SHEARMAN & STERLING LLP

Client Publication

Financial Institutions Advisory and Financial Regulatory Group | 18 November 2009

EU Regulation on Credit Rating Agencies comes into force

The Regulation of the European Parliament and of the Council on Credit Rating Agencies[1] (the "Regulation"), published in the Official Journal yesterday, comes into force on 7 December 2009. The Regulation will enforce much of what is contained in already existing voluntary codes of conduct and US legislation. The principal aim of the Regulation is to protect the stability of financial markets and investors. To that end, the Regulation aims to ensure that any part played by credit rating agencies ("CRAs") in causing and exacerbating the credit crunch and the resultant financial downturn will not recur.

The role of CRAs in the credit crunch and collapse of the financial markets has been heavily criticised, especially as many of the asset-backed securities caught in the meltdown had solid investment grade ratings. CRAs are considered to have failed, first, to reflect the risks actually inherent in certain credit instruments (especially structured obligations), and second, to adjust their credit ratings in time following the deepening market crisis.[2] Additionally, the role played by CRAs in the collapse of insurance giant American International Group Inc, which was subjected to a vicious cycle whereby a lowered rating triggered severe default obligations, further lowering its ratings, has also been widely criticised.

Criticisms have included claims that CRAs were compromised in their independence through conflicts of interests, and that CRAs did not set or adhere to appropriate codes of conduct and, in effect, could not self regulate.

In our publication on 19 February 2009 we outlined the proposals and draft regulation (the "Draft") put forward by the European Commission (the "EU Commission") for the regulation of CRAs. This memorandum summarises the key elements of the Regulation as adopted.

Overview

The EU Commission's regulation of CRAs has been both welcomed and accepted as a timely response in light of recent market developments. The Regulation establishes a compulsory registration process for CRAs which operate in the EU, along with conditions for the issuance of credit ratings. The Regulation brings the EU into line with the US, where there has been a registration and supervision requirement since mid-2007.[3] Given that the US is the country of incorporation for most of the parent companies of CRAs active in the EU, CRAs should be able to implement their obligations under the Regulation without too great an impact. It should be noted that the Draft had attracted criticism on the grounds that increasing regulation would re-enforce barriers to entry, and tying CRAs more closely to the regulatory framework would lead to a danger that they would be perceived as infallible (especially given the

[1] The Regulation can be found at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:302:FULL:EN:PDF.

[2] Recital 10.

[3] US Credit Rating Agency Reform Act 2006 (in force 27 June 2007).

perception that a high credit rating equates to liquidity or a substitution for independent research). The result, it was argued, was that there would be a more expensive and less efficient ratings industry due to the costs associated with regulatory compliance and restricted competition. This argument has, however, been dismissed, largely on the grounds that self-regulation has failed and the industry has remained effectively an oligopoly.

The EU Commission recognised that CRAs 'contributed significantly to recent market turmoil' through their rating of structured credit products.[4] CRAs indirectly encouraged investment in these products in underestimating the risk of these financial instruments. CRAs have consistently performed worse in rating structured products than in issuing traditional ratings. Therefore the Regulation is focused mainly on addressing the poor performance in relation to structured credit products.

The EU Commission has aimed to create a common approach to regulation of CRAs throughout the EU, avoiding diverging measures at a national level, and as a result proposed that a regulation be the legislation adopted.[5] The main objective of the Regulation is to ensure that ratings are reliable and accurate pieces of information.[6] More specifically, the Regulation aims to:

- ensure that CRAs avoid and manage appropriately any conflict of interest;
- ensure that CRAs remain vigilant on the quality of the rating methodology and the ratings;
- increase the transparency of CRAs; and
- ensure an efficient registration and surveillance framework to prevent forum shopping and regulatory arbitrage.

[4] The Draft Para. 1.1, Explanatory Memorandum to the Draft.

[5] Regulations have direct effect in each member state, and provisions of the regulation can therefore be relied on and enforced in national courts: Treaty of Rome 1957, Article 249.

[6] Impact Assessment, para. 4.

Existing CRAs must adopt all necessary measures to comply with the Regulation by 7 September 2010.[7]

Use of Ratings

Credit institutions and investment firms, amongst others, may only use credit ratings for regulatory purposes if they are issued by CRAs established and registered in the Community.[8] This requirement will apply from 7 December 2010. There are two exceptions to the requirement.

First, where a CRA not established or registered in the Community is in the same group of companies as a CRA which is, the latter CRA can endorse credit ratings made in whole or in part by the former if the third country CRA fulfils certain requirements.[9] Requirements include the third country CRA being registered, authorised and supervised to a level at least as stringent as the Regulation, and there being an objective reason for the credit rating to originate from outside the Community. Additionally there must be a cooperation arrangement between the competent authorities of the EU-registered CRA's Member State and the third country.

Secondly, credit ratings issued by a CRA established outside the Community which relate to an entity established or a financial instrument issued outside the Community may be used for regulatory purposes within the Community if the third country CRA seeks certification that they are regulated in an equivalent manner to CRAs registered in the EU.[10] A CRA from outside the EU will be certified by the EU Commission if it is regulated and supervised under an equivalent regime and cooperates fully with any relevant competent authorities in the EU. It should be noted however that a CRA may not be held to be regulated under an equivalent regime if its activities are of systemic

[7] Article 41.

[8] Article 4(1).

[9] Article 4.

[10] Article 5.

importance to the financial stability or financial markets of any Member State.[11]

If credit ratings are referred to in a prospectus published under the Prospectus Directive, the Regulation requires a clear and prominent statement in the prospectus of whether the credit rating was issued by a CRA established in the Community and registered under the Regulation.[12]

Registration Process

The Regulation creates a legally-binding registration regime for CRAs who want to ensure that their credit ratings can be used for regulatory purposes.[13] While all CRAs established in the EU must register, an equivalence regime for CRAs registered outside the EU, as noted above, has been introduced since the Draft. A CRA registered in one Member State can issue credit ratings anywhere in the EU.[14] Once registered, a CRA will be entered on an updated list in the Official Journal of the European Union.[15]

Under the Regulation, each Member State is required to designate a 'competent authority'.[16] These competent authorities will have supervisory and investigatory powers, but may not interfere with the content of credit ratings.[17] They will make the ultimate decision on registration and may charge a registration fee proportionate to the cost of any registration procedures in the home Member State.[18] The competent authority for a CRA will be the competent authority in the Member State in which the CRA has its registered office. Competent authorities may not impose more onerous registration requirements than those provided for in the Regulation.[19]

CRAs will be required to submit an application for registration to the Committee of European Securities Regulators ("CESR"),[20] containing the information required by Annex II to the Regulation (including details of the CRA, a description of the procedures and methods used to issue credit ratings, policies and procedures to identify and manage conflicts of interest, and information about employees).[21] The application will be transmitted by CESR to the competent authority of all Member States within five working days. The decision to register or refuse registration is made by the competent authority of the home Member State, although that authority will first send a draft of its decision to CESR.

Registration must be withdrawn by the competent authority of the home Member State in certain circumstances. These are where the CRA expressly renounces the registration, has provided no credit ratings for the preceding six months, has made false statements in obtaining the registration, no longer meets the conditions under which it was registered, or has infringed the provisions of the Regulation which deal with operating conditions.[22]

If a CRA is removed from the register, ratings made by it may still be used for regulatory purposes for three months if no other CRA has rated the same instrument or entity. The competent authority can extend this period in exceptional circumstances in the interests of financial stability.[23]

Disclosures

In order to enhance the transparency of the credit rating process and enable investors to make a more informed investment decision, the Regulation requires CRAs to make various disclosures to the public. The EU

11 Article 5 (1) (d).

12 Article 4.

13 Article 14.

14 Article 14(2).

15 Article 18(3).

16 Article 22.

17 Article 23.

18 Article 19.

19 Article 14 (5).

20 CESR's functions will be assumed by the proposed European Securities Market Authority if the EU Commission's proposals for strengthening financial regulation in the EU are adopted.

21 Article 15.

22 Article 20.

Commission notes that investors should not rely blindly on credit ratings but should take the utmost care to perform their own due diligence and undertake their own analysis in deciding whether to trust a specific rating agency.[24] The disclosures facilitate this. The most important disclosures relate to the methodologies, models and key rating assumptions used in the rating process.[25]

CRAs must disclose any credit rating on a non-selective basis and in a timely manner (unless the credit ratings are distributed by subscription).[26] Credit ratings must be presented in the required format, as set out in Section D of Annex I in the Regulation. Unsolicited credit ratings must be identified as such, and CRAs must disclose their policies and procedures in relation to the provision of such ratings. There are specific requirements for the rating of structured credit products, defined as instruments resulting from securitisation transactions, which would include CDOs.[27]

Under the Regulation, registered CRAs must publish an annual transparency report detailing their legal structure and ownership, financial information and internal systems.[28] Registered CRAs must also make full and public disclosure of matters relating to conflicts of interest (both actual and potential), policies relating to the publication of credit ratings, and any services ancillary to their core rating business, amongst other matters.[29] Such disclosures must be kept updated.

CRAs must continually review any ratings. Every six months each CRA is also required to disclose data on the historical default rates of its rating categories and every year it must give competent authorities certain information such as the list of its largest 20 clients by revenue.[30] Under the Regulation, a central repository will be established by the CESR which will be open to the public and will hold all information on the historical performance and past activities of CRAs. CESR has been going through a consultation process with regards to developing its central repository, and has stated an intention of requiring raw data instead of statistical data.

It has been argued that the above requirements should be extended further and make provision for CESR not only to maintain the central repository but to also conduct random audits of ratings to evaluate their long-term validity and initial accuracy. Such measures might, it is suggested, incentivise CRAs to issue ratings that are appropriate for the instrument under review and reduce the incidence of inflated ratings. However, such a process has not been introduced.

Independence

One of the aims behind the Regulation is to ensure that conflicts of interest are avoided or adequately managed, in order to uphold the quality and objectivity of credit ratings. Article 6 places a duty on CRAs to ensure that the issuance of a credit rating is not affected by any actual or potential conflict of interest. In doing so, the CRA is obliged to comply with various requirements,[31] the most important of which are outlined below. In addition, CRAs must ensure that all employees involved in the rating process have the appropriate knowledge and experience and are not involved in any negotiations on fee arrangements between the CRA and the rated entity (or any of its affiliates). Those employees directly involved in the credit rating process must meet various requirements (relating to independence) and be subject to a rotation mechanism (whereby individual analysts are generally required to provide rating services to an entity for between two and four years).[32] CRAs must ensure that rating analysts do not make recommendations, either formally or informally, regarding the design of

23 Article 24 (2).

24 Recital 7.

25 Article 8 (1); Annex 1 Section E Part 1.

26 Article 10 (4) and (5); Annex 1 Section D Part 1.

27 Article 10 (3); Annex I Section D Part II.

28 Article 12; Annex I Section E Part III.

29 Article 11 (1); Annex I Section E Part I.

30 Article 11; Annex I Section E Part II.

31 These requirements are found in Sections A and B of Annex I.

32 Article 7.

structured finance instruments on which they are expected to issue a credit rating. Compensation arrangements for employees involved in the rating process must be determined primarily by the quality, accuracy, thoroughness and integrity of their work, and must not be contingent on the revenue received from the rated entity or affiliates.[33]

The key independence requirements are as follows:

- *Management*: CRAs must have an administrative or supervisory board, responsible for ensuring the independence of the rating process. The board will also ensure that conflicts of interest are properly identified, managed and disclosed, and check the compliance of the CRA with the requirements of the Regulation. The senior management of a CRA must be of good repute and sufficiently skilled and experienced. There must be at least two independent non-executive members on the board, and their term of office must not be longer than five years. They can only be dismissed in cases of professional misconduct or underperformance. The remuneration of the independent members of the board cannot be linked to business performance of the CRA. Where a CRA rates structured finance instruments, at least one of the independent members and one other member of the board should be an expert in securitisation and structured finance.
- *Services provided*: CRAs should limit their activity to credit ratings and related operations, excluding consultancy or advisory services.
- *Monitor credit ratings*: CRAs must have information of a sufficient quality (and from reliable sources) on which to base their ratings,[34] and an internal function must be created to review the quality of the ratings.
- *Records*: CRAs must keep records of all their activities for at least five years. If registration is withdrawn, the records should be kept for an additional three years.

Guidance

Much of the detail on the application of the Regulation has been left to CESR to finalise, such as the registration process, the coordination of colleges and enforcement.[35] CESR has already begun to consult on the framework for the central repository, the registration process and the assessment of CRAs' systemic importance. The responses to these consultations will no doubt inform debate in other areas of proposed regulatory reform.

Enforcement

In order to ensure effective enforcement, the Regulation stipulates that Member States should lay down penalties for infringement which are effective, proportionate and dissuasive, and must notify the provisions so enacted to the EU Commission. All penalties must be disclosed publicly by Member States.[36]

The Regulation does not however prescribe specific penalties for infringements. This gives rise to the potential for disparities between the penalties levied by different Member States, which contradicts the EU Commission's stated aim of avoiding diverging measures at national level. Further, the Regulation does not directly address the issue of CRA liability. The EU Commission intends that the penalties should, at the very least, cover cases of gross professional misconduct and lack of due diligence, that penalties must be disclosed publicly by Member States and that CESR will, in addition, issue guidance to ensure the convergence of practice relating to penalties across Member States.[37]

[33] Article 7(5).

[34] Article 8(2).

[35] Article 21.

[36] Article 36.

[37] Recital 66.

The Regulation requires cooperation between the competent authorities of different Member States.[38] A mediation mechanism will be established by CESR to resolve any disagreement between competent authorities.[39] There are also provisions for an exchange of information with non-EU countries, provided that guarantees of professional secrecy are in place.[40]

The dual-level system of an EU regulation and national supervision poses problems of coordination. The EU Commission's initial suggested approach was to create a stronger role for the competent authority where the CRA is based. The Regulation as it finally emerged instead establishes an operational network of competent authorities ("colleges") to regulate each CRA.

Colleges provide an effective platform for the exchange of supervisory information among competent authorities, the coordination of supervisory activities and certain measures necessary for the effective supervision of CRAs.

The ultimate decision as to registration or certification of equivalence will lie not with the college but with the competent authority of the home Member State.[41] This framework emphasises CESR's role in coordinating cross-border supervision and mediation to ensure regulatory standards are consistently maintained in every member state.

Finally, the Regulation forms only a part of the proposed reforms to the EU financial supervisory framework.[42] According to EU Commission proposals published in September and October of this year, the Regulation will be amended to provide for a new role for the European Securities and Markets Authority ("ESMA") (the body likely to supersede CESR) to supervise CRAs. CRAs will therefore be the first type of institution subject to EU central supervision.

[38] Article 26.

[39] Article 31.

[40] Article 34.

[41] Recital 47.

[42] Recital 51.

If you wish to receive more information on the topics covered in this memorandum, you may contact your regular Shearman & Sterling contact person or any of the following:

Barnabas W.B. Reynolds
London
+44.20.7655.5528
barney.reynolds@shearman.com

Lisa L. Jacobs
New York
+1 212 848 7678
ljacobs@shearman.com

Clifford Atkins
London
+44.20.7655.5957
catkins@shearman.com

Robert Evans III
New York
+1 212 848 8830
revans@shearman.com

David Beveridge
New York
+1 212 848 7711
dbeveridge@shearman.com