confidential non-published information, and we speak from the point of view of the corporate issuer.

A rated issuer will as a matter of commercial prudence, take account in its planning of the effects of changes in the business on its credit rating. In the case of major moves – acquisitions, re-organisations or restructurings, major changes in relative importance of market sectors or geography, etc. – the rating outcome may be a significant factor.

The corporate issuer's treasury will probably have a good understanding of likely rating impacts. Sometimes, where rating outcome is of great importance, the issuer's board may seek external review of the position. Some investment banks have departments which have some experience in this area. However, it is an obvious move for the issuer to ask the rating agency "If we do x, what would be the impact on our rating?"

The enquiry will most often be informal – a brief discussion with the lead rating analyst generally assigned to the issuer. Possible developments may also have been raised in low key as part of the general regular contact, of course. These are part of the normal service level provided by the main rating agencies. The analyst always indicates before commenting that it is informal, based on an outline scenario only, that nothing said would influence the advice to a rating committee if the development was to come about, etc. However, as part of the general relationship with the treasurer, it is regarded as valuable by issuers.

An issuer may want the agency to do more work on a detailed scenario of a possible development and to give a view. Here much more work is required of the agency staff. It, not unreasonably, may ask for extra remuneration for this. However, considering a scenario in advance is not like considering a final project which is about to be or has just been realised – for it is at least unusual to realise something entirely as originally conceived and the external and internal circumstances will surely differ from those originally envisaged. The view given by the agency on the scenario is, of course, non-binding.

All work on such scenarios should, of course, benefit the agency's understanding of the issuer and its industry.

If the agency is following a proper code of conduct for the carrying on of its business, comment, even paid for comment, on a scenario or scenarios, should not influence (other than in the general understanding way) the final real rating of the issuer post the project.

We do not believe that there are conflicts of interest in responding to such queries from issuers which require especial attention over and above the general conflict of interest treatment.

However, we would see a problem if agencies were directly advising on shaping a development in order, for example, to reach a particular rating target. We believe that such advice should not be provided by a rating agency itself (and provision that it will not provide it should be part of a suitable code of conduct for credit rating

agencies). Giving such advice is the job of the issuer’s treasury internally, and an appropriate investment bank or other consultancy externally.

Brief note (2):

Payment of credit rating agencies by rated issuers and agency access to inside information

Purely statistical credit ratings involve no access to inside information (or to senior management of the issuer). Neither do unsolicited ratings which use other information but which use no access to insiders or inside information (see penultimate paragraph on this page for consideration of what is meant here by inside information).

For corporate ratings, for solicited ratings based on statistical analysis supported by consideration of other information, access to senior management and confidential non-published information from the issuer, it is industry practice that the issuer remunerates the rating agency. We believe that these two practices are appropriate.

Attached is an article taken from the ACT's *The Treasurer's Handbook 2004* (which goes to around 6,000 recipients in Europe and North America) which discusses the access and information to be provided and some of the reasons for it.

Consideration of that information is the value which an issuer achieves from a solicited (as opposed to an unsolicited) rating. In the long run more "correct" rating should lead to more "correct" pricing of an issuer's risk which – again, in the long run – is in issuers' interests as the premium for uncertainty should be reduced.

The analysts know that their firm's success in the market depends on creating/maintaining the reputation for accurate ratings. They also know that abuse of confidential information provided by issuers would severely prejudice their firm's success as that would influence the attitudes of issuers towards providing information.

Provided that the rating agency follows an appropriate code of conduct concerning segregation of the remuneration and promotion of those involved in setting ratings from the revenue raising side, we do not believe that problematic conflicts arise.

A far greater conflict would arise if the bulk of rating agency revenue came from the payment for rating information by users. The pressure on agencies to disclose to subscribers parts of the confidential information received from issuers would be great. Issuers would have grave doubts about the security of information provided.

A confidentiality clause should be a key part of rating agency contracts where confidential non-pubished information is made available to the agency. Confidentiality is a key part of the associations' draft code for participants in the credit rating industry. It has long been industry practice. This reflects, for the issuer, the importance of maintaining the confidentiality of the information[4].

It must be remembered that for issuers of listed securities, the disclosure obligations related to the listing are important. Material, price sensitive information must be published promptly, subject to some limited, conditional and temporary exemptions. Subject to those exemptions then, the information which is provided to rating agencies is not within a narrow definition of "inside information" – although it could fit under the UK FSA's concept of relevant information not generally available (RINGA) which goes beyond the EU directive definitions for insider dealing and market abuse.

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[4] It is also a condition in the USA of exemption from the SEC's fair disclosure rules (RegFD – 17 CFR 243.100-243.103)

We believe that the "issuer pays" model is, on balance, the superior model for rating agency remuneration. "User pays" is appropriate for purely statistical and other non-solicited ratings (including non solicited ratings turn into quasi-solicited[5]) and where no confidential information is provided to the agency.

[5] Cases where an issuer decides (to avoid false of misleading information to be spread out in the market) to discuss and give necessary information to an agency which has decided on its own initiative to publish a rating on the issuer . Unfortunately such cases are not unusual.

Brief note (3): "The need to ensure a level playing field" between credit rating agencies as regards access to inside information

In a solicited rating[6] with access to senior managers and to confidential non-public information there is a voluntary agreement between the issuer and the rating agency in the form of a contract freely entered into[7].

If a rating agency takes the view that it is not getting the access to information it expected – or that it is being fed misleading or incomplete information – the agency's sanction and proper course of action is to withdraw the rating, and explain why.

For the company to agree to disclose confidential non-public information is a significant step, not lightly entered into. Over and above the rating fee and the disclosure element, the process for a solicited rating is expensive of management and staff time at the issuer. A solicited rating is not lightly agreed. Companies seek to minimise the number of such ratings they agree to.

Accordingly, there can be no question of a right of a rating agency to receive confidential non-public information, just as there is no right of a rating agency to receive a fee for an unsolicited rating.

The level playing field required in this area covers two points:

- Any rating agency should be able to discuss with a company the advantages of having a rating from that agency – additional to or displacing existing providers of solicited ratings. Different rating agencies use different methodologies and accordingly seek in minor respects slightly different information from issuers. It is for the agency to be satisfied with information it is receiving or terminate the rating.
- Each provider of a solicited rating with access to confidential non-public information should expect to be provided with information in good faith by the issuer.

Accordingly it is difficult to see what the raising of this topic is driving at. A level playing field between credit rating agencies in general would be highly *undesirable* – if what is meant by this would be an equal right for all rating agencies to contract with, or be able on a full-disclosure-of-confidential-information basis to rate the securities of, an issuer even if the latter did not wish it.

[6] Or quasi-solicited rating – see footnote 5

[7] However, see the treasury associations draft code for a discussion of ways in which agencies can be inflexible about contract terms – which may more resemble contracts of adhesion rather than the outcome of open negotiation between the parties.

Brief note (3):

Other issues concerning the relationship between issuers and rating agencies

1 - Regarding the need issuers to understand how rating agencies restate the issuer's figures, we believe that there should be also an obligation for rating agencies not only to explain their restatements to the issuers themselves but also to set out the restatement computations as an annex to any public release made by the rating agencies which includes such restated figures.   This is will allow not only issuers but also the investment community at large to have a better understanding of the basis on which rating agencies' opinions are constructed.

In addition, rating agencies should be requested to clearly mention any change in their restatements when they arise. Treasury association draft code suggests that any change in the methodology used by rating agencies should even be made public before any rating action is taken as a consequence of such change. This is needed to avoid any misunderstanding by the market and to leave time to issuers themselves to understand and possibly discuss the possible impact of such changes on their ratings.

2 – As far as the need for all rating agencies to have access to the same information from companies, we believe that our comments on "the need to provide a level playing field" between credit rating agencies (Brief note 3, above)should apply.

Brief note (4):

The need to distinguish in regulation or codes between types of rating

We quote from the ACT's response[8] to the SEC concept release of June 2003[9] - which was made in the context of a jurisdiction with existing rating agency regulation.

> **Distinguish types of rating**
> In framing regulation of credit rating agencies we believe that it is essential to distinguish between three types of ratings
> – those issued based purely on published information without contact with the issuer,
> – those based on published information where the issuer has been contacted for clarification needed to interpret published information for the purposes of the rater's evaluation model and the skills necessary to make the judgements this calls for have been deployed, and
> – those based on extensive discussion with management of the issuer and disclosure of confidential, non-published information.
>
> This distinction may not necessarily be important for diversified investment portfolios or regulatory purposes related to diversified investments. However it is very important for narrow portfolios and related regulations *and for affected issuers*.
> The same agency may publish ratings assessed under all three practices. It should therefore be required that they are distinguished (and certainly the first two are distinguished from the last) whenever and wherever they are published or quoted. It is not enough for this to be indicated only when the rating is first issued.

The principal distinction is between the last category above - those ratings issued with access to confidential non-public information - and the first two -those without such access.

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[8] Full response available on www.treasurers.org
[9] Concept Release [Release Nos. 33-8236; 34-47972; IC-26066; File No. S7-12-03] RIN 3235-AH28, *Rating Agencies and the Use of Credit Ratings under the Federal Securities Laws Trustee Exemptions* (Securities and Exchange Commission, June 2003)

Article taken from *TheTreasurer's Handbook, 2004*, The Association of Corporate Treasurers, London

Corporate credit ratings: what information to give a credit rating agency?

Which agencies?

These comments apply to credit rating agencies (CRAs) providing 'solicited' ratings and subject to a confidentiality agreement in respect of identified material/price sensitive information.

What is not disclosable to the agency?

The key is that the agreement with the CRA must impose a duty of confidentiality on the agency in respect of identified un-published price-sensitive information. Subject to this, market practice is for free disclosure to CRAs. The main CRAs are happy to explain their arrangements to ensure that they can honour the contracted confidentiality obligations.

Internationally, Principle 4 of the IOSCO Principles for CRAs[1] deals with the need for confidentiality and the comment in the accompanying report[2] explains that 'The principles also are designed to encourage issuer disclosure and communication with CRAs'.

In the US, the SEC's rules on selective disclosure of 'material information' about companies[3] (Regulation FD) provide an explicit exemption for the CRAs[4]. There is in any case a general exemption for disclosure under a confidentiality agreement[5].

In the EU, under the Market Abuse Directive, disclosure of information likely to have a 'significant effect on the prices' of the financial instruments or related derivative financial instruments is permitted if the recipient 'owes a duty of confidentiality'. MAD implementation is not finalised at the time of writing.

In the UK, the Financial Services Authority acknowledges that local market practice is for disclosure of price sensitive information to CRAs under a confidentiality agreement, although it is, strictly, against the Listing Rules[6]. In the consultation on the listing régime being undertaken by the FSA at the time of writing[7], the FSA again notes the market practice. It goes on to say it will issue a clarifying note once MAD implementation is finalised.

What to provide?

Some CRAs will give ratings based merely on a statistical analysis of the published information about the company. With a solicited rating, the CRA has access to top management of the company and to non-public information. That should lead to more appropriate and more stable ratings, and so a lower cost of capital for the company – which is what it is paying for. Best practice is for CRAs to distinguish 'public information ratings' whenever shown; better practice would be to similarly mark solicited ratings where access to management and information has not been satisfactory[8].

While CRAs normally do a good job of handling information, companies should not assume that information provided has been digested, rather than filed. Or that the

1. *'Principles Regarding the Activities of Credit Rating Agencies', IOSCO, September 2003*
2. *'Report on the Activities of Credit Rating Agencies', IOSCO, September 2003*
3. *'Selective Disclosure and Insider Trading', Release No. 24-43154 (15 August 2000), 65 FR 51716 (August 24, 2000).*
4. *'Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets, as required by S. 702(b) of the Sarbanes-Oxley Act of 2002', US Securities & Exchange Commission, January 2003 (SEC Interim Report) explains in note 60 p22, that with the 'widely available publication of the rating… the impact of non-public information of the creditworthiness of an issuer is publicly disseminated, without disclosing the non-public information itself'.*
5. *Reg FD (17 CFR 243.100-243.103). Both exemptions are in 100(b)(2). A rating agency here is an 'entity whose primary business is the issuance of credit ratings, provided the information is disclosed solely for the purpose of developing a credit rating and the entity's ratings are publicly available (fourth exemption)'.*
6. *Financial Times, 30 August 2002*
7. *Review of the listing regime, Consultation Paper October 2003*
8. *See ACT response (www.treasurers.org/ actcommentssec.pdf) to the SEC's Concept Release: Credit Ratings under the Federal Securities Commission, [Release Nos. 33-8236; 34-47972; 12-03] RIN 3235-AH28, June 2003*

basic information provided when a first rating is made or when a matter first became important has been retained on file and read and understood by successive generations of analyst. Or that the analyst has explained it satisfactorily to the other members of the 'rating committee' in the agency. Some prodding by the company may be needed over the years[9].

Information for an initial rating

Before starting, look to see if the CRA rates similar companies. Read the rating reports. If there are important factors distinguishing your company from others in the industry, resolve to make them clear.

The easy part is to provide all relevant publicly available information about the company. Care is needed even here. For example, there will be a lot of financial information: if there are particular accounting conventions/impacts affecting the company's business, provide covering explanations (even re-presentations) with the material – don't let the analyst form false impressions at the outset.

In all of this, you'll find the rating CRA's description of its methodology for corporate rating on its website helpful. They usually set out their favourite ratios, based on one GAAP or another – and if you are unclear how your particular company's figures would be treated in calculations, meet and talk it through with the rating analyst using actual numbers from your published accounts (supplemented by internal analyses if need be) before providing any information – otherwise you will be unsure of where the reassurances or problems may arise.

What else? Companies usually make a major presentation to the rating analysts. Ensure that 'hard copies' of presented material are available with supplementary material as necessary – but all of this must be labelled and indexed or it will be mostly useless.

Careful selection of material for a written submission to the agency in good time before the meeting is important to ensure that the agency brings the right experts and to make best use of costly meeting time.

• 'Macro' factors

Start with the big picture. While the CRA will usually be experienced in reviewing the company's industry, it is unwise to assume their knowledge is adequate, current or correctly selected.

The CRA needs a summary of how the company sees the risk factors affecting its industry, and how they will develop. Capital intensiveness, maturity (technological and market), cyclicality, competition, barriers to entry, substitutes for the industry's products, demand factors, under/over capacity, growth/decline and what is happening to customers, the operating model (national, regional, multi-national or global), environmental impact and 'social responsibility' issues should all be addressed. It may be necessary to deal with separate major product sectors.

A similar run-down on the environment in which the company operates is needed – geographical, social, regulatory and technical/technological.

• 'Micro' factors

With the wider picture established, start to deal with the company's particular situation.

Outline very briefly the management and legal structure of the group.

Cover the market position of key products, ability to differentiate the product and provide competitive advantages, with a review of specific product life-cycle positions and sales/distribution patterns in various geographies.

Relative costs and how sourcing arrangements are advantaged/disadvantaged, implications of single sourcing of key components/materials need to be explored, and the impact of the company's relative size in its industry.

Access to/ownership of necessary intellectual property ('know-how' as well as protectable matter), trademark/ copyright or regulatory privilege must be explained. If the company operates in certain markets under price regulation or particular orders of restrictive-practices courts or competition authorities, point this out.

The principal risks – and opportunities – arising from the story so far must be outlined and related to the industry risk profiles discussed previously. Consider too risks from dependence on particular customers or from particular end uses where the company sells intermediate products.

This leads on naturally to strategy. Outline the company's strategic processes, and go on to current corporate strategy and approach to risk management/risk financing. An important aspect will be the company's balance sheet and cash flow profile and how it is related to the risk financing task. And cover business continuity plans too.

Show how current strategy relates to past strategies – are strategies the Chairman's current whim, or deeply thought out and tested and measured against the real world and a range of future external developments?

If they are not already clear, outline the main drivers of profitability and (with emphasis) cash flow.

Provide copies of the company's business plan, a commentary on any divergences between last year's plan and this year's, and on actual variances. If there are identifiable risks or developments ahead, model their effects and how management will react to deal with these changes. It it is not self-evident, explain the link between the business plan and the strategy.

The CRA's evaluation of the management's abilities and the suitability of the management structure will be important to the eventual rating. Partly derived from the strategic expositions given, the evaluation will also look at the management's track-record: what does the strategic record show? Set it out for the agency: has the business been on an improving track or a muddled/declining one (operationally as well as strategically); has there been delivery of past strategic plans? How has the company performed against previous shorter-term plans; how has it coped with previous unexpected developments with

9. Rated company frustration with failure of rating agencies to retain information provided has been a feature of comments to regulators in 2003. France has introduced a requirement for rating agencies to retain some information for 3 years.

significant impact for good or ill? The rating attempts to be forward looking so it is impossible to overstress how important it is that the agencies understand and respect the management's approach.

Cash flow is inevitably important. In presenting past and projected financials (after the first delivery of published information), ensure that cash flow is highlighted, together with the quantitative aspects of the major cash-flow drivers previously identified. The CRA's favourite ratios will look at cash-flow coverages as well as conventional measures of gearing. Trends in the ratios will be important. The impact of financial transactions (share issuance, share buy-backs, etc.) must be made clear, especially in projections.

Take further the discussion of the balance sheet under 'risk financing' previously, explaining the overall approach to the balance sheet, target duration of debt, etc. as well as dividend policy/objectives.

Consider the impact of the legal structure of the Group on rated obligations (structural subordination) as well as their formal priority/subordination in the issuing company/guarantors and the impact of, for example, exchange controls, controls on inter-company transactions etc. which may shut off obligor companies from resources elsewhere in the Group.

Consider contingent liabilities – those noted in the report and accounts and those not so mentioned. Pension and medical benefits and environmental obligations can loom large here.

Set out the company's 'strategy for financial mobility': how aggressive is gearing (however defined); how flexible are capital/major revenue project expenditures; how disposable/re-deployable are assets; how strong are banking relationships; how fragile are roll-overs of drawn facilities; what multi-year facilities are un-drawn – and what might make them unavailable for drawing; how receptive might equity markets be (given that in this context some corporate stress is assumed)?

The treasurer, who will be the main on-going routine contact for the CRA analyst, needs to be on top of all of the foregoing – but then (s)he should be anyway as part of the general responsibilities for financial strategy. By planning the presentation/meeting carefully, (s)he can make best use of the time of top management colleagues.

Finally, when you let the analysts ask their questions, you will find that there are aspects you have not covered at all or which require further explanation. It is vital that the management team do not blow it all away at this stage. Giving wrong answers off the cuff can weaken the excellent impression built up so far. A good team will be able to give full, correct answers immediately to some questions – but follow these up in writing after the meeting. For other questions, while pointers can be given immediately, analysis or research may be needed and a written answer be given later. There is no shame in that – credit analysts inevitably look at the world through different eyes from businessmen and their worries are not always top of mind for company executives, even the treasurer.

It can also be useful to take the analyst to see convenient important or example company sites, etc. Seeing the attention to hygiene in a food or electronics factory or the application of unique technologies or the differentiation in use of the company's products in the real world can give reassurance for which there is no substitute. But be aware that analyst time is the major CRA overhead and don't do visits just for the sake of it.

▪ Information for a continuing rating

CRAs will need updates on all the above as developments and changes occur.

Normally, analysts are well on top of the job, but careful reading of an agency's rating report on your company may throw up matters to focus on. Sometimes they can be minor misunderstandings by the analyst or they may be important. Sometimes, while you believe the analyst has understood something, it is clear that (s)he has failed to convince the rest of the rating committee.

CRAs usually review formally the ratings annually and this provides an opportunity for updating and dealing with worries and for them to meet and hear from top management again. Try to economise on your top management's time by running through most material with the analyst without them. They can then be brought in for particularly important points and for general questions.

Published information should be provided to CRAs as it is issued.

Minor corporate announcements can be handled similarly and the treasurer should call the analysts to answer any questions and to ensure they are happy. Usually, results announcements would fall into this category.

Major announcements will often be about matters considered in strategic plans. Even in such cases, it is sensible to give the analysts a bit of notice of major announcements and, if need be, access, so that, where possible, they can, after a rating committee, issue a firm 'no change' or a firm change, rather than putting the company on 'credit watch' (perhaps with 'negative implications'). Of course, the company should have thought through the implications of the matter of the major announcement on all the factors relevant to the credit rating as discussed above. Thus the contact with the CRA can be fruitful and use least time when corporate executives, including the treasurer, may be very busy.

Conclusion

Remember that the reason you are paying for a 'solicited rating' is so that the rating analyst has a good appreciation of material matters. Ensure that you get full value in this. And if you allow an inappropriate rating of a listed security to persist by failing to communicate effectively with the agency, reflect on the company's obligations under the securities and market abuse laws and regulations in your country/ies of listing.

10.Donaldson G (1969), 'Strategy for financial mobility', Harvard Graduate School of Business Administration, Division of Research (available in the Harvard Classics series)