STANDARD & POOR'S RATINGS SERVICES
PUBLIC COMMENT ON CODE OF CONDUCT
FUNDAMENTALS FOR CREDIT RATING AGENCIES

28 MARCH 2014

Standard & Poor's Ratings Services ("S&P Ratings Services") appreciates the opportunity to comment on IOSCO's Consultation Report entitled "Code of Conduct Fundamentals for Credit Rating Agencies" (the "Code") significantly revising the 2008 Code.

S&P Ratings Services views IOSCO as having an important role in providing principles to guide credit rating agencies ("CRAs") in developing procedures to:

- advance the quality and integrity of the ratings process,
- address potential conflicts,
- increase transparency and protect confidential information, and
- provide regulators with a foundation for CRA regulation promoting consistent regulation and oversight of CRAs globally.

A significant number of rules and regulations affecting CRAs have been implemented since the last revision of the Code in 2008 and we believe that IOSCO should continue to focus its efforts on co-ordination and agreement among international regulators (in line with the recommendations of the Financial Stability Board).

We reaffirm our commitment to the general objectives behind the IOSCO CRA Principles and the Code in particular and its underlying principles regarding the quality and integrity of the rating process, managing potential conflicts of interests and the provision of transparency to investors and issuers. As and when a revised Code is adopted by IOSCO, S&P Ratings Services may consider amending its own Code of Conduct in light of changes to the Code.

Executive Summary

As more fully discussed in this response, S&P Ratings Services supports IOSCO's initiative to strengthen and update the Code. However, we have some concerns and questions about certain changes IOSCO has proposed.

S&P Ratings Services considers that in light of certain of the proposed changes, it will be very important to further clarify the status and purpose of the Code and its intended relationship with national regulatory regimes. Although the Code makes it clear that national regulatory regimes take precedence over the Code, it is important to note that some of these national regimes do reference mandatory compliance with the Code or base their own regulatory requirements on Code provisions.

The stated goal of the Code is to "*work [ ] in harmony with CRA registration and oversight programs and continue [ ] to operate as the international standard for CRA self-governance*". In a number of areas, the proposed revisions are unnecessarily prescriptive. They add detail that could result in unintended consequences; confusing the role of the Code within and among the expanding global CRA regulations and diminishing the principles-based self-governance approach the Code was designed to promote. Furthermore, the expanded disclosure requirements may lead to conflicting regulatory mandates and confusion among investors and other market participants. For example, the provision that now places on individual CRAs (instead of on the industry) the obligation to encourage issuers of structured finance products to publicly disclose their information could be seen as expanding the role of CRAs. The increasingly prescriptive provisions also make IOSCO's previous "comply or explain" approach less workable. Because flexibility is necessary for effective self-governance, we believe IOSCO should clarify whether the Code, as proposed, is meant to serve as another layer of CRA regulation or a model upon which CRAs can establish and improve their own internal controls.

S&P Ratings Services believes that IOSCO's addition of definitions of key terms could be problematic as it might not reflect each market's practices and could create confusion and operational challenges for CRAs operating in multiple jurisdictions, many of which have developed their own definitions for such terms that differ from

IOSCO's proposed definitions. We are also concerned by the suggestion that the word "opinion" could suggest a level of "casualness" in determining credit ratings. The term "opinion," as well as all of the other terms within the Code, must be read in the context of the entire document. The Code provides a number of principles relating to the quality of a rating, making it clear that determination of a rating involves process that includes the application of criteria and sophisticated analyses and is, therefore, anything but casual. It is highly unlikely in this context that the use of the word "opinion" would connote "casualness." Instead, S&P Ratings Services believes that the use of the word "opinion" best captures the forward-looking and subjective nature of credit ratings.

We believe that by adding a number of details on controls and extensive definition of methodologies the Code would become unnecessarily prescriptive and intrude into what should be ultimately be business and analytical decisions for individual CRAs. We believe that the Code should continue to lay out high level principles and leave the specific details regarding disclosure regimes, processes and controls to national regulatory regimes according to local requirements. We agree that the Code should continue to "*offer a degree of flexibility in how [the] measures are incorporated into the individual codes of conduct of the CRAs themselves, according to each CRA's specific legal, business and market circumstances*".

Below we set out the changes proposed by IOSCO that we believe would benefit from further revision. Our comments on matters of a more technical nature are attached as an annex to this response.

Section 1 – Changes proposed by IOSCO which may need further consideration

1. Proposed changes to the definition of "*credit ratings*"

IOSCO proposes to refer to "*credit ratings*" as assessments instead of opinions. We do not share IOSCO's view that "*the use of the term "opinion" could suggest a level of casualness in determining credit ratings that is inconsistent with these provisions of the IOSCO CRA Code*".

We have explained publicly that in our view credit ratings are forward-looking opinions about a borrower's or a security's creditworthiness. They are based on analysis by experienced credit professionals who evaluate and interpret information received from issuers and other available sources to reach a considered opinion. Additionally, the terms opinion and assessment are both used by national regulatory regimes in the categorisation of credit ratings without resulting in any misapprehension that a credit rating is determined casually in those jurisdictions (e.g., the EU, Australia, Hong Kong, Singapore) that use "opinion." In fact, we believe that the use of the word "opinion" is more consistent with a forecast based on current and past information and we would not want to imply (by changing opinion to assessment) that a credit rating is a definitive view about future events, since a credit rating should not be understood to convey predictive certainty.

We therefore believe that the existing definition of "*credit ratings*" should be retained.

2. Addition of key terms in the Code

IOSCO proposes to introduce definitions of certain key terms (Affiliate/Analyst/Credit rating/Credit rating action/Credit rating agency/Credit rating methodology/Credit rating process/Employee/Entity/Trading instruments/Obligations/Obligor). We have reservations about introducing further detailed definitions because certain definitions

might not reflect local market practices and potentially different definitions enshrined in national regulatory regimes.

The definitions of '*credit rating methodology*' and '*credit rating process*' seem particularly broad. For instance the definition of "*credit rating methodology* " includes "*the information that must be considered or analyzed to determine a credit rating*" as well as *"analytical process to be undertaken to determine the credit rating, including, as applicable, the models, financial metrics, assumptions, criteria, or other quantitative or qualitative factors to be used to determine the credit rating* ".

We believe that it is confusing to define methodologies as including models, financial metrics, assumptions and criteria, and we are not clear as to the rationale for proposing this change. For S&P Ratings Services, methodologies refer to the methods that govern the application of criteria principles to a particular rating or practice. Methodologies are effectively broad subsets of criteria, with principles and assumptions.

As a result, when considering the breadth of the definition of "*credit rating methodology*" we believe that the reference to "*rigorous, formal and periodic review*" of '*all aspects of the CRA's credit rating methodology*' in provision 1.2 substantially expands the requirements contained in the previous version of the Code and goes beyond certain national regulations.[1]

The proposed definition of "*credit rating methodology*" would also affect the type and extent of information that a CRA would have to publicly disclose as provision 3.2 states that "*a CRA should publicly disclose sufficient information about its credit rating process and its credit rating methodologies, so that investors and other users of credit ratings can understand how a credit rating was determined by the CRA*."

As a general matter S&P Rating Services promotes the full disclosure of its rating methodologies but the proposed definition would significantly extend the type and

[1] See, for example, Annex 1.9 of the EU CRA Regulation that refers to periodic reviews of "*methodologies, models and key rating assumptions such as mathematical or correlation assumptions, and any significant changes or modifications thereto as well as the appropriateness of those methodologies, models and key rating assumptions where they are used or intended to be used for the assessment of new financial instruments*."

scope of public disclosure for CRAs and potentially reveal confidential sensitive business information of the CRA.[2]

We would like to emphasise that certain terms such as *"credit* rating action", "*credit rating methodology*" or "*credit rating process*" are not defined in regulation applicable to CRAs, including the EU CRA Regulation and the US Credit Rating Agency Act of 2006. S&P Ratings Services has created its own definition of such terms, based on its business practices. Defining such terms in the Code does not permit the necessary flexibility that the variety of business practices of different CRAs requires.

We believe that the content of credit ratings and methodologies should remain independent and not be influenced by national regulators.[3]

In order to better align the Code with the international regulatory framework we would therefore recommend removing the definitions of "*credit rating action*", "*credit rating methodology*" and "*credit rating process*".

3. A number of provisions of the proposed Code appear unduly prescriptive – this goes against the IOSCO objective of having high-level principles operating as an international standard for CRA self-governance

S&P Ratings Services has identified in the proposed Code a number of provisions that strengthen the requirements appearing in the existing Code, albeit with a level of detail that we believe goes beyond the original objective of the Code and which could have adverse effects on the global regulation of CRAs.

The rationale behind some of the proposed changes is unclear and for these reasons we would in certain instances recommend retaining provisions as they appear in the current version of the Code.

[2] EU CRA Regulation (at Recital 25) recognises that "*Disclosure of information concerning models should not, however, reveal sensitive business information or seriously impede innovation.*"

[3] In the US, a key principle of the regulation of Nationally Recognized Statistical Rating Organizations ("NRSRO") is that the SEC may not regulate either the substance of credit ratings or the procedures and methodologies by which the NRSROs determine credit ratings (U.S.C. 78o-7(c)). Most other regulators have also adopted this principle.

The regulatory environment for CRAs has evolved considerably since the last revision of the Code, making the addition of such prescriptive provisions unnecessary and inconsistent with a Code that is still, as we understand it, intended to be an international standard for CRA self-governance.

We also believe that it could potentially run counter to the objective of "*working in harmony with existing CRAs laws and regulations*" as some of the proposed revisions may not be aligned with existing laws and regulations. Some of the additional provisions increase the obligations of CRAs beyond what is required by current regulation. While we do not object to the continuing enhancements, CRAs as an industry are already subject to extensive and continuously evolving regulatory requirements. Effecting these changes could instigate another round of regulatory changes at a time when CRAs need regulatory stability in order to properly implement the regulations, and regulators need time to assess the impact and effectiveness of these regulations.

We list below specific provisions that we believe to be overly prescriptive:

1. QUALITY AND INTEGRITY OF THE CREDIT RATING PROCESS

A. Quality of the Credit Rating Process

- **Provision 1.1.** The proposal to remove the qualifier "*where possible*" and as a result to always require each credit rating methodology to be subjected to "*some form of objective validation based on historical experience"* could potentially limit the ability to provide ratings on new and innovative products where, notwithstanding the sufficiency of information to be able to provide ratings on those products, historical experience may not always be available. Additionally, there is generally limited historical information in developing markets, and the proposed change could prohibit CRAs from providing ratings in those markets, extending the reach of national CRA regulation extra-territorially and potentially

hindering the growth of emerging markets. This conflicts with regulations that permit the provision of such ratings.[4]

The proposed changes also imply that there must always be a methodology for each class of entity or obligation. However in certain cases, such as where a new asset is introduced, a CRA may adopt a different approach for example by using principles and/or criteria from other sectors (at least initially). The revised provision, as proposed, does not provide the flexibility to continue to do that. The insistence upon specific methodologies appears to be a potential and meaningful intrusion into a CRA's analytical independence.

We would therefore recommend that IOSCO keep the reference to "*where possible.*"

2. CRA INDEPENDENCE AND AVOIDANCE OF CONFLICTS OF INTEREST

A. General

- **Provision 2.5.** The existing Code provides that a CRA should operationally and legally separate its credit rating business from other businesses. The proposed revisions go further and suggest that these businesses should also be physically separated "*where practicable*". We believe that legal and operational separation is a robust standard which has been adopted in a number of national regulatory regimes and which can also be achieved by CRAs whether large or small, while physical separation may be too onerous for CRAs to implement.

B. CRA Policies, Procedures, Controls and Disclosures

- **Provision 2.7.** The additional statement that when a "*conflict is unique to a particular rated entity, obligor, underwriter, arranger, or obligation, the conflict should be disclosed in the relevant credit rating report or elsewhere as*

[4] For example in the EU CRA Regulation (Annex I D4) it is provided that "*If a credit rating or a rating outlook involves a type of entity or financial instrument for which historical data is limited, the credit rating agency shall make clear, in a prominent place, such limitations*."

appropriate," which we have not seen widely reflected in national regulatory regimes, could be onerous for CRAs to implement.

- **Provision 2.9.** With respect to the disclosure by structured finance issuers of information relevant to structured finance products, we understand that IOSCO would like CRAs to encourage the issuer to publicly disclose such information if it remains non-public. However it is important to be clear that it is the responsibility of the issuer to disclose such information and we do not believe it is appropriate to impose such an obligation on CRAs. This change potentially expands the role and potential importance of CRAs by making CRAs responsible for the promotion of transparency by issuers of structured finance products.

3. CRA RESPONSIBILITIES TO THE INVESTING PUBLIC, RATED ENTITIES, OBLIGORS, ORIGINATORS, AND ARRANGERS

A. Transparency and Timeliness of Credit Ratings Disclosure

- **Provision 3.13.** The proposed provision provides that a CRA should clearly indicate the attributes and limitations of the credit opinion including the extent to which the rating analyst verifies information provided to it by the rated entity. The proposed revisions add that if a credit rating involves a type of entity or obligation for which there is limited historical data, the CRA should disclose this fact and how it may limit the credit rating. This provision seems to go beyond most existing national rules.

- **Provision 3.14.** The proposed provision suggests that a CRA should include with each rating announcement certain information about the version of the methodology that was used, and indicate when the rating "*was last updated or reviewed*". This proposal is more prescriptive than the previous version of the Code and could be challenging to implement at a global level, particularly if such information needs to be included in the rating announcement. The addition of the words "*last reviewed"* could require CRAs to issue an updated announcement for every affirmation or sector review. We believe that it should be for CRAs to determine how best to provide relevant transparency. For

example we believe that a web link would be sufficient for a description of where a credit rating methodology can be found.[5]

- **Provision 3.16.** The proposed provision includes "*financial statement adjustments*" in the announcement accompanying the issue or revision of a credit rating. This disclosure requirement goes beyond what is required by existing national rules.

[5] as per the EU CRA Regulation Annex I Section D.5 "*Where the information laid down in points 1, 2 and 4 would be disproportionate in relation to the length of the report distributed, it shall suffice to make clear and prominent reference in the report itself to the place where such disclosures can be directly and easily accessed, including* ***a direct web link*** *to the disclosure on an appropriate website of the credit rating agency*." *[emphasis added]*

Appendix

to

Standard & Poor's Ratings Services Response to IOSCO's Consultation Report on Code of Conduct Fundamentals for Credit Rating Agencies

Technical comments

- **Provision 1.8**: We are not clear as to the rationale behind the use of the term "*reconstruct*". We have not identified any national regulation that refers to "*reconstructions*" of credit rating process. We suggest that a provision which more broadly reflects existing national requirements would be preferable. For example the EU CRA Regulation (Recital 42) provides that "*A credit rating agency should keep records [for five years] of the methodology for credit ratings and regularly update changes thereto and also keep a record of the substantial elements of the dialogue between the rating analyst and the rated entity or its related third parties.*"

- **Provision 1.11** refers to situations where a CRA should not issue a rating as it does not have "*appropriate knowledge and expertise*". The example provided which is specific to structured finance products does not seem relevant as it refers to a different situation, namely "*lack of robust data*".

- **Provision 1.12** the term "*review function*" is also used in article 1.11 (for reviewing the feasibility of providing credit ratings for new type of entities or obligation) which could be confusing. We therefore recommend using two different terms.

  If all aspects of credit rating methodologies are required to be reviewed, the reference '*including significant changes*…' appears redundant. In the last sentence '*employees*' should be changed to '*analysts*' as '*employees*' do not generically determine credit ratings, analysts do.

- **Provision 1.14** (c) the language "*models or key rating assumptions*" is not needed as it is already covered within the definition of "*credit rating methodology*" (in relation to which we have commented separately).

- **Provision 1.16** we believe that the wording "…*that clearly set forth guidelines*..." is redundant and should be deleted.

- **Provision 1.18** the reference to "*issuers, investors, other market participants, and the public*" has been replaced by "*rated entities, obligors, arrangers, and users of credit ratings*" which we do not believe covers exactly the same scope. We are not clear as to the rationale for the proposed change.

- **Provision 1.19** this provision which refers to the "*highest standards of integrity*" is unclear and could lead to different interpretations. We suggest retaining the previous version that referred to "*high standards*". We believe that this remains a robust and appropriate standard.

- **Provision 1.21** refers to employees making "*promises or threats*". We are not clear as to the rationale for including this language which does not appear in national regulatory regimes as far as we are aware. The use of the word "*threat*" suggests criminal behaviour and also gives the impression that such behaviour has occurred.

- **Provision 2.1** provides that CRAs should not "*unnecessarily delay*" taking a credit rating action. We do not believe that the wording is clear and this could lead to different interpretations and implementation challenges.

- **Provision 2.6** expands the scope of application of the provision from "*individuals a CRA employs who have an influence on rating decisions*" to "*all CRA employees*". Additionally the provision refers to the "*judgement or analyses of CRA employees*" – in line with our comments elsewhere in this response we believe that "*employees*" do not influence rating outcomes and this should be replaced by "*analysts*" as appears in the current version of the Code.

- **Provision 2.14** addresses preventing CRA employees from holding and transacting in financial instruments and engaging in other transactions or relationships that can present certain conflicts of interest. 2.14(a) expands the scope of persons who should not engage in the identified activities that create conflicts to include a "*close relative*" of the CRA employee and "*an entity managed by the [CRA] employee*". We believe that these terms could give rise to different interpretations and should be clarified. For purposes of conflicts management and with respect to securities disclosure, S&P Ratings Services refers to the *"immediate family living in one's household or having control of investments like a child for a parent but not living in the household*". Regarding 2.14(d), we also believe that monitoring the holdings or transactions in a "*trading instrument issued by an arranger or underwriter of the obligation*" should be restricted to certain classes such as structured products. Regarding 2.14(e) we would recommend defining the term "*recent employment*".

- **Provision 2.18** we are not clear as to the need to expand the lookback provisions from "*analysts*" to "*employees*" who participated in the credit rating process". We have not seen similarly broad interpretations in national regulatory regimes.

- **Provision 3.2** we generally agree with full disclosure of methodologies but we refer back to our earlier comments addressing the very broad definition of "*methodologies*".

- **Provision 3.7** we suggest replacing the term "*different credit rating identifier*" with "*specific credit rating identifier*" as the word "*differentiate*" is already used at the beginning of the provision.

- **Provision 3.10** refers to reaching a "*rating decision*" which is not a term we have seen elsewhere. We would recommend instead using the term "*taking a rating action*", as appears for example in proposed provision 3.9.

- **Provision 3.12** we suggest combining this article with proposed provision 3.4 relating to unsolicited ratings.

- **Provision 3.15** we are not sure that "*can easily understand*" is a standard or test that is readily definable or realistic to meet in the circumstances. As regards descriptions of loss and cash flow analysis, we believe the Code should permit a CRA to disclose this information in a way which it considers appropriate (for example by web link) rather than prescribing that it must be published "*with the credit rating*".

- **Provision 3.19** in relation to confidentiality - the third parties listed in this proposed provision provide information to the CRA on behalf of the rated entity. The CRA's duty of confidentiality should be towards the rated entity on whose behalf the information is provided. The current wording suggests that the CRA has separate, potentially conflicting duties towards third parties who provide information to assist the rated entity in its rating, which could be problematic. To the extent that the CRA obtains information from other third parties who in practice are independent and do not provide the information on behalf of the rated entity, the CRA should be free to negotiate the basis on which it receives the information from the third party and we can see no reason why the Code should impose additional obligations on the CRA.

  We propose removing the reference to "*inadvertent disclosure*" because we are not clear as to how this could in practice be implemented. We suggest keeping the existing reference to "*fraud, theft and misuse*". Regarding 3.19(c) we believe that compliance with and enforcement of contractual duties is a matter for the civil courts and therefore should not appear in the Code.

- **Provision 3.19 (a)** instead of "*disclosure is not necessary in connection with*", we suggest referring to "*unrelated to the CRA's credit rating activities*" to be consistent with the wording used in the same provision. We believe that the paragraph should also expressly allow further use or disclosure of information if the rated entity has given its consent. We cannot see any reason why use or disclosure should be restricted in that case.

In addition to "*law or regulation*" we would recommend also referring to "*any judicial, governmental or regulatory authority*".

- **Provision 3.19 (c**) we are unclear as to the meaning of an "*understanding*" with the rated entity. Either the parties have entered into some form of contractual agreement, in which case the CRA has a contractual duty to comply with it, or they have not, in which case the CRA has no contractual duty and should not be obliged by the Code to "*comply*" with potentially vague, uncertain non-binding terms of a non-contractual "*understanding* ". In our view this provision should be limited to what is in contract or law. We do not believe the Code should impose quasi-statutory requirements on CRAs to comply with their contractual duties as compliance with and enforcement of contractual duties is a matter for the civil courts.

- **Provision 3.20** we believe that if the CRA is bound by statutory obligations, it is by definition obliged by law to comply with these. We do not believe that the Code should regulate how CRAs ensure compliance with such laws.

- **Provision 5.1** refers to "*understandable language*" but "*plain language*" is used in the previous provision 3.1 and is preferable.

- **Provision 5.4** provides that CRAs should make readily accessible on their public websites a number of documents and information. We recommend that the term "*readily accessible*" should be clarified.