

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



**OICU-IOSCO**

**TECHNICAL COMMITTEE  
OF THE  
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## **IOSCO TECHNICAL COMMITTEE**

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

#### **REPORT OVERVIEW – SCOPE AND PURPOSE**

The purpose of this report is to determine the extent to which credit rating agencies have incorporated the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies (IOSCO CRA Code) into their own codes of conduct. The IOSCO CRA Code,<sup>1</sup> first drafted in 2004, contains provisions that, if incorporated into a rating agency's code of conduct, are designed to protect investors and enhance market efficiency by improving the transparency by which credit rating agencies (CRAs) decide on ratings. Its provisions also are intended to 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. 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, regulators, issuers and other market participants. This information is intended to help 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. For this reason, the IOSCO Technical Committee directed its Chairmen's Task Force on Credit Rating Agencies (CRA Task Force) to review the codes of conduct of various CRAs around the world to determine whether the CRAs have incorporated the IOSCO CRA Code, resulting in this Report.<sup>2</sup>

The extent to which the IOSCO CRA Code is incorporated into a CRA's code of conduct is particularly relevant to users of credit ratings now, in light of the ongoing financial crisis arising from concerns in the credit markets. The IOSCO CRA Code was updated in May 2008 to address problems that emerged in credit markets and the downgrades in credit ratings experienced by a number of issuances of securities, particularly structured finance products. The revised version of the IOSCO CRA Code contains new provisions intended to specifically address problems that arose with respect to structured finance products.

Reviewing whether CRAs have issued codes of conduct along the lines of the IOSCO CRA Code can be viewed as the first of three levels of encouraging implementation of the IOSCO CRA Code. The second level regards whether variations from the IOSCO CRA Code matter to users of ratings. This second level of encouraging implementation is the remit of the market. The third level of encouraging implementation involves determining whether CRAs comply in fact with the statements made in their individual codes of conduct. This last level of encouraging implementation is the responsibility of individual regulators, as determined by their own laws and regulations.

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<sup>1</sup> The IOSCO CRA Code is a set of principles addressing issues that securities regulators agree should be addressed by CRAs, and, as such, represents a common point understanding across jurisdictions regarding CRA activities.

<sup>2</sup> This report focuses on a CRA's implementation of the IOSCO CRA Code and not on CRAs' implementation or compliance with any particular jurisdiction's regulation concerning CRAs.

Since 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 the CRAs have publicly stated, the Technical Committee instead is focusing on the first level of encouraging implementation. A key feature of the revised IOSCO CRA Code is that CRAs should publish a link to their codes of conduct on their home webpages in a prominent place. This approach is resource-efficient, since IOSCO (as well as any interested party) can easily confirm whether 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.<sup>3</sup> It is also a basic element of disclosure – while most provisions of the IOSCO CRA Code are “principles-like” in the sense that the nature of compliance is not spelled out in exacting detail, this particular element of the IOSCO CRA Code is thought to be so basic (and the cost of compliance so minimal) that the exact form compliance should take is described in the Code itself.

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, the IOSCO Technical Committee believes that widespread adoption of the IOSCO CRA Code among smaller CRAs is desirable in order to signal to 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,<sup>4</sup> 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.

## **BACKGROUND ON THE IOSCO CRA CODE AND THE WORK OF THE CRA TASK FORCE**

As mentioned above, the first version of the IOSCO CRA Code was issued in December 2004. It resulted from extensive discussions with investor groups, credit rating agencies, issuers, and other interested organizations such as the Basel Committee of Banking Supervisors and the International Association of Insurance Supervisors.

In 2006, the IOSCO Technical Committee considered that it would be useful to assess the level of implementation of the IOSCO CRA Code two years after its creation. Accordingly, it reconstituted the CRA Task Force and asked it to evaluate the level of implementation of the IOSCO CRA Code by CRAs around the world. The CRA Task Force subsequently

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<sup>3</sup> The IOSCO CRA Code of Conduct envisages that actual verification of the implementation of a CRA’s code of conduct will vary according to the legal and market circumstances of the different IOSCO member jurisdictions, with reliance on market forces rather than direct regulation considered one of several options. See IOSCO Code of Conduct Fundamentals for Credit Rating Agencies, p. 2.

<sup>4</sup> See IOSCO Code of Conduct Fundamentals for Credit Rating Agencies, p. 2.

examined the codes of conduct of 32 CRAs of varying size, focus and methodologies from seven jurisdictions. As with the current report, the Task Force looked only at codes of conduct that were available to the public,<sup>5</sup> and did not seek further information from the CRAs themselves. In particular, the Task Force assessed (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.

A consultation paper was published in February 2007 discussing the results of the Task Force’s work (2007 Report). Among the 32 CRAs reviewed, a number were found to have substantially implemented the IOSCO CRA Code.<sup>6</sup> This group included the largest three CRAs – Moody’s Investor Services, Standard and Poor (S&P), and Fitch Ratings. A somewhat larger group had partially implemented the IOSCO CRA Code, while a relatively large group (which mostly included smaller CRAs) had only minimal or non-existent implementation of the IOSCO CRA Code.

## **2008 REVISIONS TO THE IOSCO CRA CODE**

In the wake of market turmoil relating to the market for subprime mortgage-backed securities in the latter half of 2007,<sup>7</sup> the CRA Task Force took another look at the IOSCO CRA Code to determine whether it could be enhanced in light of market events, particularly with respect to ratings of structured finance products. After extensive meetings with the CRA industry and a variety of market participants involved in the structured finance industry, the Task Force published a revised version of the IOSCO CRA Code in May 2008. The revised Code incorporates changes designed to directly address certain conflicts of interest and transparency issues associated with ratings of structured finance instruments. The IOSCO CRA Code remains designed to be useful for all CRAs, regardless of their business model or size. However, not all of its provisions may be applicable to all CRAs, as a number of CRAs do not rate structured finance products. Changes also were made to the Code to clarify certain of its provisions that appeared to cause confusion among CRAs and which came to light while the Task Force was preparing its 2007 Report.

Given the gravity of the credit crisis, and the critical role of the CRAs in financial markets, in September 2008 the IOSCO Technical Committee directed the CRA Task Force to follow up on the 2007 Report and assess (1) the degree to which CRAs have adopted codes of conduct that reflect the updated provisions of the IOSCO CRA Code, and (2) whether any trends exist with regard to whether CRAs consistently choose to “explain” (rather than comply with) specific provisions of the IOSCO CRA Code.

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<sup>5</sup> Provision 4.1 of the IOSCO CRA Code states that CRAs should make their codes of conduct available to the public.

<sup>6</sup> Provision 4.1 of the IOSCO CRA Code also states that CRAs should indicate how their codes of conduct fully implement both the IOSCO Principles Regarding the Activities of Credit Rating Agencies and the IOSCO CRA Code.

<sup>7</sup> Report on the Subprime Crisis – Final Report of the IOSCO Technical Committee, May 2008.

## STRUCTURE OF THE IOSCO CRA CODE

As noted above, 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. One crucial component of the IOSCO CRA Code is a “comply or explain” provision.<sup>8</sup> In order to build in flexibility to reflect the widely varying legal and market circumstances under which CRAs operate, 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 should 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.

## STRUCTURE OF THE REVIEW

The sample of CRAs assessed in preparing this Report includes the three largest CRAs (Fitch, Moody’s and Standard & Poor’s), as well as smaller CRAs operating in markets around the world. 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-implementation of the IOSCO CRA 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.

## RESULTS

The CRA Task Force looked at the codes of conduct of 21 CRAs from six jurisdictions:

Brazil	Austin Ratings LF Rating SR Ratings
Germany	Assekurata Assekuranz Rating-Agentur GmbH Creditreform Rating AG

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<sup>8</sup> 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.

	MAR Rating GmbH Euler Hermes Rating GmbH Prof. Dr. Schneck Rating GmbH RS Rating Services AG URA Rating Agentur AG
Japan	Japan Credit Rating Agency, Ltd. (JCR) Rating and Investment Information, Inc.(R&I)
Canada	Dominion Bond Rating Service (DBRS)
Switzerland	Fedafin AG (Fedafin)
United States	A.M. Best Egan Jones Fitch Ratings (Fitch) LACE Financial Moody's Investor Services (Moody's) Realpoint LLC Standard and Poor's, Inc. (S&P)

Fewer CRAs were reviewed for this report than for the 2007 Report largely because CRAs in a number of markets exited the credit rating business or merged with competitors.

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.

Another point to note is that there are a number of CRAs that implemented fully or partially the 2004 version of the IOSCO CRA Code, but not the 2008 revisions to the Code. These variations also were examined in the course of this analysis.

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 CRA Code may have been reflected in practice by the CRAs.

### *Level of implementation of the 2008 revisions to the IOSCO CRA Code*

Seven out of 21 of the CRAs reviewed in this paper have implemented the 2008 IOSCO CRA Code revisions.<sup>9</sup> The three largest CRAs, Fitch, Moody's and S&P, have substantially implemented the revisions to the IOSCO CRA Code. S&P explained in its code of conduct why it deviated from the Code in several instances, while Moody's states that it will publish an annual report of its deviations from the code.<sup>10</sup> Fitch does not explicitly state that it has deviated from the IOSCO CRA Code, although in a few instances it does not fully incorporate provisions from the Code into its own code of conduct. Of the two Japanese CRAs, JCR is in complete compliance with the IOSCO CRA Code, and R&I deviates from it only with respect to one provision, for which it provides an explanation. DBRS substantially incorporates the 2008 revisions to the IOSCO CRA Code, with a few deviations. In its code, DBRS identifies the sections that differ from the IOSCO CRA Code, and states that it believes that the modified provisions achieve the objectives of the IOSCO CRA Code. However, it does not explain how the deviations achieve the objectives of the IOSCO CRA Code and the principles that underlie it.

Fedafin (Switzerland) adopted the 2008 revisions, but in many instances, Fedafin explains that it does not believe that the Code provisions are applicable to it due to its business model of not receiving compensation from issuers and not rating structured finance products.

One Brazilian CRA, Austin Rating, and one German CRA, Euler Hermes Rating GmbH, indicate that they intend to update their codes of conduct in the near future. In the case of Austin Rating, its code of conduct already addresses certain of the new provisions of the revised IOSCO CRA Code. Euler Hermes does not rate structured finance products, so several of the new provisions of the revised IOSCO CRA Code would not apply to it.

### *Non-Implementation of the 2008 IOSCO CRA Code*

Fourteen of the CRAs whose codes were reviewed for purposes of this Report did not address the 2008 revisions to the IOSCO CRA Code. Several factors may have contributed to this disconnect between adoption of the 2004 Code and subsequent adoption of the 2008 revisions. One such factor is that in the fall of 2008, the European Commission proposed a regulation establishing an oversight regime for CRAs, which has not been finalized. EU CRAs may be waiting to update their codes of conduct until there is greater regulatory clarity.

Other possible factors include resource constraints, which may have impeded CRAs' ability to update their codes of conduct, particularly in the case of the smaller CRAs. A number of the 2008 revisions to the IOSCO CRA Code were aimed at addressing concerns with respect to structured finance product ratings, but many of the smaller CRAs do not appear to offer

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<sup>9</sup> AM Best has informed the CRA Task Force that it has implemented the 2008 revisions to the IOSCO CRA Code. However, the revised version was published too late for inclusion in this report.

<sup>10</sup> Although Moody's published its annual report of deviations from the IOSCO CRA Code for 2008, publication was too late for inclusion in this Report.



such ratings. This fact may have reduced the urgency of needing to incorporate the 2008 revisions to the IOSCO CRA Code into their own codes of conduct.

#### ***Partial or Substantial Implementation of the 2004 IOSCO CRA Code of Conduct***

Eleven of the fourteen CRAs that did not implement the 2008 Code revisions have implemented partially or substantially the 2004 IOSCO CRA Code. In the 2007 Report, the largest group of CRAs had not published any code of conduct, or had published codes that only minimally implemented the provisions of the IOSCO CRA Code. A number of the CRAs in that category last time and also included in the present Report have created or augmented their codes of conduct so that they incorporate many aspects of the 2004 IOSCO CRA Code. These include one firm in Brazil (SR Ratings) and four in Germany (Creditreform Rating AG, RS Rating Services AG, URA Rating Agentur AG, and Assekurata Assekuranz Rating-Agentur GmbH). This is a significant positive step. One German CRA, Prof. Dr. Schneck Rating GmbH, has not increased its partial implementation of the 2004 IOSCO CRA Code, nor has it provided explanations for not incorporating the entire 2004 IOSCO CRA Code into its code of conduct.

#### ***Minimal or No Implementation of the 2004 IOSCO CRA Code of Conduct***

Two US CRAs, Egan-Jones and LACE Financial, remain in the category of minimal implementation of the IOSCO CRA Code. Both have codes of conduct, although these codes are not published prominently on their websites. The codes of conduct of both Egan-Jones and LACE Financial are directed primarily at their employees and do not address most other points raised by the IOSCO CRA Code, such as CRA transparency and conflicts of interest.

One German CRA, MAR Rating GmbH, does not have a specific code of conduct, but publishes a few general principles on its website. The lack of a code of conduct may be due to the fact that it entered the CRA business only recently.

## **RESULTS OF THE REVIEW**

Below is a discussion of the areas in which there were significant and/or numerous deviations from the 2008 IOSCO CRA Code. The analysis below does not take into consideration those CRAs that have yet to implement the 2008 revisions, nor does it include CRAs that have not incorporated an IOSCO CRA Code provision because of inapplicability (provided that inapplicability is noted by the CRA). For example, this is the case for many of the new IOSCO CRA Code provisions that apply to structured finance products, because many of the CRAs reviewed do not provide ratings of structured finance products.

### *Provision 1.2*

Provision 1.2 of the IOSCO CRA Code states that CRAs should only use rating methodologies that are rigorous, systematic and, where possible, result in ratings that can be subjected to some form of objective validation based on historical experience. Some CRAs, such as Creditreform and URA, state in their codes that they have not been in operation long enough to have sufficient historical performance data for purposes of objective validation. Instead, Creditreform, for example, validates its financial statement analysis methodologies by using 350,000 financial statements of German companies on hand at the Society of Investment Professionals in Germany. The analysis of the annual reports is based on a seven-year period of data. URA uses a similar process to validate its analysis, rather than historical experience.

### *Provision 1.15*

Provision 1.15 of the IOSCO CRA 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. A number of CRAs differed in their implementation of this provision.

SR Rating does not indicate one person who is responsible for compliance with its code, but rather states that its directors collectively are responsible. Fedafin deviates from this provision in that the responsibility for assessing and monitoring Fedafin's and its employees' compliance is assigned to the Executive Manager. The Executive Manager may receive compensation related to Fedafin's rating operations. However, the Executive Manager reports any potential violation of Fedafin's code to Fedafin's Monitoring Committee, which is composed of two members of the board who are lawyers. These board members and their compensation are independent of both Fedafin's ongoing rating business and its clients.

Realpoint and Austin Rating do not commit to separating the reporting lines and compensation of the person responsible for compliance with their codes of conduct from rating operations. There is no explanation for failing to include such a separation in their codes of conduct, so it is difficult to determine whether these agencies address these conflicts of interest in another way. Creditreform simply states that, due to its size, its compliance function is executed by the CEO. It is unclear whether this would achieve the goal of the IOSCO CRA Code, as the CEO's compensation likely is linked to the ratings operations.

In the 2007 Report, S&P did not explicitly state that there was a separation of its compliance officer's reporting lines and compensation. S&P has altered its code of conduct in this area, and now its code states that the persons responsible for compliance with the code have compensation and reporting lines independent of S&P's ratings operations.

### *Provision 1.16*

Provision 1.16 contains a description of situations in which employees and managers should report untoward behavior by other CRA employees. It states that employees should report to the appropriate person any actions by other employees that are illegal, unethical, or in violation of the CRA's code. CRAs also should prohibit retaliation against employees who report inappropriate behavior.

Realpoint and SR Rating do not state that management will prohibit retaliation by staff or anyone else against any employee that reports questionable conduct in good faith. Failure to protect employees against retaliation could have a significant dampening effect on employees' willingness to report inappropriate actions. There are no explanations for not including the full language of the IOSCO CRA Code provision in the codes of conduct of these CRAs.

### *Provision 2.8(a)*

Provision 2.8(a) states that where a CRA receives from a rated entity compensation unrelated to its ratings service, such as compensation for consulting services, a CRA should disclose the proportion such non-rating fees constitute against the fees the CRA receives from the entity for ratings services. R&I states in its code of conduct that disclosing such information about an individual client may violate its confidentiality agreements, so it does not commit to disclosing this information.

### *Provision 2.8(b)*

A similar confidentiality concern is raised by Fedafin in response to new provision 2.8(b). This provision states that CRAs should disclose if they receive 10 percent or more of their annual revenue from a single issuer, originator, arranger, client, or subscriber. Fedafin explains that disclosing this information may violate the confidentiality provisions in some of its contracts, given that it is a small rating agency with a relatively small number of clients, and publication of this information may make it possible to determine what each client pays.

### *Provision 2.8(c)*

New provision 2.8(c) states that CRAs as an industry should encourage structured finance issuers to publicly disclose all relevant information regarding these products so that investors and other CRAs can conduct independent analyses and even arrive at their own ratings. In addition, CRAs should disclose in their rating announcements whether the issuer of a structured finance product has informed it that it is publicly disclosing all relevant information about the product being issued. Three CRAs failed to implement the second part of this provision.

Fitch, Moody's, S&P and DBRS state that they will encourage structured finance issuers and originators to publicly disclose all relevant information regarding these products. However, they do not state that they will disclose in ratings announcements whether the issuer/originator has informed them that it will disclose such information. Only S&P provides an explanation for this, which is that it believes it is the obligation of the issuer to provide this information, rather than that of S&P. By publishing such information, S&P believes it could create an obligation for S&P to review or verify the information provided by

the issuer, while S&P believes that it should only be responsible for providing opinions on creditworthiness.

The other CRAs address this provision in several ways. Fitch states that it expects that issuers will provide the information.<sup>11</sup> DBRS states only that it believes it accomplishes the objectives of the IOSCO CRA Code and Principles with its support of an issuer disclosure regime. Moody's may provide an explanation of its deviation from the IOSCO CRA Code in this regard, but its explanation was not published in time to be included in this Report.

#### *Provision 2.11(a)*

Provision 2.11(a) states that a CRA's code of conduct should state that a CRA analyst will not be compensated or evaluated on the basis of the amount of revenue that the CRA derives from issuers that the analyst rates or with which the analyst regularly interacts. One notable deviation from this provision is by the German CRA Assekurata. In general, its code of conduct states that reporting lines for Assekurata employees and compensation arrangements are structured to eliminate or manage actual and potential conflicts of interest. Assekurata's analyst compensation scheme does not take into account individual ratings for which they are responsible. However, a portion of the compensation received by managers varies based on the yearly revenue of their respective business units, and analysts' compensation varies based on the total number of ratings for which an individual analyst is responsible.

#### *Provision 2.12*

Provision 2.12 states that a CRA 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. Deviations from this provision continue in the codes of conduct of certain CRAs in the same manner as discussed in the 2007 Report.

DBRS analysts are allowed to quote factual fee-related information and/or send standard fee schedules to current or proposed issuers. However, analysts below managing director are not permitted to initiate, or participate in, discussions regarding fees or payments with such parties. URA allows analysts to engage in first contact discussions, but do not have permission to negotiate fees. Management participates in discussions regarding ratings as well as fees. Final decisions regarding fees are taken only by top management.

In the 2007 Report, Fitch, Moody's and R&I were in the category of CRAs that deviated from the IOSCO CRA Code with respect to this provision. However, since then, all three have conformed their codes of conduct in this area to the IOSCO CRA Code.

#### *Provision 2.14*

Section 2.14 of the IOSCO CRA Code would prevent analysts from engaging in transactions related to securities of an issuer within the analyst's area of primary analytical responsibility except for holdings in diversified collective investment schemes. Several CRAs provide greater flexibility to their employees with respect to their investment options. The codes of conduct of DBRS, LACE Financial, Egan-Jones, and AM Best prohibit their analysts from

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<sup>11</sup> This expectation is contained in a section of Fitch's code of conduct entitled "What Fitch Expects of Issuers," which describes Fitch's expectations of issuers that it is rating.

buying, selling or owning securities of the specific issuers such staff are involved in rating, but do not prohibit transactions in all issuers in that analyst's area of primary responsibility. In addition, the exception to this requirement in the DBRS and Egan-Jones codes is not only for diversified collective investment schemes but also for securities of a sovereign government or agency of a sovereign government or holdings independently managed accounts over which the analyst has no influence or control. It should be noted that at least several CRAs are more restrictive than the IOSCO CRA Code in other ways with regard to the securities transactions in which their employees are allowed to engage. For example, AM Best does not allow any of its employees to engage in securities transactions of any of the issuers it rates, even if they have no involvement with that rating.

#### *Provision 3.5 (a)*

New provision 3.5(a) states that, where a CRA rates a structured finance product, it should provide investors and/or subscribers with sufficient information about its loss and cash-flow analysis so that an investor allowed to invest in the product can understand the basis for the CRA's rating. A CRA should also disclose the degree to which it analyzes how sensitive a rating of a structured finance product is to changes in the CRA's underlying rating assumptions.

S&P deviates from this IOSCO CRA Code provision in that it states only that it will provide a "brief statement of its analytic rationale" for assigning a rating to a structured finance product, rather than committing explicitly to providing sufficient information about loss and cash flow analysis so that an investor can understand the basis for the rating. It also does not address the second part of provision 3.5(a) regarding disclosure of the degree of analysis of the sensitivity of a rating of a structured finance product to changes in underlying assumptions. If it believes that the language in this area addresses the underlying goals of the IOSCO CRA Code provision, it does not provide an explanation of why it believes this, even though it provides an explanation of other areas in which its code differs from that of IOSCO.

#### *Provision 3.5(b)*

New provision 3.5(b) also prompted significant deviation among several CRAs surveyed in this Report that adopted the 2008 Code revisions. Provision 3.5(b) calls for CRAs to differentiate ratings of structured finance products from those of corporate bonds, preferably through a different rating symbology. None of the three largest CRAs has adopted a different symbology, though all three indicate in their ratings releases that the security being rated is a structured product. Fitch implements this provision of the IOSCO CRA Code by stating that it will differentiate its ratings of structured finance products through additional commentary. Moody's code of conduct states that it does not use a different scale to differentiate structured finance products from traditional corporate bond ratings, but if it did so, it would notify the public and clearly define the use and application of the different scale.<sup>12</sup> S&P explains that it does not believe that a separate rating scale would provide any additional information about the meaning and limitations of ratings. It also believes that efforts to increase the transparency and enhance the rating process would be more effective in helping the capital markets than creating a different rating scale. S&P further states that creating a separate rating scale would create unintended consequences in the form of substantial administrative

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<sup>12</sup> Additional explanation for this deviation may be available in Moody's annual report on deviations from the IOSCO CRA Code, which was not published in time for inclusion in this Report.

and operational burdens and costs for market participants. In addition, neither Moody's nor S&P explicitly state that they will differentiate structured finance ratings using a method other than a different symbology.

Although it has not yet adopted the 2008 revisions to the IOSCO CRA Code into its code of conduct, Austin Rating also states that it does not use a different rating symbology for structure finance products, citing increased investor confusion as a reason for not doing so. However, it states that it will analyze whether to adopt a different symbology in the future.

#### *Provision 3.9*

There continues to be considerable variety among CRAs with respect to Provision 3.9. Provision 3.9 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.

S&P states that it identifies its unsolicited ratings, but for some ratings that it deems "unsolicited" it may have received certain information from the issuer. S&P does not distinguish those unsolicited ratings for which it has received information from the issuer. It explains this lack of distinction by stating that it only will develop an unsolicited rating where it has sufficient information, and whether the issuer provided limited information in the course of developing that rating is irrelevant. S&P further provides a disclaimer with each unsolicited rating indicating that the issuer may or may not have provided certain information used in coming up with that rating.

DBRS' code remains unclear with respect to whether ratings are unsolicited. Its code states that DBRS 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.

Several CRAs do not discuss unsolicited ratings in their codes of conduct. Neither Realpoint nor URA states that it will indicate whether a rating is unsolicited, the issuer participated in the rating process, or its policies and procedures relating to unsolicited ratings. This may be because they do not rate issuers and issuances on an unsolicited basis. However, this is unclear from their codes of conduct.

#### *Provision 4.1*

Section 4.1 of the IOSCO CRA Code states that a CRA should explain how any deviations from the IOSCO CRA Code in the CRA's own code of conduct nonetheless achieve the objectives of the IOSCO CRA Code. Certain of the CRAs lack transparency in this area, perhaps due to the belief that the rationale for the deviations is self-explanatory. However, this is not always the case, and it may be most helpful to investors for CRAs to err on the side of providing redundant, rather than insufficient, explanations.

Several of the CRAs do not publish explicit explanations of deviations from the IOSCO CRA Code. For example, the DBRS and Realpoint codes identify the sections of the code of conduct that deviate from the IOSCO CRA Code's requirements. DBRS and Realpoint also

state that they believe that the modified provisions achieve the objectives of the IOSCO CRA Code. However, they do not explain how the deviations achieve the objectives of the IOSCO CRA Code and the principles that underlie it.

Other ways in which the CRAs deviate from this IOSCO CRA Code provision are by not providing any information on any deviations, or not providing information on all deviations from the Code. SR Rating does not state where it deviates from the IOSCO CRA Code, or provide an explanation for the deviations. S&P provides an explanation of certain areas in which its code of conduct differs from the IOSCO CRA Code. However, it does not explain all deviations.

Moody's plans to publish an annual report specifically identifying and explaining deviations from the IOSCO CRA Code. However, this analysis was published too late for inclusion in this Report.

## **CONCLUSION**

Unlike the 2007 Implementation Report, in preparing this Report, a larger proportion of the CRAs reviewed were at least aware of the IOSCO CRA Code and have taken steps to incorporate its provisions into their codes of conduct than when the 2007 Report was written. This is an encouraging sign that CRAs of all sizes and methodologies are more aware of the concerns surrounding the credit rating industry and are taking steps to address those concerns.

While the CRA Task Force believes it unfortunate that more CRAs have not adopted the 2008 revisions to the IOSCO CRA Code, the revisions have been in place for less than a year. More positively, most of the larger CRAs that have been actively involved in rating structured finance products have modified their codes of conduct to take into account the new IOSCO provisions. In most cases, they have adopted the IOSCO provisions in their entirety, or with minimal changes that are disclosed and explained. Given that the 2008 modifications were designed to address concerns raised primarily by larger CRAs rating these products, this is an encouraging sign. For those CRAs that did adopt the revisions to the IOSCO CRA Code, there does not appear to be any confusion regarding the new provisions.

Finally, the Task Force has been informed by a number of CRAs that they are either in the process of updating the codes of conduct to reflect the May 2008 revisions, or plan to revisit their codes of conduct to reflect some of the issues raised in this report.

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