

**INTERNATIONAL COOPERATION  
IN OVERSIGHT OF CREDIT RATING  
AGENCIES**

**NOTE**



**OICU-IOSCO**

**TECHNICAL COMMITTEE  
OF THE  
INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS**

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The role of credit rating agencies in the financial markets has long been an area of vital importance to IOSCO. Beginning with the publication of the *Statement of Principles Regarding the Activities of Credit Rating Agencies* in September 2003, followed by the issuance of the *Code of Conduct Fundamentals for Credit Rating Agencies* (“IOSCO CRA Code”) in December 2004 and most recently the Technical Committee’s 2009 “Review of Implementation of the IOSCO Fundamentals of a Code of Conduct for Credit Rating Agencies,” the IOSCO Technical Committee and its Task Force on Credit Rating Agencies has continually monitored and evaluated the impact of credit ratings on the financial markets and the activities of CRAs in issuing credit ratings.

IOSCO’s work regarding CRAs has recently focused on the current financial market crisis and the role credit ratings have played in the crisis. Based on an evaluation of structured finance credit ratings and how CRAs conduct their activities with regard to structured finance products, last year the Technical Committee issued a report *The Role of Credit Rating Agencies in Structured Finance Market*. This report identified several specific issues related to ratings of structured finance products and how the IOSCO CRA Code could be amended to better address the activities of CRAs in the structured finance markets.

Specifically, the report noted that CRAs’ activities related to rating structured finance products raised concerns about (1) CRA transparency and market perceptions, (2) independence and avoidance of conflicts of interest, and (3) CRA competition and the interaction of this competition on CRA independence. While these issues had been addressed in the original IOSCO CRA Code, they were especially relevant in rating structured finance products. As a result of the report, the IOSCO CRA Code was amended in May 2008 to reflect new provisions directed at addressing these issues as they related to rating structured finance products.

Currently, CRAs are not regulated in most jurisdictions. Further, although most CRAs (and all CRAs with significant cross-border operations) have largely adopted the IOSCO CRA Code provisions within their own codes of conduct, adherence to the IOSCO CRA Code is not mandatory in any IOSCO jurisdiction at this time.<sup>1</sup> Rather, as originally drafted, the IOSCO CRA Code relies upon disclosure as a “compliance” mechanism, with individual CRAs publishing their own codes of conduct so that market participants could evaluate the degree to which a CRA had incorporated the IOSCO CRA Code within its own internal requirements. If a CRA does not publish a code of conduct, its code of conduct does not incorporate the IOSCO CRA Code provisions, or market participants do not accept any explanations that the CRA offers for deviations from the IOSCO CRA Code provisions, market participants are in a position to decide for themselves how much weight to lend to the ratings opinions offered by that CRA.

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<sup>1</sup> A number of IOSCO jurisdictions are currently considering regulations that would make adherence to the IOSCO CRA Code mandatory, at least with regard to IOSCO CRA Code Provision 4.1, which states:

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 deviations exist, and how any deviations nonetheless achieve the objectives contained in the IOSCO provisions. A 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.

In addition to evaluating the conduct of CRAs and the role ratings have had on the markets, IOSCO has also studied the extent to which individual CRAs have adopted the IOSCO CRA Code as their own. The IOSCO Technical Committee has issued two reports, one in 2007 and one in 2009, detailing the extent to which CRAs have adopted the provisions of the IOSCO CRA Code in their own codes of conduct. These reports have assisted investors and regulators in evaluating the quality of CRAs' ratings and their business operations. The most recent report, issued in March 2009, details the extent to which CRAs have adopted the IOSCO CRA Code and specifically the amended provisions relating to structured finance products that were adopted in May 2008. While these reports have proved useful in collecting in one place the public announcements of CRAs' support and adoption of the IOSCO CRA Code, neither IOSCO nor any other international body currently is in a position to determine whether or not a given CRA in fact complies with its own code of conduct in the manner in which its public statements indicate.<sup>2</sup>

Given that CRAs played such a prominent role in the recent financial market crisis, many jurisdictions are now considering ways to regulate CRAs. However, as jurisdictions adopt regulations for the oversight of CRAs, the issue of regulatory fragmentation becomes a concern for CRAs, investors and regulators. Because the IOSCO CRA Code is viewed as the international consensus regarding the regulatory issues stemming from the activities of CRAs and the processes by which CRAs develop credit ratings, the IOSCO CRA Code can serve (and is serving) as a template for regulation of CRAs.

Given the importance of the issues involved and the fact that the largest CRAs operate across borders (complicating enforcement and inspections efforts for any single regulator), IOSCO has been considering ways to avoid fragmentation in the supervision of CRA activities while enhancing the abilities of IOSCO members to oversee the CRA industry globally. Specifically, the IOSCO Technical Committee has debated the merits of several proposals advanced over the past several months that would address oversight of globally active CRAs. These include creation of an international monitoring body, increasing compliance and enforcement by national regulators, establishing a self-regulatory organization, and increasing cross-border cooperation among national regulators. While each of these alternatives has distinct advantages, the Technical Committee ultimately agreed that the most effective approach would be via enhanced cross-border cooperation among national regulators with regulatory powers to inspect and oversee CRAs. This enhanced cooperation could, for example, take the form of a college of regulators and/or a series of bilateral regulatory arrangements, both designed to address the oversight issues unique to CRAs that operate in multiple jurisdictions and frequently draw upon overseas offices and analysts when rating issuers who themselves operate in multiple markets.

Enhancing cross-border cooperation among national regulators has several advantages. It allows each IOSCO member that has regulatory authority over CRAs to retain their primary responsibility over CRA activities that occur within their jurisdiction. At the same time, it

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<sup>2</sup> In many IOSCO jurisdictions, a CRA that deliberately deviates from its public statements regarding its compliance with its own internal controls may be violating existing laws and regulations against fraud, market misconduct, etc. (depending on the jurisdiction). In the United States (at the time of this Note, the only jurisdiction that regulates CRAs), CRAs that are registered with the US Securities and Exchange Commission must publish their codes of conduct or explain why they do not have one. Registered CRAs are subject to SEC inspections, and a CRA that deviates in practice from its published code of conduct may be subject to SEC enforcement actions.

permits regulators with concurrent jurisdiction to coordinate with one another to in devising regulations and in their inspection and oversight activities. Further, enhanced international cooperation could:

1. Promote the coordination of efficient regulatory design – by engaging in regular dialogue with one another, regulators can better coordinate their responses to current market threats in ways that avoid duplicative or inefficient requirements. Thus, the potential for inefficient regulation is minimized.
2. Facilitate monitoring and surveillance – by pooling information as to the activities of CRAs in foreign jurisdictions, regulators will be able to achieve greater insight into CRAs’ activities in their own domestic jurisdictions. It also acknowledges, as a legal reality, that enforcing compliance with the substance of the IOSCO CRA Code will necessarily be domestic.
3. Permit a greater degree of cross-border regulatory efficiency through cross-border cooperation – in particular, as some jurisdictions have indicated a desire to not directly regulate CRAs because of the degree of oversight that already exists in other jurisdictions (or in the jurisdictions in which the largest CRAs are based), enhanced cooperation may offer these regulators more insight into the degree of oversight that exists elsewhere and any ongoing concerns a CRA’s home regulator may have.

Considering these objectives, the CRA Task Force discussed both bilateral arrangements among regulators and a college of regulators approach to oversight cooperation as possible mechanisms for monitoring the activities of globally active CRAs. Neither a college of regulators approach nor bilateral arrangements would necessarily be exclusive of the other.

A college of regulators by design would consist of several regulators, so one challenge to this approach would be to include those regulators in the college that are necessary for effective oversight while not creating a college that is so large that its ability to act will be compromised. During the CRA Task Force’s discussions, several possible criteria were advanced, including focusing college membership on: (1) those jurisdictions in which the relevant CRA is headquartered; (2) those jurisdictions that regulate the relevant CRA; (3) those jurisdictions who can share oversight and inspection information with counterparts; and (4), a general criterion based on overall market size. The objective of these criteria would be to ensure that membership in the college of regulators is limited to a manageable size, that the most significant CRA regulators are nonetheless part of the college, and that all college participants are legally able to share information with the other members.

Bilateral agreements among national regulators could also prove useful to overseeing the activities of CRAs. Bilateral arrangements would be more focused and might provide more robust joint oversight of specific CRAs, and might have the advantage of being more tailored between regulators to address common regulatory concerns. They also may facilitate more information sharing, given that some IOSCO members can share inspection and confidential regulatory information only after certain types of confidentiality agreements have been executed.

The CRA Task Force has also developed a confidential model examination module to be used by IOSCO members that have examination authority and have a regulatory regime coherent with the IOSCO CRA Code. The model examination module provides suggestions for

IOSCO members to use when conducting inspections of CRAs' compliance with the IOSCO CRA Code provisions. The CRA Task Force believes that the model examination module can help to foster consistent interpretation and application of IOSCO CRA Code provisions across jurisdictions, while also offering something of a "baseline" for the types of information that an examiner might want to look at with regard to CRA operations. Such a baseline can help foster information-sharing by IOSCO members, since through the model examination module individual regulators can share basic expectations regarding the types of information they may request from a counterpart.

The model examination module is not "final" official IOSCO document, but rather a tool of the CRA Task Force that will be modified and updated on a continuous basis as Task Force members gain experience conducting examinations of CRAs.

As evidence of its continued commitment to assisting securities regulators with monitoring the global activities of CRAs, during its February 2009 meeting, the Technical Committee agreed to convert the CRA Task Force from an *ad hoc* task force into a permanent standing committee. The new Standing Committee on Credit Rating Agencies will have two important functions: it will regularly discuss, evaluate and consider regulatory and policy initiatives vis-à-vis CRA activities and oversight, in an effort to seek cross-border regulatory consensus through such means as the IOSCO CRA Code; and the Standing Committee will facilitate regular dialogue between securities regulators and the CRA industry itself. The Technical Committee believes both functions will greatly augment the work of those IOSCO members comprising the college of regulators or engaged in a bilateral arrangement regarding CRA supervision by facilitating international regulatory consensus and by offering a locus for industry dialogue.