Comments on behalf of
The Association of Corporate Treasurers ("ACT'')
and of the
Association Française des Trésoriers d'Entreprises (''AFTE'')

in response to

Consultation paper (CESR/04-612b):

CESR's technical advice to the European Commission on possible measures concerning credit rating agencies *(November 2004)*

I Introduction

The ACT and AFTE welcome the opportunity to comment on the consultation paper, having made previous input at the call-for-evidence stage[1].

We would be pleased to expand further any point made herein or to assist the CESR in any other way. Contact details for the ACT and the AFTE are given on the back page of these comments.

The Associations

Association Française des Trésoriers d'Entreprise (AFTE), founded in 1976, represents more than 1,400 members, including 1,050 Corporate Treasurers or Financial Managers of approximately 900 industrial and commercial companies; 450 members are based in the provinces. There are also 350 correspondent members. Its development is concentrated on five activities: technical committees, conferences, education, publications and representation of corporate treasurers. AFTE is a founding member of the Euro Associations of Corporate Treasurers (EACT).

Established in the UK in 1979, The Association of Corporate Treasurers (ACT) is a professional body for those working in corporate finance, treasury, risk, and cash management operating in the international marketplace. It has over 3,300 members, mainly UK based. There are 1,500 students in more than 40 countries. ACT examinations are recognised by both practitioners and bankers as the global standard setters for treasury education and it is the leading global provider of treasury education. The ACT promotes study and best practice in finance and treasury management. Although a large number of members work in the financial services sector, the ACT represents the interests of non-financial sector corporations in financial markets to regulators, standards setters, trade bodies, etc.

January 2005

[1] Available at http://www.treasurers.org/technical/papers/resources/ACTAFTEresponseCESR.pdf

II Principal comments

- The ACT and AFTE believe that CESR is right to acknowledge the importance of the IOSCO Code of Fundamentals. They do however believe that a limited number of amendments will eventually be necessary to address fully some of their concerns.
- We believe that the IOSCO code should be allowed to bed in for a couple of years before any additional provisions by way of registration requirements or regulation are introduced.
- If, in the event, any form of registration or compliance filing is considered necessary for a CRA, we believe that a single such registration or filing should meet all compliance obligations throughout the EU for any legal entity.
- We consider the market to be the best regulator of CRAs, and that this can be assisted by the adoption by the industry of a suitable code of conduct.

III Comments on the Consultation Paper (CP)

Preliminary

In general, the ACT and AFTE believe that the market is the best regulator of credit rating agencies (CRAs) and that the market can be helped in that by adoption by participants in the industry of a suitable code of practice. Given the recent publication of the IOSCO Code Fundamentals, the ACT and AFTE believe that a couple of years should be allowed to see how that works in practice before any consideration of regulation is made. However, the ACT and AFTE with other issuer organisations will urge additions to code of practice by agencies on a voluntary basis and may suggest a limited number of amendments to the existing IOSCO code.

All responses to the CP questions below should be read in this context.

CP I. INTRODUCTION

CP I *QUESTION 1: Do you agree with the definition of credit rating agencies?*

We acknowledge that the focus of securities regulators' attention will be on the use of credit ratings in relation to "lending to … or purchasing an issuer's debt and debt-like securities". However, even with that focus, regulators should have in mind too the wider uses to which published ratings are put[2].

We agree that the definition should extend more widely than those CRAs whose ratings are used for regulatory purposes.

If registration/regulation of CRAs were introduced, the ACT and AFTE would be concerned if any CRA that supplied ratings to persons outside of its own organisation, and did so using a ratings methodology that involved access to non-published confidential information provided by the security issuer, and such an activity were not embraced by any eventual regime.

In Paragraphs 36 and 37, the Paper says that the focus will be on "…entities whose primary business is the issuance of credit ratings…[3]" "*…at this stage…*[4]". We believe it would be necessary to consider extension to entities where the supply of credit ratings was not the supplying entity's "primary business" before any regime with mandatory requirements were introduced.

CP I *QUESTION 2: Do you agree with the definition of credit ratings?*

The ACT and AFTE strongly endorse the proposed approach set out in Paragraphs 38 and 39.

---

[2] "CRAs also play an important role for companies when evaluating counterparties for financial transactions, in evaluating actual or potential suppliers or customers for non-financial goods and services, and in similarly evaluating partners, collaborators, or joint venture prospects" - Exposure Draft: Code of Standard Practices for Participants in the Credit Rating Process, published by The Association of Corporate Treasurers (ACT), London, England, The Association for Financial Professionals (AFP), United States, and the Association Française Des Trésoriers D'Entreprise (AFTE), Paris, France, April 2004, available in English and in French at http://www.treasurers.org/technical/papers/index.cfm#ratings, at page 6

[3] A similar definition is widely used internationally – for example the carve-out for disclosure of price-sensitive information to rating agencies in the US SEC's Reg. FD (17 CFR 243.100-243.103) defines a rating agency as an 'entity whose primary business is the issuance of credit ratings".

[4] Emphasis added

CP I *QUESTION 3: Do you agree with the definition of unsolicited ratings?*

The ACT and AFTE endorse the approach set out in Paragraph 42. However, we consider the more important matter to be indicated is whether or not there was access to management and to confidential non-published information.

We also reiterate the need to have a clear distinction made in all public releases between solicited and unsolicited ratings.

CP I *QUESTION 4: Do you think that issuers should disclose rating triggers included in private financial contracts?*

The ACT and AFTE believe that disclosure is appropriate where what is triggered is itself material. A "margin ratchet" is not material.

Disclosure of material effects is probably covered in implementation of the Prospectus Directive, but the we believe that the "once-off" nature of disclosure in prospectuses is not sufficient.

CESR's consultation paper 04-225b re implementation of the Prospectus Directive and disclosure requirements for prospectuses, calls for discussion "where the issuer has entered into covenants with lenders which could have the effect of restricting the use of credit facilities, and negotiations with the lenders on the operation of these covenants are taking place or are expected to occur".

We believe that the general nature of such undertakings, whether expressed as covenants (however characterised in the particular documentation, for example as instances of "material adverse change") should be disclosed in prospectuses and also in regular reporting (for example in the (annual) Management's Discussion and Analysis or Operating and Financial Review or local equivalent), without confining the requirement to the circumstance of negotiations with lenders.

This would of course apply to any such covenants that could be triggered by credit ratings downgrades.

In answer to the specific question, then:

- We believe that issuers in a reporting environment such as that of the Operating and Financial Review in course of introduction in the UK should be required to disclose the general nature (but not the specific details) of rating triggers potentially affecting the availability of finance to the issuer in such Reviews.
- If there is a reasonably high probability that one or more triggering events will occur and will materially damage the financial situation of the issuer, all issuers should do this, and, indeed, provide more detail as necessary to ensure that what is disclosed is not misleading and to ensure the avoidance of the creation of a false market in the issuer's securities.

CP I *QUESTION 5: Do you think that use of ratings in European legislation should be encouraged beyond the proposed framework for capital requirements for banks and investment firms?*

No.

Credit ratings should be used where and justified and convenient.

The dominant model[5] whereby issuers pay for credit ratings and the influence of the US SEC's Reg. FD[6] whereby non-published price-sensitive information may be provided to CRAs provided that the eventual rating is publicly available, mean that credit ratings using such information are in practice available free of charge to users. The final IOSCO Code Fundamentals provides at 3.4 that such ratings should be available free of charge.

Use of such credit ratings can thus be a low-cost-to-the-user part of a way of achieving a regulatory objective.

However, we believe that unthinking use of ratings in regulation can be inherently de-stabilising to markets. For example, were insurance regulations to require insurance companies that hold bonds among their realisable assets to sell any bonds which suffer a credit rating downgrade below a particular threshold, this would be de-stabilising ("credit cliff") whereas a requirement to "top-up" holdings by applying a valuation discount that progressively increases as credit rating falls would be much less de-stabilising.

CP II. COMPETITIVE DIMENSION: REGISTRATION AND BARRIERS TO ENTRY

CP II ***QUESTION 1: Do you think there is a sufficiently level playing field between CRAs or do you think that any natural barriers exist in the market for credit ratings that need to be addressed?***

The ACT and AFTE are conscious that the very limited number of credible worldwide rating agencies do not create a high level of competition in the rating industry but do not believe however that there are any competition issues which cannot be covered by existing competition laws

In addition, we generally take the view that regulation can easily add barriers to competition but can only rarely reduce natural barriers.

At the lowest level, why should not the publication of credit ratings based solely on a statistical analysis of published financial information about an issuer – very low cost to achieve – be allowed freely for sale to anyone willing to buy them, with no regulation? Risk of damages claims from issuers and the need to preserve reputation to preserve sales could keep the analyses "honest": the market is probably an adequately efficient and acceptable "regulator".

Regulation, inevitably adding to barriers, only begins to be appropriate where the rating is based in part on discussion with management and the availability of material non-published confidential information. Even here it should be minimised and exist only where there is substantial justification.

---

[5] Since the collapse of Penn Central.in 1970. See for example Richard Cantor and Frank Packer, The credit rating industry, *Federal Reserve Bank of New York Quarterly Review*, Summer-Fall, 1994 , ISSN: 0147-6580, page 4. (Article available at http://www.ny.frb.org/research/quarterly_review/1994v19/v19n2article1.pdf)

[6] Reg FD (17 CFR 243.100-243.103). 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).

CP II ***QUESTION 2: Do you believe that coverage of certain market segments or certain categories of economic entity (such as SMEs) may be sub optimal? Are there measures that regulators could use to effect this scenario? Which are they, and would it be appropriate to use them?***

Sub-optimal coverage of particular sectors would represent market failure. We are not aware of any examples, but have not researched the question.

As regards coverage of smaller companies, we note that only relatively large entities get the economies of scale necessary to justify the costs of issuing debt securities widely into markets where credit ratings are customary. Lenders to such smaller enterprises generally recognise that external credit ratings are less useful in these cases where greater direct knowledge of the company and, especially, its management, is essential.

The availability of credit reports under brand names such as Dunn and Bradstreet or from local development bodies (such as Business Link in the UK), partly funded by public funds, does more appropriately cover the smaller company sector for potential (non-financial) creditors of such companies.

CP III. RULES OF CONDUCT DIMENSION

Interests and conflicts of interest

CP III: Interests and conflicts of interest: ***QUESTION 1: To what extent do you agree that in order to adequately address the risk that any conflicts of interest might adversely affect the credit rating it is sufficient to have the credit rating agency (i) introduce and disclose policies and procedures for management and disclosure of conflicts of interests, and (ii) disclose whether the said policies and procedures have been applied in each credit rating?***

The ACT believes that the introduction and disclosure of such policies will adequately address the risk. It is important to recognise that persons of bad faith will introduce any required policies and procedures and ignore them at their convenience and that all systems depend on individuals. The creation of a culture of proper behaviour within a firm is the objective. The policies and procedures are a tool to encouraging that.

Requiring attestation with each rating that the firm's policies and procedures have been followed in the particular case is unlikely to add value in this process. The statement of compliance would become part of the "boiler plate" appended to each rating announcement and not even be noticed by the compiler of the rating. It would be mere "box-ticking".

More effective is likely to be the need of the firm to maintain its reputation with market participants, inducing better practice. Regulation is not needed to achieve that.

The IOSCO Code Fundamentals are sufficient in this area.

CP III: Interests and conflicts of interest: ***QUESTION 2: Do you consider that to adequately address the risk that the provision of ancillary services might influence the credit ratings process it is necessary to prohibit a credit rating agency from carrying out those services? If your answer is yes, how would you address the entry barriers that could be created by imposing such a ban?***

The ACT agrees with the CP analysis in Paragraph 83.

We do not believe that such a prohibition is necessary or desirable. It is not desirable to go beyond the provisions of the IOSCO Code Fundamentals – for example at 2.5 and 2.8.

However, while we would include in ancillary services responses from the CRA analysts to questions from companies as to what would be the effect of a possible project or change in the company's circumstances, we would exclude active participation in design of a project to achieve a particular rating level as going beyond "ancillary". Such advice should not actually be provided by persons who could influence the eventual rating and the persons who set the rating should not have their remuneration or promotion prospects affected by the provision of such services. The advice should in no way affect the eventual rating. This should all be part of the CRA's own internal procedures and is covered by IOSCO's Code Fundamental 2.5.

CP III: Interests and conflicts of interest: ***QUESTION 3: Do you think that structured finance ratings give rise to specific conflicts of interest that should be addressed in CESR's advice to the Commission?***

No.

CP III: Interests and conflicts of interest: ***QUESTION 4: To what extent do you agree that in order to adequately address the risk that the provision of ancillary services might influence the credit ratings process it is sufficient to have the credit rating agency (i) introduce and disclose policies and measures managing and disclosing multiple business relationships with issuers in general and the issuer being rated in particular, and (ii) disclose whether the said policies and procedures have been applied in each credit rating?***

Our response is similar to that to CP III Interests and conflicts of interest Question 1, above.

We believe that (i) may be helpful but that (ii) has no practical significance.

It is not necessary or desirable to go beyond the IOSCO Code Fundamentals on this point.

CP III: Interests and conflicts of interest: ***QUESTION 5: To what extent do you agree that in order to adequately address the risk that an issuer paying for a credit rating might influence its rating it is sufficient to have the credit rating agency (i) introduce policies and procedures, including but not limited to the introduction of a fee scheme, (ii) disclose its fee scheme and (iii) disclose whether the fee scheme has been applied in each credit rating?***

First we should say that the presumption in CP Paragraphs 86-90 that issuers are solely interested in securing the most favourable credit rating requires nuancing. To minimise cost of capital in the long run companies need *appropriate* credit ratings. The fall-out from a correction to (lowering of) a too-high rating increases future costs. Indeed, historically, some new CRAs used deliberately wrongly high, as well as deliberately wrongly low, ratings to try to get companies to give them access to confidential information and convert unsolicited and free-to-the-issuer ratings into solicited and paid-for ratings.

While ACT and AFTE don't approve such strategies, they are of the opinion that these were not noticeably successful strategies

The "unique selling proposition" (USP) which the issuer buys from the CRA is the agency's reputation for fair, evidence-based ratings.

The ACT does not consider that, for the larger CRA, there is any problem over the matter of issuer influence. In the longer run, sensible new/smaller CRAs need to develop the reputation for issuing useful ratings – i.e. unbiased by issuer payments.

A CRA policy segregating the remuneration scheme and promotion prospects of those determining a rating from the revenue received from the rated party (or associates thereof) will be appropriate.

As regards fee schemes, issuers generally deplore that the contracts they must enter into with CRAs are very akin to contracts of adherence rather than freely negotiated contracts. Issuers find it difficult to negotiate service and response levels. It does not seem desirable to eliminate the power of issuers to negotiate discounts from fee schemes. It would further reduce the negotiating powers of issuers if deviation from fee schemes had to be disclosed on a case by case basis.

Recent history shows that corrupt issuer managements may mislead CRAs (and auditors and regulators) and find there is no need to resort to monetary incentives to CRAs. Of course, CRAs are not really in a strong position to prove that there are false or misleading elements among the information and representations provided to them by corrupt issuer managements until after some disaster.

The more interesting question is why CRAs have not been seen to refuse to rate or to continue to rate where they suspect that they are not getting full and frank disclosure from issuers. We think that the risk of legal action if the CRA states that it is withdrawing from rating an issuer because it is not happy with the disclosures is the source of this mischief, rather than the CRA's concern at the loss of the rating fee. Indeed, for rating of long-term instruments, there is commonly only one payment to the CRA at inception of rating and it would only be income from future issues that would be at risk.

The alternative model of "user-pays" was found unable to pay for the level of ratings required by investors after the Penn Central default[5]. And, of course, requirements such as the US Reg. FD[6] and IOSCO's final Code Fundamental 3.4 require free-to-the-user dissemination of ratings using non-public information, eliminating the user-pays model.

Issuers would in any case be more concerned under a user-pays model that pressure on a CRA's analysts to disclose confidential non-published information to subscribers would be increased. There is no objection to a user-pays model for purely statistical and other ratings where no confidential information is provided to the CRA

CP III: Interests and conflicts of interest: ***QUESTION 6: In order to deal with issues related to unsolicited ratings, to what extent to you agree that it is sufficient to have the credit rating agency (i) introduce and disclose policies***

and measures with regard to unsolicited credit ratings and (ii) disclose when a particular rating has been unsolicited?

We believe that the possible mischief from deliberately wrong ratings arising, whether they are set too high or too low (see comments re Question 5, above), should be the concern of CP Paragraphs 91ff. rather than simply ratings set deliberately low.

We consider the provisions outlined in the question are sufficient and 3.9 among the final IOSCO Code Fundamentals addresses the solicited/unsolicited question satisfactorily. Fundamental 3.9 also requires disclosure of whether or not the issuer participated in the rating process, which may cover the key disclosure from the point of view of users and issuers too, of whether or not the CRA had access to management and to non-published confidential information.

While CRAs may observe IOSCO Code Fundamental 3.9 in announcements of rating actions, we are concerned that it is more difficult to observe in published tabulations of ratings. We expect CRAs to achieve it by appropriate use of colour or typography or appropriate symbols."

CP III: Interests and conflicts of interest: ***QUESTION 7: To what extent do you agree that in order to adequately address the risk that any financial or other link between a credit rating agency and an issuer might influence the credit ratings process it is sufficient to have the credit rating agency (i) introduce policies and measures managing and disclosing financial links or other interests between a credit rating agency and issuers or its affiliates or investments in general and the issuer or its affiliates or investments being rated in particular, (ii) disclose the said policies and procedures and (iii) disclose whether the said policies and procedures have been applied in each credit rating?***

We believe that such provisions would be sufficient.

Fair Presentation

CP III: Fair presentation: ***QUESTION 1: To what extent do you agree that in order to adequately address the risk that lack of sufficient or inappropriate skills might lead to poor quality credit ratings it is sufficient to have the credit rating agency (i) introduce policies and measures managing and disclosing levels of skills of staff, (ii) disclose the said policies and measures and (iii) disclose whether the said policies and measures have been applied in each credit rating?***

These would be sufficient, but we question if they are necessary.

First, we doubt the utility of requiring disclosure as in (ii) on a case-by-case basis. Our comments re CP III Interests and conflicts of interest Question 1, above are pertinent.

Secondly, as said above, the USP of a CRA for its major paying customers (issuers) is its reputation for issuing appropriate, fair ratings – believed to be such by users of ratings. To create and safeguard that reputational capital certainly requires the availability of competent staff. An external regulatory or

quasi-regulatory requirement for competent staff is otiose. The market is the best regulator in this area.

CP III: Fair presentation: ***QUESTION 2: Do you have any alternative approaches to address the actual or potential risk that lack of sufficient or inappropriate skills might lead to poor quality credit rating assessments?***

No. The market is the best regulator in this area.

CP III: Fair presentation: ***QUESTION 3: Do you think that undisclosed methodologies could lead to biased credit ratings or to biased interpretation of credit ratings?***

Yes.

But we believe that where a CRA does not use access to confidential non-published information, there is no reason to stop it issuing ratings based on undisclosed methodology.

If it proves a reliable methodology over time, the business can succeed. If not, it is unlikely to. In this context it is interesting that the US SEC's principal criterion for recognition as a Nationally Recognized Statistical Rating Organisation seems to be market acceptance of the ratings and not a prescribed or a disclosed methodology.

Adequate disclosure of methodologies and of their changes make it possible to understand the rationale behind a rating and to to be reassured that they are sufficient to allow a reliable and objective rating.

For new such CRAs, it is of course unlikely that issuers would pay for such ratings to be initiated. Disclosure of methodology enables issuers and users to form a view ex-ante on the likely usefulness of such ratings. Ex-post evaluation of utility of the ratings would require a multi-year study, not available for a new CRA.

The capital required to publish such ratings for some years in order to build up credibility would be a huge barrier to entry.

CP III: Fair presentation: ***QUESTION 4: Do you see more advantages or disadvantages in the regulation of CRAs methodologies by securities regulators? Please describe the advantages and disadvantages that you consider and which is the best way of dealing with them. Do you believe that this regulation would contribute in some ways to lead to common global standards for CRAs?***

We strongly oppose regulation of methodologies.

First, such regulation would be a strong barrier to entry to new CRAs and to competition among existing ones.

Secondly, we believe that any number of methodologies should be allowed to be tried by rating agencies and allowed to flourish or fail according to the acceptability of the ratings in the market place.

Thirdly, we believe that common global methodological standards are important for ratings issued by a single CRA using the same rating scale. No such common methodological standards are required or desirable between different

CRAs. The differing ratings potentially produced by different methodologies contain important information. To suppress them would devalue the advantages of having several rating agencies.

CP III: Fair presentation: ***QUESTION 5: Do you believe provisions of the IOSCO Code are sufficient, in terms of rules on CRAs' methodologies and the corresponding disclosure? Do you believe that CRAs should disclose to issuers changes in methodologies before starting to use new methodologies?***

Overall, we believe that the IOSCO Code Fundamentals are sufficient, particularly Code Fundamental 3.10. However, we believe that CRAs should be strongly encouraged to publish all material changes to their methodologies and to allow for a reasonable period of time (5 working days?) prior to taking rating actions that would be a consequence of such changes. It is indeed potentially helpful for CRAs using a methodology which involves access to management and to non-published confidential information to publicise intended changes in methodologies prior to their introduction. This can provide interested parties with the opportunity to comment and help issuers and users to evaluate the impacts.

Ex-post analyses of rating appropriateness always look at the rating methods used in the past. Current and future ratings may use different methodologies. It is appropriate for markets to be kept informed about methodology changes.

However, because in the dominant model CRAs have access to confidential non-published information and the model requires the exercise of judgements at many levels, it cannot be expected that third parties could readily replicate the CRA's opinions from its published methodologies.

CP III: Fair presentation: ***QUESTION 5: Do you believe that regulation should concern all aspects of CRAs' methodologies? How appropriate is the choice of explicitly regulating the four proposed issues (disclosure and explanation of the key elements and assumptions of a rating, indication of some forms of risk warning, rules on updating of ratings and the inclusion of some market indicators within a rating opinion)? Would you deal with these issues by regulation?***

No, we do not believe that these issues should be the subject of regulation – see response to Question 4, above.

"disclosure and explanation of the key elements and assumptions of a rating"

To go beyond the IOSCO Code Fundamentals in this area is undesirable. The dominant model of ratings demands the exercise of judgements by the CRAs and over-explanation reduces the essential scope for judgement.

It also raises questions in regard to use of confidential non-published information, discussed in the next sub-topic. The reduction of all the relevant credit information to a simple alpha-numeric rating avoids such risks[7]. Extensive published discussion of the key factors jeopardises this.

[7] '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

"indication of some forms of risk warning"

While there could develop a business model involving such indications more formally and completely, we think this raises more difficulties where the model involves use of access to management and non-published confidential information as discussed immediately above.

In any case, it is unusual for a single risk factor to be identifiable as crucial – it is only such dramatic cases as loss of a fundamental operating licence, or the failure of critical intellectual property registration that single risk factors may be crucial. More commonly it is the combinatory effects of numerous factors which affect ratings. Inherently these cannot meaningfully be the subject of brief comments or tabulations.

We do not believe that regulation of CRA evaluation models is appropriate in any case.

"rules on updating of ratings"

IOSCO Code Fundamentals 1.9 and 1.10 deal perfectly adequately with this topic.

"inclusion of some market indicators within a rating opinion"

(It must not be overlooked that credit ratings are also used in many contexts not relating to securities or even financial obligations and their derivatives generally.)

A particular rating will have different price implications at different times and for different rated entities or instruments, even for instruments with the same duration. Credit spreads are, for example, much more volatile than credit ratings.

A credit rating is only part of price formation for affected securities or derivatives. Apart from differing views towards particular companies or industries or geographical area of activity, one important factor for lower rated credits is the question of recovery after default. The credit ratings which are commonly used are an indicator of the likelihood of default – default ratings. Of course price will be affected by the possibility of recoveries to debt holders after default on the debt: an expected 90% recovery will have different price effects from an expected 10% recovery. CRAs may issue "recovery ratings" for weak or defaulted issuers.

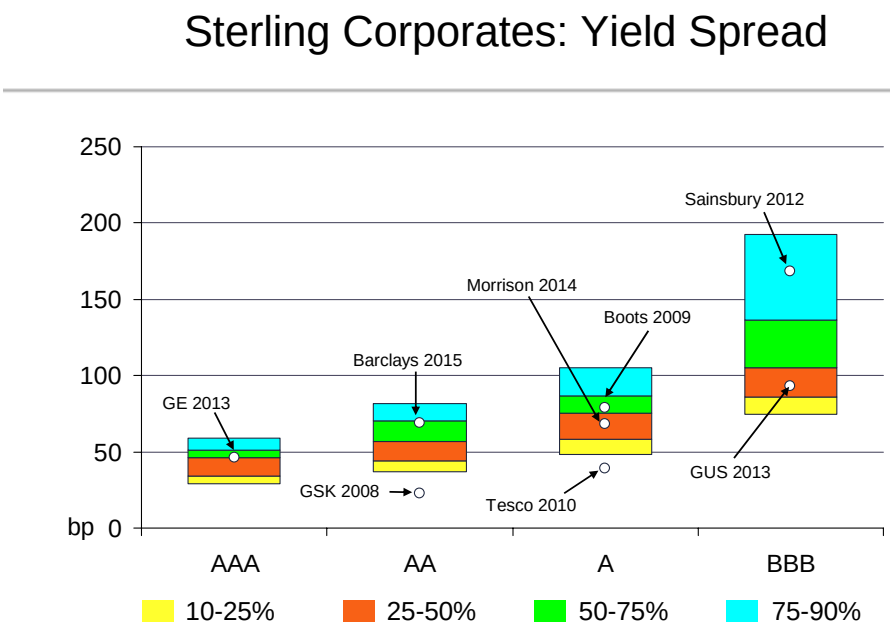
Furthermore, ratings commonly indicate relative risk of default rather than actual statistical probability of default[8] which users may impute from their evaluation of the market and the economy as a whole.

The following chart illustrates how credit ratings (default ratings) are not determinant of credit spreads, particularly for lower rated entities.

---

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'.

[8] See Cantor and Packer (footnote 5, above), pp 10 ff.



14.01.2005 Source: Makinson Cowell Limited, London

Most users of credit ratings would regard the synthesis of a pricing view, taking account of credit ratings and other information as their role. CRAs generally would not see such synthesis as their role.

Access to inside information by credit rating agencies AND

Other issues concerning the relationship between issuers and rating agencies

CP III: Access to inside information by credit rating agencies; other issues concerning the relationship between issuers and rating agencies: *QUESTION 1: Do you consider that the combination of the requirements of the Market Abuse Directive in this area and the requirements of the current version of the IOSCO Code adequately address the issue of access to inside information by CRAs?*

(An article discussing the type of information likely to be provided by issuers to CRAs was attached to our response to CESR's call for evidence[9].)

The ACT and AFTE take the view that the definition of inside information used regarding restrictions on trading in securities by persons with special knowledge of an issuer's circumstances required by MAD do not go far enough.

The ACT supports the regime in the UK whereby there are restrictions on trading by persons possessing relevant information not generally available (RINGA)[10]. RINGA is defined to include information such as about the state

[9] See footnote 1, above.

[10] RINGA is Relevant Information Not Generally Available (FSA Handbook, Market Conduct, Chapter 1, Code of Market Conduct, September 2004, section 1.4, Misuse of information

of negotiation of a major contract or the directors' consideration of a major change of strategy for the issuer which would probably be excluded from the MAD definition of "inside information" as not being specific.

We would welcome the wider adoption of trading restrictions on persons possessing RINGA throughout the EU, but this is beyond CESR's present consultation.

Accordingly we welcome both the general prohibition on trading in securities connected to an "entity within such analyst's area of primary analytical responsibility" in IOSCO Code Fundamental 2.14 – such CRA analysts being those likely to have access to RINGA furnished to the CRA by issuers – and the specific prohibition in 3.14 on trading in a security by CRA employees possessing "confidential information concerning the issuer of such security" and other relevant provisions of Fundamentals 3.11-3.18.

As regards potential disclosure of confidential non-published information generally (i.e. including commercially confidential information as well as RINGA (which itself includes "inside information"), IOSCO Code Fundamentals 3.11 and 3.12, taken with other relevant Fundamentals, and the confidentiality requirements normally contained in issuers contracts with CRAs, satisfactorily cover the matter.

CP III: Access to inside information by credit rating agencies; other issues concerning the relationship between issuers and rating agencies: *QUESTION 2: What is your view on requiring an issuer itself to disclose an imminent rating change where it has been advised of this by a CRA and where the rating announcement may itself amount to inside information in relation to the issuers' financial instruments?*

The ACT and AFTE believe that such a a requirement would not be in the public interest in that it would cause CRAs to issue changes without notice to companies, preventing the review of the announcement by the issuer or the communication proposed between CRA and issuer in IOSCO Code Fundamental 3.7.

CP III: Access to inside information by credit rating agencies; other issues concerning the relationship between issuers and rating agencies: *QUESTION 3: Do you consider that the requirements of the Market Abuse Directive in this area sufficiently address the risks that inside information might be disseminated, disclosed, or otherwise misused?*

(www.fsa.gov.uk)). The joint HM Treasury and Financial Services Authority consultation on implementation of the EU Market Abuse Directive ("UK Implementation of the Market Abuse Directive", 18 June 2004 (www.hm-treasury.gov.uk/consultations_and_legislation/consult_fullindex.cfm) explains (B.23 p. 46) that the concept is used to "explicitly prohibit people from trading to their advantage and to the disadvantage of others on the basis of information not generally available to investors." And, at 3.18, page 18: "This prohibition is important to ensuring that the UK has a flexible insider dealing regime. It enables action to be taken in relation to behaviour based on information which would be taken into account by investors but is not sufficiently precise to be inside information. It might include, for example, information about the state of negotiations over a major contract."

In respect of the narrowly defined "inside information" dealt with by MAD, yes. However as we believe that the MAD does not go wide enough in respect of information relevant to securities dealing (see response to question 1 above). Furthermore, MAD of course ignores information provided by issuers which is commercially confidential but not relevant to securities dealing.

Accordingly, the ACT and AFTE welcome IOSCO Code Fundamental 3.11 which restricts disclosure of "confidential information" generally.

CP III: Access to inside information by credit rating agencies; other issues concerning the relationship between issuers and rating agencies: ***QUESTION 4: Are there any other issues concerning access to information which CESR should consider from the perspective of establishing a level playing field between CRAs?***

No.

While CESR should in formulating approaches to regulation normally seek to avoid by that regulation aggravating or creating additional distortions affecting the competition within an industry (except where there are sound public policy grounds for accepting such distortions), it is generally the responsibility of competition authorities not of CESR to consider "level playing fields" in competitive markets.

Furthermore, we doubt whether a "level playing field" is even desirable between CRAs in this context. The information disclosed to a CRA is very much part of a dialogue and while some "hard" information may be provided to all such agencies solicited by an issuer – e.g. certain financial information – other such information and most "soft" information – e.g. the views or hopes or expectations of management on a wide variety of topics will have been given in response to analysts' questions which can vary significantly between analysts.

The ability of analysts to manage this dialogue well and usefully – or not – is a key part of the "know how" of an agency. Regulation which restricted this potential differentiation between CRAs would be regretted.

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 ask 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.

CP III: Access to inside information by credit rating agencies: *QUESTION 5: Are there any other issues concerning the Market Abuse Directive's provisions concerning inside information that you consider to be of relevance to CRAs and their activities which need to be considered?*

Yes. Under the MAD, issuers may disclose inside information to third parties in the normal course of their activities assuming the recipient owes a duty of confidentiality. It should be mentioned explicitly that, while an issuer can give non public information to a CRA, it should be under no obligation to do it. This is part of the issuer's judgment at any point in time. If a CRA whose model uses access to management and confidential non-published information feels that access or information disclosed is insufficient or incomplete or in any way misleading, it should refuse to rate or should withdraw an existing rating.

CP III: Access to inside information by credit rating agencies; other issues concerning the relationship between issuers and rating agencies: *QUESTION 6: Do you consider that it would be helpful to have a dedicated regime governing CRAs and their access to inside information?*

Other than that provided by the IOSCO Code Fundamentals, no.

CP III: Access to inside information by credit rating agencies; other issues concerning the relationship between issuers and rating agencies: *QUESTION 7: Is this provision sufficient to ensure that issuers have an opportunity to discuss and understand the underlying basis for any rating decision? If not, what other measures do you consider should be introduced?*

It is not clear to what antecedent "this provision" refers.

If it refers to the IOSCO final Code Fundamental 3.7 (or the combination of Fundamentals 3.6 and 3.7) we consider this to be satisfactory.

However, we would urge CRAs and issuers soliciting ratings to go beyond the IOSCO Code Fundamentals.

- While IOSCO implies a contract between CRAs and soliciting issuers, we consider formalisation of relationships through a contract to be essential. This needs to include protection of confidential non-published information released by the issuer to the CRA. It could also refer to the parties' practice of following a "Code of Conduct'' in managing their relationships (while specifying that no contractual rights or obligations not otherwise specified in the contract itself are to be imputed from such a Code).
- We reiterate our comment that CRA's should systematically and publicly disclose in advance not only the methodologies and criteria, but also their material changes to methodology, with any exceptions limited to the most extreme and urgent (and therefore extremely rare) situations. We take "material" as meaning a methodology change which will lead directly to variation of some ratings.

We would also go beyond article 3.7 of the IOSCO code and have all draft public releases or analysis being sent to the issuer prior to its public release to allow for correction of factual errors or strong misinterpretation and not only ''where feasible and appropriate'' as indicated in the IOSCO code. This can be achieved by adoption of a wider code of practice for all participants in the credit rating process as proposed by international treasury associations[11]

CP III: Access to inside information by credit rating agencies; other issues concerning the relationship between issuers and rating agencies: ***QUESTION 8: In addition to being able to discuss the basis for a rating, should an issuer have a "right of appeal" where they disagree with the CRA's opinion?***

It is common practice for CRAs to allow issuers to have a rating action reconsidered by a new rating committee in the days immediately following a rating action. This is sometimes referred to as a ratings appeal. The new committee, which would of course be advised by the same analysts as advised the earlier committee, should have drawn to its attention any relevant comments made by the issuer.

Furthermore, the ACT and the AFTE have taken the view that issuers should be allowed (at their cost) to request a fresh analysis of the company by a new team of analysts in the few weeks after a rating action. As well as researching the CRAs files on the issuer this new team should be provided with any additional information the issuer thought relevant and have the opportunity to meet management and put new questions to them. This is not because of any expectation of any number of issuers wanting to take advantage of this. It would be a relatively costly exercise. But availability of such an opportunity could help avoid acrimony between individuals and could on occasion improve the quality of ratings – and, well handled, the issuers understanding of the ratings process and the implications of different ratings.

None of this should be the subject of regulation, however.

CP III: Access to inside information by credit rating agencies; other issues concerning the relationship between issuers and rating agencies: ***QUESTION 9: Do you consider the provisions of the current draft IOSCO Code and the Market Abuse Directive to be sufficient to ensure that information published by CRAs is accurate?***

Within the limits of human fallibility, and our comment under question 7 above (last paragraph), yes.

CP III: Access to inside information by credit rating agencies; other issues concerning the relationship between issuers and rating agencies: ***QUESTION 10: Given the lack of specificity in the current draft IOSCO Code to maintain internal records for any particular time period, do you think***

[11] The AFTE and ACT with the Association for Financial Professionals (United States), with the support of The International Group of Treasury Associations and The Euro-Associations of Corporate Treasurers will following consolations in 2004 (see Footnote 12), publish such a code in early 2005 and this will be available on the AFTE and ACT websites, details at the back of these comments.

more specific measures would be appropriate, requiring for example all the information received by a CRA to be kept, along with records supporting its credit opinions, for a minimum of 5 years?

No.

The ACT and AFTE together with the Association for Financial Professionals (in the USA) have called[12] for CRAs to retain information provided by companies while it remains relevant. This is because a new analyst's apparent or admitted failure to read the files (or claim to have no access to the files) of information previously supplied is a major cause of irritation by issuers with rating agencies. This is particularly true for "story credits" – where unusual features of the business or its circumstances are important to the credit rating.

We do not believe that this should be a matter for regulation, but for an industry code of conduct.

Retention of material so as to provide a CRA with the opportunity to review ratings decisions long after the event in the light of subsequent developments represents a learning tool for the CRA. What material to retain for this is a matter for the CRA.

As we do not believe generally that CRAs should be a regulated sector of the economy, we see no need to mandate retention of records for regulatory reasons. CRAs may wish to retain information sufficient potentially to rebut later allegations of malpractice – but again we see that as a commercial judgement to be exercised by the CRA.

CP III: Access to inside information by credit rating agencies; other issues concerning the relationship between issuers and rating agencies: ***QUESTION 11: Do you consider that it would be appropriate to introduce measures requiring the establishment of a rating agency data room to ensure that all CRAs had access to the same information concerning a particular issuer?***

Absolutely not.

Please see our response to Question 4 above.

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

CP IV: ***QUESTION 1: Could you assess the policy options concerning the need for regulation or other measures, with particular reference to the practical implications for competition in the rating market and for the quality of ratings and of information to the market? In particular:***

- ***A full registration/regulation regime based upon detailed criteria;***
- ***A lighter registration/regulation regime essentially based upon the IOSCO Code;***

[12] Exposure Draft: Code of Standard Practices for Participants in the Credit Rating Process, published by The Association of Corporate Treasurers (ACT), London, England, The Association for Financial Professionals (AFP), United States, and the Association Française Des Trésoriers D'Entreprise (AFTE), Paris, France, April 2004, available in English and in French at http://www.treasurers.org/technical/papers/index.cfm#ratings, at 6.8 page 13

- ***To assess compliance to IOSCO Code Fundamentals in a parallel process to CRD's recognition;***
- ***A third party's certification or enforcement of the IOSCO Code;***
- ***Relying upon rules covering only specific aspects of CRAs' activity;***
- ***Monitoring the market developments.***

AND

CP IV: ***QUESTION 2*: *Could you please indicate your preferred option and highlight pros and cons that you see with regard to each policy option?***

We see no need for a full registration/regulation regime. We are not aware of a problem requiring such a solution.

It is not a valid purpose of registration to provide a badge of respectability to new or small rating agencies as a way of helping with their marketing.

We disagree strongly with CP Paragraph 192. We believe that collectively, issuers do have significant influence on CRA conduct – if not on the standard terms and conditions in rating agency contracts. The business press take an interest in CRA behaviour and the possibility of publicity is a powerful tool in the hands of issuer associations.

If there is to be any registration/regulation we would favour a registration scheme which simply requires the CRA to attest that it is following at least the IOSCO Code Fundamentals (second bullet point of Question 1) and/or disclosing which of the Code Fundamentals it is not following – which could arguably be backed up by making the reckless or negligent filing of such an attestation or the making of a false attestation an administrative offence.

Linking a regime to the CRD process seems to add unnecessary complication.

Third-party certification or enforcement seems to be taking a sledge-hammer to crack a nut. Self-certification as referred to previously should be quite sufficient.

Relying on rules covering only specific aspects of a CRA's activity is better than trying to provide rules for the total business, but we prefer the IOSCO approach of a Code.

Broadly we favour at the current time that CESR and its constituent regulatory bodies should monitor market developments for a couple of years while the effects of the IOSCO Code Fundamentals work through – the last bullet of Question 1.

In any case, should registration requirements be introduced, the ACT believes that any one legal entity wishing to register in the EU should only have to register once and that registration should be acknowledged by all regulators within the EU. The CRA should be able freely to choose with which single national securities regulator to register. This is important as, for example, a rating for securities listed in Luxembourg, issued out of a special purpose subsidiary in the Netherlands and guaranteed by its Belgian parent company may be assessed by analysts based in Germany and France and the rating be issued out of London.

A requirement for more than one registration would not only hamper the activities of larger CRAs, it would be a significant barrier to entry or growth for new or smaller CRAs.

CP IV: *QUESTION 3*: *Do you think the IOSCO Code of Conduct is conducive to reducing or increasing competition?*

We regard the IOSCO Code Fundamentals as encouraging wide adoption within the industry of current best practice, discouraging less responsible CRAs arising.

We do not believe that the Code Fundamentals are any deterrent to the establishment or growth of responsible smaller firms – or even to competition between the established firms.

CP IV: *QUESTION 4*: *Are there any areas where any European rules of conduct should be extended beyond the IOSCO Code?*

Issuer organisations will, on a global basis, urge CRAs and other participants in the credit rating process (notably issuers) to go beyond the IOSCO Code Fundamentals in certain respects (some of which have been referred to under CP III Question 7 above).

However, we do not believe that a separate European approach to a code of conduct is desirable – and certainly not to "rules".

CP IV: *QUESTION 5: To what extent is a joint treatment of rating agencies by banking and securities regulators desirable?*

We believe that minimal registration/regulation provision (by either body of regulators) is desirable. In any case, such requirements as may be introduced should be crafted so as not to be in conflict or to increase the regulatory burden – which would be a significant barrier to entry by new firms or the growth of small firms.

.

CONTACTS

AFTE Contacts:

Richard Cordero, Chief Executive
(richard.cordero@afte.com)

Patrice Tourlière, Treasury and Finance Manager, Lafarge
(Telephone: + 33 (0) 1 44 34 11 64;
patrice.tourliere@lafarge.com)

Association Française des Trésoriers d'Entreprise
20 rue d'Athènes
75 442 Paris Cedex 09

Telephone: + 33 (0)1 42 81 98 36
Website: http:www.afte.com

ACT Contacts:

Richard Raeburn, Chief Executive
(020 7213 0734; rraeburn@treasurers.co.uk)

John Grout, Technical Director
(020 7213 0712; jgrout@treasurers.co.uk)

Martin O'Donovan, Technical Officer
(020 7213 0715; modonovan@treasurers.co.uk)

The Association of Corporate Treasurers
Ocean House
10/12 Little Trinity Lane
London EC4V 2DJ

Telephone: +44 (0)20 7213 0728
Fax: +44 (0)20 7248 2591
Website: http://www.treasurers.org