**REVIEW OF IMPLEMENTATION OF THE IOSCO
FUNDAMENTALS OF A CODE OF CONDUCT FOR
CREDIT RATING AGENCIES**

CONSULTATION REPORT

TECHNICAL COMMITTEE

OF THE

INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS

FEBRUARY 2007

The Chairmen's Task Force of the Technical Committee of the International Organization of Securities Commissions is seeking comment on this Consultation Report on a Review of Implementation of the IOSCO Fundamentals of a Code of Conduct for Credit Rating Agencies. The public is invited to submit comments on this Consultation Report by 11 May 2007. Instructions regarding the submission of comments are set out below.

In December 2004, after extensive discussions with investor groups, credit rating agencies (CRAs), issuers, and other interested organizations such as the Basel Committee of Banking Supervisors and the International Association of Insurance Supervisors, the IOSCO Technical Committee released its Code of Conduct Fundamentals for Credit Rating Agencies (IOSCO CRA Code). This IOSCO CRA Code includes a set of provisions designed to protect investors and enhance market efficiency by improving the transparency by which CRAs decide on ratings and guard against conflicts of interest and other factors that may unduly influence a CRA's analysis and ratings away from the actual merits of an issuance. The IOSCO CRA Code is designed to be useful for all CRAs using all business models, and not just the largest and most widely recognized CRAs using an "issuer-pays" model. To date, the IOSCO CRA Code has received praise from investor groups, regulators and governments, as well as issuers and the CRAs themselves.

The IOSCO CRA Code is now two years old. Accordingly, IOSCO's Technical Committee agreed that it may be valuable to reconstitute the Chairmen's Task Force on Credit Rating Agencies to assess (1) the degree to which CRAs have adopted codes of conduct that reflect the provisions of the IOSCO CRA Code, and (2) whether any trends exist with regard whether CRAs consistently choose to "explain" (rather than comply with) specific provisions of the IOSCO CRA Code. If such trends exist, the Technical Committee believes such information may prove valuable in determining whether any aspects of the IOSCO CRA Code should be modified to better reflect market realities, or better explained to help ensure more consistent implementation

After the consultation process, the Chairmen's Task Force will submit a final version of the Implementation Report to the IOSCO Technical Committee for approval.

How to submit comments

Comments may be submitted by one of the following three methods, at the latest on 11 May 2007. To help us process and review your comments more efficiently, please use only one method.[1]

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[1] Important: All comments will be made publicly available, unless anonymity is specifically requested. Comments sent via e-mail, fax or post will be converted to PDF format and then posted on the IOSCO website. Personal information (such as e-mail addresses) will not be deleted from submissions.

1. **E-mail**

   - Send your comments to Ms. Tillie Rijk: t.rijk@iosco.org

   - The subject line of your message should indicate "Comment on Consultation Report on Board Independence"

   - Please, do not submit attachments as HTML, GIF, TIFF, PIF, ZIP or EXE files.

Or

2. **Fax**

Send your comments by fax to the attention of Ms. Tillie Rijk at the following fax number: +34 91 555 93 68.

Or

3. **Post**

Send your comment letter to:

Ms. Tillie Rijk
IOSCO General Secretariat
C/ Oquendo 12
28006 Madrid
Spain

Your comment letter should indicate prominently that it is a "Comment on the Consultation Report on Implementation of the IOSCO CRA Code".

BACKGROUND

In December 2004, after extensive discussions with investor groups, credit rating agencies (CRAs), issuers, and other interested organizations such as the Basel Committee of Banking Supervisors and the International Association of Insurance Supervisors, the IOSCO Technical Committee released its Code of Conduct Fundamentals for Credit Rating Agencies (IOSCO CRA Code). This IOSCO CRA Code includes a set of provisions designed to protect investors and enhance market efficiency by improving the transparency by which CRAs decide on ratings and guard against conflicts of interest and other factors that may unduly influence a CRA's analysis and ratings away from the actual merits of an issuance. The IOSCO CRA Code is designed to be useful for all CRAs using all business models, and not just the largest and most widely recognized CRAs using an "issuer-pays" model. To date, the IOSCO CRA Code has received praise from investor groups, regulators and governments, as well as issuers and the CRAs themselves.[2]

One crucial component of the IOSCO CRA Code is a "comply or explain" provision.[3] In order to build in flexibility so that the IOSCO CRA Code could be useful to all types of CRAs operating in widely varying legal and market circumstances, the IOSCO CRA Code is meant to be incorporated by individual CRAs into their own codes of conduct. The IOSCO CRA Code provides that these individual codes of conduct should be published and, while CRAs are free to not include or alter specific provisions of the IOSCO CRA Code, if they do so, they must explain where their own codes differ from the IOSCO CRA Code and how these variances nonetheless address the underlying objectives that the IOSCO CRA Code provisions seeks to address. In this way, market participants and others can judge for themselves whether the CRAs' variations from the IOSCO CRA Code make sense, and react accordingly.

The IOSCO CRA Code is now two years old. Most of the largest CRAs have adopted and published codes of conduct based on its provisions. Accordingly, IOSCO's Technical Committee agreed that it may be valuable to reconstitute the Chairmen's Task Force on

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[2] Currently, a number of Task Force jurisdictions are considering initiatives relating to CRAs. The Committee of European Securities Regulators recently issued a report on CRAs and the U.S. Congress passed the Credit Rating Agency Reform Act in which sets forth a process for CRAs to apply to register with the US SEC as nationally recognized statistical rating, and establishes a regulatory regime for such CRAs. The US SEC currently is in the process of drafting rules that would implement this legislation.

[3] Provision 4.1 of the IOSCO CRA Code states that a CRA should disclose to the public its code of conduct and describe how the provisions of its code of conduct fully implement the provisions of the IOSCO Principles Regarding the Activities of Credit Rating Agencies and the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies. If a CRA's code of conduct deviates from the IOSCO provisions, the CRA should explain where and why these variations exist, and how any variations nonetheless achieve the objectives contained in the IOSCO provisions. The CRA should also describe generally how it intends to enforce its code of conduct and should disclose on a timely basis any changes to its code of conduct or how it is implemented and enforced.

Credit Rating Agencies to assess (1) the degree to which CRAs have adopted codes of conduct that reflect the provisions of the IOSCO CRA Code, and (2) whether any trends exist with regard whether CRAs consistently choose to "explain" (rather than comply with) specific provisions of the IOSCO CRA Code. If such trends exist, the Technical Committee believes such information may prove valuable in determining whether any aspects of the IOSCO CRA Code should be modified to better reflect market realities, or better explained to help ensure more consistent implementation.

SCOPE AND PURPOSE OF THE REVIEW

Because IOSCO as an organization does not have the resources or legal authority to conduct a full assessment of whether CRAs have implemented the IOSCO CRA Code in ways that they have publicly stated they have, the Technical Committee instead is focusing on the most basic and essential aspect of implementation: whether a given CRA has, in fact, adopted a code of conduct and the degree to which this code of conduct is coherent with the provisions of the IOSCO CRA Code. A key feature of the IOSCO CRA Code is that CRAs make their codes of conduct public. Accordingly, this approach is resource-efficient, since IOSCO (as well as any interested party) can easily confirm whether or not CRAs have published codes of conduct that seek to address the concerns laid out by IOSCO in its CRA Code of Conduct and its Principles Regarding the Activities of Credit Rating Agencies.[4] (In practical terms, most CRAs complying with the IOSCO CRA Code publish their own codes of conduct on their websites, a practice which the IOSCO Technical Committee supports and recommends.)

In this sense, the Technical Committee's goal is not a review of legal compliance (which remains the province of national regulators and legal systems), but functional implementation. Whether a CRA has adopted a code of conduct and the degree this code complies with the provisions of the IOSCO CRA Code constitute important information for investors, issuers, and regulators. Such a code helps market participants determine how much credence they should lend to a CRA's opinions, and can help assure regulators that potential conflicts of interest and other problematic issues are being addressed. In this sense, the IOSCO CRA Code may be viewed as having three levels of "enforcement." The first level is ascertaining that CRAs have issued codes of conduct along the lines of the IOSCO Code, which is the objective of this Report. The second level regards whether variations from the IOSCO Code matter to users of ratings. This second level of enforcement is the remit of the market. The third level of enforcement involves determining whether CRAs comply in fact with the statements made in their individual codes of conduct. This last level of enforcement is the responsibility of individual regulators, as determined by their own laws and regulations.

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[4] The IOSCO CRA Code of Conduct envisages that actual enforcement of implementation of a CRA's code of conduct will vary according to the legal and market circumstances of the different IOSCO member jurisdictions. See IOSCO Code of Conduct Fundamentals for Credit Rating Agencies, p. 2.

Because the IOSCO CRA Code was designed for use by all CRAs, of all sizes and business models and operating under a variety of legal systems, this review is not limited to just the largest CRAs. Indeed, in order to promote competition within the CRA industry, IOSCO's Technical Committee believes that widespread adoption of the IOSCO CRA Code among smaller CRAs is necessary in order to signal investors, issuers and others that transparency and conflicts of interest issues are not just being addressed by the biggest firms or just CRAs in certain jurisdictions.

Finally, because the IOSCO CRA Code is designed to offer CRAs a considerable degree of flexibility in how its measures are put into effect,[5] this review is designed to determine whether there are any trends with respect to the explanations given for non-implementation (or variations in interpretation of what constitutes implementation), and whether there has been any market reaction to these patterns. The overarching goal is to determine whether certain aspects of the IOSCO CRA Code may not reflect the realities of how credit ratings are determined by CRAs and used by the market. This, in turn, will inform the Technical Committee about whether any aspects of the IOSCO CRA Code should be modified or better explained.

STRUCTURE OF REVIEW

As IOSCO's Report on the Activities of Credit Rating Agencies notes, there currently are several dozen different CRAs throughout the world, which vary considerably in size, focus and methodologies.[6] In order to capture as many CRAs as possible, the Task Force divided its work by region and jurisdiction. Accordingly, 32 different CRAs from seven jurisdictions were reviewed:

Jurisdiction	Firms
Australia	Rapid Ratings Pty Ltd
Brazil	LFRating Austin Ratings SR Ratings
Germany	Euler Hermes Rating GmbH Prof. Dr. Schneck Rating GmbH Creditreform Rating AG RS Rating Services AG Extern Rating AG Integrated Rating GmbH URA Unternehmens Ratingagentur AG

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[5] Id.

[6] Report on the Activities of Credit Rating Agencies, IOSCO Technical Committee (September 2003) (accessible via the Internet at: http://www.iosco.org/library/pubdocs/pdf/IOSCOPD153.pdf).

	GDUR – Mittelstands-Rating AG BayRate Bavaria Rating AG Global-Rating GmbH Assekurata Assekuranz Rating-Agentur GmbH e-ratingservice AG
Japan	Japan Credit Rating Agency, Ltd. R&I, Ltd.
Ontario	Dominion Bond Rating Service
Switzerland	Fedafin AG ComRating (Swiss Public Financial Rating SA) Schweizer Verband Creditreform KMU-Rating-Agentur AG
United States	A.M. Best Cantwell and Company Egan Jones Fitch Ratings Furlin Financial LACE Financial Moody's Investor Services Multiple Markets, Inc. Standard and Poor's, Inc.

While it is very likely that this group of CRAs is only a limited sample of the entire population of credit rating agencies throughout the world, the Task Force believes that the sample is large enough, and broad enough, to provide a good representation of how the IOSCO CRA Code has been implemented. The sample includes the three largest CRAs (Fitch, Moody's and Standard and Poor's), as well as the largest CRAs found in many of the world's most significant financial markets.[7] In addition, the sample also includes a selection of smaller CRAs and CRAs that focus predominantly on one market or market segment.

For each CRA, the Task Force reviewed the published code of conduct against the provisions of the IOSCO CRA Code. In conducting this review, the Task Force was mindful that **a CRA's *deviation* from a provision of the IOSCO CRA Code is not itself non-implementation of that provision, or non-compliance with the IOSCO Code**. On the contrary, the IOSCO CRA Code envisages that individual CRAs may vary in the manner in which they implement the individual IOSCO provisions, with disclosure of these variations empowering market participants to decide collectively whether these variations are necessary or wise.

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[7] Given the significant cross-border presence of several CRAs, the markets covered by this survey include not only the jurisdictions mentioned above (Australia, Brazil, Germany, Japan, Ontario, Switzerland and the United States), but also the United Kingdom, Hong Kong, Italy, Mexico, Spain, Portugal, and France.

Accordingly, the Task Force categorized a CRA's implementation of a provision of the IOSCO CRA Code in one of three ways:

1. Full implementation, by which the CRA's code of conduct materially reflects the IOSCO CRA Code of Conduct provision;

2. Variation, by which the CRA's code of conduct does not materially reflect the relevant IOSCO provision, and the CRA notes this variation and explains how the CRA otherwise addresses the objectives that the IOSCO provision seeks to achieve; and,

3. No provision, by which the CRA's code of conduct does not materially reflect the relevant IOSCO provision and the CRA does not note this fact or explain the variation.

Additionally, because CRAs are not required to structure their own codes of conduct to match the structure of the IOSCO CRA Code, in some cases CRAs addressed individual provisions of the IOSCO CRA Code in logically different, but functionally similar, ways. Consequently, the Task Force carefully looked at each CRA's entire code of conduct to understand how the broad concepts contained in the IOSCO Code may have been reflected in practice by the CRAs.

RESULTS AND TRENDS

Generally speaking, CRAs tended to fall into one of three categories regarding their implementation of the IOSCO CRA Code:

1. CRAs with codes of conduct containing few (if any) significant variations from the IOSCO Code, and those variations that do exist tend to be well-explained and documented by the CRAs themselves;

2. CRAs who have published codes of conduct that partially implement the IOSCO Code and with variations that tend not to be well explained; and,

3. CRAs with no published code of conduct.

CRAs with strong implementation

The largest CRAs (Moody's, Fitch and S&P) have all adopted codes of conduct that largely follow the provisions of the IOSCO CRA Code. Further, smaller CRAs in Germany (Euler Hermes Rating GmbH), Japan (R&I, Japan Credit Rating Agency), Ontario (DBRS), Switzerland (Fedafin Federlaism & Finance) and the United States (A.M. Best) also had codes of conduct that tracked the provisions of the IOSCO CRA Code, with relatively few

(five or fewer) variations. In most (though not all) of these cases, the variations from the IOSCO Code were well documented and explanation for the variations offered.

Variations and non-implementation (where a provision of the IOSCO CRA Code was not addressed) for these firms were infrequent enough that trends are hard to establish. Nonetheless, a few trends may be apparent. As discussed in more detail below, some of the "variations" reported by these CRAs (such as S&P's reported variation with regard to IOSCO Provision 3.9, and Euler Hermes Rating GmbH's reported variation regarding IOSCO Provision 1.3[8]) seem to be more explanations of practice rather than true variations.

However, there a handful of specific IOSCO provisions that CRAs with the strongest implementation of the IOSCO Code either deviated from and explained, or did not address. These include:

Provision 1.10

Provision 1.10 of the IOSCO Code provides CRAs that make their ratings available to the public should publicly announce if they discontinue rating an issuer or obligation. Where a CRA's ratings are provided only to its subscribers, the provision provides that CRAs should announce to its subscribers if it discontinues a rating. In both cases, continuing publications by the CRA of the discontinued rating should indicate the date the rating was last updated and the fact that the rating is no longer being updated.

The code of conduct developed by Fedafin Federlaism & Finance does not have a corresponding provision similar to IOSCO Provision 1.10. No explanation for this variation is offered.

Provision 1.15

Provision 1.15 of the IOSCO Code provides that CRAs should have an individual charged with overseeing the firm's compliance policies and that this individual's compensation and reporting lines should be independent of the CRA's ratings operations. S&P's code of conduct clearly states that the Executive Vice President in charge of S&P's Ratings Services has responsibility for the design, implementation of and compliance with S&P's code. However, S&P's code does not indicate whether this individual's reporting lines and compensation are independent of the firm's ratings operations. If these reporting lines and compensation arrangements are not independent of the firm's ratings operations, S&P does not explain this variation.

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[8] IOSCO CRA Code Provision 1.3 states that in assessing an issuer's creditworthiness, analysts involved in the preparation or review of any rating action should use methodologies established by the CRA and that analysts should apply a given methodology in a consistent manner, as determined by the CRA. Euler Hermes Rating GmbH's code of conduct regarding this provision, while listed as a variation, seems largely consistent with the IOSCO provision.

Provision 2.5

Provision 2.5 of the IOSCO Code provides that CRAs should legally and operationally separate its credit rating business and analysts from other businesses of the CRA that may present a conflict of interest. This provision also provides that CRAs should have in place procedures and mechanisms designed to minimize possible conflicts of interest between the CRA's rating business and any ancillary business operations.

S&P indicates a variation from the Provision 2.5 in its own code of conduct, which arises because S&P is owned by (and not legally separate from) its parent company, McGraw-Hill. S&P, however, is operationally separate from its parent, and S&P believes that this operational separation, when combined with a firewall policy and surveillance processes to protect against conflicts of interest and the misuse of confidential information, achieves the objectives of the IOSCO Code.

Both DBRS' and Japan Credit Rating Agency's codes of conduct (as with several other CRAs) indicates that they do not have any ancillary businesses and that IOSCO Provision 2.5, therefore does not apply. Presumably, this is not a variation from the IOSCO Code, provided that the CRAs are clear that they will adjust their codes of conduct if, in the future, they develops any non-ratings business operations.

Provision 2.8

Provision 2.8 of the IOSCO Code states that CRAs should disclose the general nature of their compensation arrangements with rated entities, as well as the proportion non-rating fees constitute against the fees the CRA receives from an entity for its ratings services. The purpose of this provision is to help investors and market participants determine whether non-rating fees (such as consulting fees) the CRA earns from an issuer are sufficiently high to call into question the CRA's analytical independence regarding its ratings of that issuer.[9]

Moody's code of conduct notes that, generally, the non-ratings issuer fees constitute less than 1 percent of all fees Moody's receives from these issuers. Moody's does not, however, indicate the proportion of ratings versus non-ratings fees it receives for each individual issuer. Moody's explains this variation from the IOSCO Code by noting that the overall proportion of non-ratings fees is so low that an individual breakdown is not necessary for each and every case and that, at any rate, the barriers it places between its ratings operations and consulting services are sufficient to prevent the creation of conflicts of interest.

Likewise, R&I's code of conduct states that ti will disclose in its annual report the overall proportion of non-ratings versus ratings fees it receives. However, like Moody's, it does not

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[9] While it is not clear that CRA ratings in the past have had their independence undermined by extensive consulting arrangements with rated entities, such problems have occurred in other "information gatekeeper" industries such as auditing and securities analysis. In this sense, Provision 2.8 is a preventative, rather than reactive, measure.

disclose this proportion for each issuer. R&I explains this variation from the IOSCO CRA Code by stating that disclosing this proportion for each issuer might reveal confidential business secrets of its clients and implicate their privacy. R&I also states that it has instituted policies and procedures to limit the percentage of total revenues it receives from those issuers that generate the most income the most income for the firm.

Provision 2.12

DBRS (Ontario), Fitch (US), Moody's (US) and R&I (Japan) each indicate a variation from Provision 2.12 of the IOSCO Code, which states that CRAs should not have employees who are directly involved in the rating process initiate, or participate in, discussions regarding fees or payments with any entity they rate. DBRS indicates that its analysts may quote factual fee-related information to current or proposed issuers, but that any other discussions or negotiations about fees for corporate ratings are referred to the firm's marketing group. Nonetheless, DBRS does permit structured finance analysts to discuss fees with clients.

Fitch similarly permits some analysts involved in the ratings process to engage in discussions regarding fees with that entity. However, Fitch argues that this is necessary because certain employees have specialized language skills which are necessary for communication with those entities. At the same time, Fitch states that this variation is in accordance with the spirit of the IOSCO Code because those analysts participating in fee discussions may not be a member of the global marketing team or hold the title of Managing Director or higher. Further, such exceptions must be discussed in advance by the Managing Director responsible for the affected analytical team with the Group Managing Director for the global marketing team.

Moody's indicates that it does not permit analysts who do not have management responsibilities to partake in any fee discussions with issuers. However, Moody's code does permit analysts *with* management responsibilities to participate in such discussions. Moody's nevertheless believes it meets the IOSCO Code's objective of minimizing conflicts of interest that may impact a credit rating because it provides that the analysts with primary analytical responsibility (i.e., those who prepare the initial credit rating recommendation for rating committee consideration) should not participate in fee discussions.

R&I indicates that it generally provides that rating analysts should not take part in the negotiation of a rating fee. However, as with DBRS, it makes an exception for structured finance analysts. R&I argues that such analysts typically are senior and have a sufficient understanding of conflicts of interest and the complexity and difficulty of the subject matter that their involvement in fee discussions is still coherent with the objectives of the IOSCO CRA Code.

Provision 2.13

Provision 2.13 of the IOSCO Code provides that the employees of a CRA should not participate in a rating of an issuer or obligation if the employee owns securities of that issuer or any related entity, or if the employee used to work for or has an immediate relation who works for that issuer.

DBRS's code of conduct repeats the IOSCO Code provision, but includes a "grandfather clause" for securities that its employees bought prior to joining DBRS or prior to DBRS rating the issuer. DBRS explains that it believes it prevents these grandfathered securities from presenting a conflict of interest to its employees by requiring the employees to report to the ratings committee if they own such securities. The ratings committee must then determine if a conflict of interest exists prior to permitting the employee to participate in a rating of the issuer. Further, DBRS prohibits its employees from selling such securities without first receiving the approval of DBRS's chief compliance officer.

Provision 3.9

The single most prominent trend among those firms that most comply with the IOSCO CRA code is with regard to Provision 3.9. This provision has three components: (1) a requirement that CRAs describe their policies regarding unsolicited ratings; (2) a requirement that CRAs disclose whether the issuer participated in the process of developing a given rating; and (3) a requirement that the CRA disclose if a rating was not initiated at the request of the issuer.

Five firms (Moody's, S&P, Fitch, DBRS and A.M. Best) possibly deviate from this provision. However, the nature of the variation varies. For example, while Moody's code states that the firm will indicate if an issuer did not participate in a rating, it does not explicitly state that it will indicate if an issuer did not initially request the rating. Nonetheless, Moody's does state that it has not assigned unsolicited ratings in the recent past. Consequently, this variation may indicate an oversight rather than a true variation. Likewise, while S&P actually indicates it deviates from the IOSCO Code regarding Provision 3.9, its explanation for this variation, however, hints that it may be taking a very cautious approach to this provision: S&P states that it may issue unsolicited ratings when it believes it has sufficient information to be able to reach a robust credit opinion, and that it discloses this in its policies on unsolicited ratings on its website and identifies unsolicited ratings as such. Since the IOSCO CRA Code provides that a CRA should do nothing more than this, S&P's approach does not seem to be an actual variation.

By contrast, while A.M. Best's code of conduct states it will disclose whether an issuer participated in the ratings process, it does not state that it will disclose its policies regarding unsolicited ratings or whether a rating was not initiated at the request of the issuer. A.M. Best does not offer an explanation for this variation.

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Fitch's code of conduct states that where it initiates a rating of a security or issuer, it will disclose this fact in accordance with its established policies and procedures. However, Fitch's code does not indicate whether Fitch will disclose whether the issuer participated in the ratings process.

DBRS's code of conduct, by contrast, states that it will disclose whether the issuer participated in the ratings process. However, it does not explicitly state that it will disclose whether the rating was not initiated by the issuer. While it may be implied that a rating based solely on public information is one not initiated at the behest of an issuer, it is possible that a rating in which the issuer participated was also not initiated at its behest, and on this point DBRS's code is not clear.

Provision 4.1

IOSCO Code Provision 4.1 provides that CRAs should disclose to the public their codes of conduct and describe how the provisions of their codes fully implement the provisions of the IOSCO Principles Regarding the Activities of Credit Rating Agencies and the IOSCO CRA Code. If a CRA's code of conduct deviates from the IOSCO provisions, the CRA should explain where and why these variations exist, and how any variations nonetheless achieve the objectives contained in the IOSCO provisions. The CRA should also describe generally how it intends to enforce its code of conduct and should disclose on a timely basis any changes to its code of conduct or how it is implemented and enforced.

Fedafin Federlaism & Finance has a code of conduct which it will provide to the public upon request. However, this code of conduct has not yet been published on its website. While there is a presumption that CRAs will publish their codes of conduct online, the IOSCO CRA Code does not mandate this. Consequently, Fedafin's practice does not appear to be a variation from the IOSCO Code.

CRAs with partial implementation

By contrast with the relatively small group of mostly larger CRAs that have strongly implemented the IOSCO CRA Code, there is a larger group of mostly mid-sized CRAs that have adopted codes of conduct that only partially implement the IOSCO Code. Some of these firms have implemented significant portions of the IOSCO Code (e.g., LFRatings and Austin Ratings in Brazil), with many of the variations noted being largely technical (and more akin to explanations of practice rather than true variations). In other cases (e.g., Rapid Ratings in Australia and ComRating in Switzerland), while some portions of the IOSCO CRA Code have been incorporated into the CRA's own code of conduct, a significant number of the IOSCO provisions have not been adopted.[10]

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[10] With Rapid Ratings, this variation is explained as a result of the CRA's business model, which relies entirely on a quantitative analysis of publicly available information. Consequently, Rapid Ratings believes significant

Many of the variations noted for these CRAs tend to fall into one of three types: (1) IOSCO CRA Provisions not reflected at all in the CRA's code of conduct because the CRA believes the provision is not applicable (but where this explanation is not always explicitly stated); and (2) actual variations from an IOSCO Code Provision, but with no explanation offered for this variation. In addition to these, in some cases IOSCO Code Provisions are simply not implemented, with no explanation offered.[11]

A common example of the first situation involves IOSCO Provision 2.5, which, as noted above, provides that CRAs should legally and operationally separate their ancillary businesses from their ratings business. Since many smaller and mid-sized CRAs do not have ancillary businesses, Provision 2.5 is often seen as being inapplicable to the CRA in question. However, some CRAs do not explain their reasons for why Provision 2.5 is not reflected in their own codes of conduct (perhaps believing the reasons are obvious).

An example of the second type of variation is IOSCO Provision 1.13, which states that a CRA's analysts should be held to high standards of integrity, and that the CRA should not employ individuals with demonstrably compromised integrity. In one case (Rapid Ratings of Australia), the CRA's code of conduct requires analysts to perform their work with integrity, but does not state that the CRA will not employ individuals with demonstrably compromised integrity. No explanation is offered for this variation. A second example is IOSCO Provision 1.1, which states that CRAs should adopt, implement and enforce written procedures to ensure that the opinions it disseminates are based on a thorough analysis of all information known to the CRA that is relevant to its analysis according to the CRA's published rating methodology. In one case (LF Ratings of Brazil), the CRA's own code of conduct substitutes "all information obtained from the issuer" for "all information known to the CRA." This is a substantive variation, but the CRA does not explain the change.

CRAs with no implementation

The largest group of CRAs reviewed by this study are those that have not published any codes of conduct or that have published codes that only minimally implement the provisions of the IOSCO CRA Code. These include one firm in Brazil (SF Ratings), 10 in Germany (Creditreform Rating AG, RS Rating Services AG, Extern Rating AG, Integrated Rating GmbH, URA Unternehmens Ratingagentur AG, GDUR – Mittelstands-Rating AG, BayRate Bavaria Rating AG, Global-Rating GmbH, Assekurata Assekuranz Rating-Agentur GmbH and e-ratingservice AG), one in Switzerland (KMU-Rating-Agentur AG),[12] and five in the United States (Egan Jones, LACE Financial, Multiple-Markets,

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portions of the IOSCO Code are not applicable.

[11] For example, the code of conduct published by Prof. Dr. Schneck Rating GmbH of Germany implements several provisions of the IOSCO CRA Code, but is silent on many others.

[12] A third Swiss agency, Schweizer Verband Creditreform, also currently does not have published code of conduct. However, this firm does not yet publish credit ratings and only plans to do so in the future. Therefore, it is not included in this group.

Cantwell & Company, and Furlin Financial). Most of these firms are comparatively small. Since no explanation for the lack of a published code of conduct is offered by these firms, it is hard for the Task Force to draw conclusions about the reasons behind this lack of implementation. However, it seems possible that part of this failure to implement the IOSCO CRA Code may be due to a lack of information of the IOSCO Code's existence, or the fact that a local-language translation of the IOSCO Code may not yet be widely available.

That said, there are a few cases where knowledge of the IOSCO CRA Code may be implied from the fact that the CRAs in question actually commented on the IOSCO Consultation Report regarding the IOSCO Code.[13] In this case, the lack of implementation may be a result of lack of information about market participant and regulator expectations regarding the value that the IOSCO CRA Code offers CRAs.

CONCLUSIONS

From the Task Force's review of implementation of the IOSCO CRA Code, several trends are noticeable, which generally track the size of the CRAs involved.

Generally speaking, the largest CRAs tend to have implemented the IOSCO Code extensively. Where there are variations from the IOSCO Code, these variations usually are noted and explained. However, in some cases, explanations for these variations, while extensive, may not be entirely clear to regulators or market participants.

For small and mid-sized firms with partial or no implementation of the IOSCO Code, however, better publication and explanation by IOSCO and its members regarding the existence of the Code may be a crucial step in strengthening the competitiveness of this segment of the market. Since the perception of iron-clad integrity is a necessary prerequisite for widespread market acceptance of a CRA's ratings, it does not benefit the CRA industry for market participants to believe that CRAs have two tiers — large and medium-sized firms that that have adopted the IOSCO CRA Code and have enacted policies designed to limit conflicts of interest and improve transparency, and smaller firms where implementation of the IOSCO objectives is weaker. Consequently, smaller CRAs should be informed about and encouraged to adopt the IOSCO CRA Code. Further, as local language translations of the IOSCO CRA Code become available, IOSCO members should inform the IOSCO Secretariat so that the location of these translations can be publicized.

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[13] See Code of Conduct Fundamentals for Credit Rating Agencies, Consultation Report from the TC Chairmen Task Force on CRAs (October 2004), accessible via the Internet at: http://www.iosco.org/library/pubdocs/pdf/IOSCOPD173.pdf. A copy of public comments on this Consultation Report can be accessed via the Internet at: http://www.iosco.org/library/pubdocs/pdf/IOSCOPD177.pdf.

Potential areas for clarification of the IOSCO CRA Code

In conducting this implementation review and in its dialogue with IOSCO members and groups of securities regulators (such as the Committee of European Securities Regulators), it appears that certain aspects of the IOSCO Code have, on occasion, generated confusion among regulators and CRAs. These aspects of the IOSCO Code may benefit from clarification.

General applicability

In its review, the Task Force discovered that some CRAs believe that the IOSCO CRA Code is designed for only those ratings agencies with a particular business model (either the issuer-pays model or an analytical model dependent on non-public information provided by issuers). Accordingly, the Task Force believes it important that the IOSCO Technical Committee restate its belief that the IOSCO CRA Code is equally applicable for all types of CRAs, regardless of the business or analytical model. Potential conflicts of interest, for example, are not just limited to CRAs using non-public information in their analyses, nor is transparency just important for CRAs using an issuer-pays business model. Where a particular IOSCO provision is, in fact, not applicable, the Task Force believes CRAs should be encouraged to explain this fact and reassure market participants that this particular objective of the IOSCO CRA Code is nonetheless addressed.

Explanation clarity and implied third party rights

The Task Force recognizes that many of the issues the CRAs seek to address in their codes of conduct are extremely complicated and may be perceived as presenting possible legal risks. Nonetheless, clarity and simplicity may nonetheless best serve both the CRAs and other market participants. In this regard, the Task Force believes it important to state that the IOSCO Code of Conduct Fundamental for Credit Rating Agencies is not meant to create any third party legal rights not already present in the jurisdictions in which CRAs operate. Its provisions are, rather, designed to guide and advise, while offering CRAs sufficient flexibility to devise their own codes of conduct tailored to their own circumstances. A key component of this flexibility, however, is the "comply or explain" provision that mandates that variations from the IOSCO Code be noted and explained. Clear explanations, in this regard, can act to reassure both market participants and regulators that the objectives of the IOSCO Code are fully addressed.

IOSCO Code Provision 1.15

IOSCO Code Provision 1.15 states:

> *The CRA should institute policies and procedures that clearly specify a person responsible for the CRA's and the CRA's employees' compliance with the provisions*

of the CRA's code of conduct and with applicable laws and regulations. This person's reporting lines and compensation should be independent of the CRA's rating operations.

This provision parallels, in part, Principle 2.4 of the IOSCO Statement of Principles Regarding the Activities of Credit Rating Agencies.[14] The focus of Principle 2.4 is on ensuring that the compensation and performance appraisals of CRA analysts do not depend on the amount of revenue that a CRA derives from the issuers that the analysts evaluate. Since the compliance function plays such an important role in protecting the CRA's analytical independence, IOSCO believes that the individual responsible for the CRA's compliance function should also be insulated from any undue pressures that income from a particular issuer may present. Clearly, however, neither analysts nor the CRA's compliance personnel can be completely insulated from the CRA's economic performance, nor can their compensation be completely independent of the CRA's "ratings operations," strictly speaking, if the CRA's primary source of income is from its ratings business. Consequently, it might be useful for IOSCO to clarify that Provision 1.15 is meant to ensure that the compensation and reporting lines of the person in charge of the CRA's compliance program is not dependent on or influenced by any issuer, client, or group of issuers or clients. At the same time, where the CRA's chief compliance official is a member the CRA's ratings operations, the CRA should note this, either in the code of conduct or in a related report, and ensure that the individual's reporting lines and compensation are designed to maintain the individual's independent judgment and ability to enforce the firm's compliance policies.

   Provision 2.5

As noted above, Provision 2.5 provides that CRAs should have in place procedures and mechanisms designed to minimize possible conflicts of interest between the CRA's rating business and any ancillary business operations. Following preliminary discussions among some IOSCO members, it is possible that some confusion exists regarding what constitutes an "ancillary" business. There has also been the suggestion that IOSCO should define what constitutes an "ancillary service," and, in particular, whether "rating assessment services" are "ancillary" to a CRA's ratings business.

"Ratings assessment services" is not a well-defined term, but is widely understood to mean the type of services some CRAs offer as a way for companies involved in structured finance and merger transactions to determine how a contemplated transaction might affect their credit rating. IOSCO CRA Code Provision 1.14 explicitly contemplates CRAs providing such services, and explicitly contemplates that such services might typically fall under the ambit of the CRA's analytical staff.

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[14] See IOSCO Statement of Principles Regarding the Activities of Credit Rating Agencies, accessible via the Internet at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD151.pdf.

More generally, however, given the infinite array of services that might be "ancillary" to a CRA's ratings operations, the fact that the IOSCO CRA Code takes a principles-based approach, and that the IOSCO CRA Code has several conflicts of interest "catch-all" provisions (such as Provision 2.2), the Task Force believes that additional explication of what constitutes an "ancillary service" is unnecessary. Instead, the IOSCO Code asks CRAs to define what they consider constitutes an "ancillary service," with investors and other market participants then in a position to judge for themselves whether this adequately addresses any conflicts of interest.

Provision 3.9

The IOSCO provision with the widest degree of variation is Provision 3.9. In some cases, this variation is explained by the CRAs. However, in other cases, variations are not explained. Consequently, it may be valuable for IOSCO to emphasize that Provision 3.9 has three components: (1) a statement regarding unsolicited ratings policies, (2) disclosure of issuer participation in a rating, and (3) disclosure of whether a rating was not initiated at the behest of the issuer. A CRA's code of conduct should address each of these three points, since each, in turn, addresses a different market concern. Where a CRA's code deviates from the IOSCO CRA Code on any one of these points, this variation should be noted and explained.

Provision 4.1

An additional area that might benefit from clarification is the method by which CRAs should publish their codes of conduct and any explanations of variations from the IOSCO CRA Code. The IOSCO Code states that individual CRA codes of conduct should be made public, but does not state a preferred method. Since most regulators, issuers and financial firms now make their disclosures available via the Internet, the Task Force believes the Technical Committee should state that CRAs should publish their codes of conduct using this method.