



ASIC

Australian Securities & Investments Commission

CONSULTATION PAPER 160

Credit rating agencies: IOSCO Code Annual Compliance Report

June 2011

About this paper

This consultation paper seeks the views of stakeholders, including credit rating agencies (CRAs), parties that commission credit ratings, investors and their professional advisers, on proposals for the form and content of annual compliance reporting by licensed CRAs under their AFS licence conditions.

About ASIC regulatory documents

In administering legislation ASIC issues the following types of regulatory documents.

Consultation papers: seek feedback from stakeholders on matters ASIC is considering, such as proposed relief or proposed regulatory guidance.

Regulatory guides: give guidance to regulated entities by:

- explaining when and how ASIC will exercise specific powers under legislation (primarily the Corporations Act)
- explaining how ASIC interprets the law
- describing the principles underlying ASIC's approach
- giving practical guidance (e.g. describing the steps of a process such as applying for a licence or giving practical examples of how regulated entities may decide to meet their obligations).

Information sheets: provide concise guidance on a specific process or compliance issue or an overview of detailed guidance.

Reports: describe ASIC compliance or relief activity or the results of a research project.

Document history

This paper was issued on 1 June 2011 and is based on the Corporations Act as at 1 June 2011.

Disclaimer

The proposals, explanations and examples in this paper do not constitute legal advice. They are also at a preliminary stage only. Our conclusions and views may change as a result of the comments we receive or as other circumstances change.

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The consultation process

You are invited to comment on the proposals in this paper, which are only an indication of the approach we may take and are not our final policy.

As well as responding to the specific proposals and questions, we also ask you to describe any alternative approaches you think would achieve our objectives.

We are keen to fully understand and assess the financial and other impacts of our proposals and any alternative approaches. Therefore, we ask you to comment on:

- the likely compliance costs;
- the likely effect on competition; and
- other impacts, costs and benefits.

Where possible, we are seeking both quantitative and qualitative information.

We are also keen to hear from you on any other issues you consider important.

Your comments will help us develop our policy on the reporting requirements for credit rating agencies.

Making a submission

We will not treat your submission as confidential unless you specifically request that we treat the whole or part of it (such as any financial information) as confidential.

Comments should be sent by 13 July 2011 to:

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Australian Securities and Investments Commission
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Melbourne VIC 3001
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What will happen next?

Stage 1	1 June 2011	ASIC consultation paper released
Stage 2	13 July 2011	Comments due on the consultation paper
Stage 3	Late August/early September 2011	Implementation of the Annual Compliance Reporting for CRAs

A Background to the reporting requirements

Key points

Credit rating agencies (CRAs) have specially tailored conditions on their AFS licence that require them to, among other things, annually lodge an IOSCO Code Annual Compliance Report (Compliance Report) with us.

We are able to specify in writing the information, statements, explanations or other matters that CRAs must include in their Compliance Report.

This paper seeks stakeholders' views on the form and content of that Compliance Report.

Introduction

- 1 On 22 May 2008, the Minister for Superannuation and Corporate Law, Senator Nick Sherry, announced that he had asked Treasury and ASIC to review the regulation of credit rating agencies (CRAs) and research houses.
- 2 The Minister released a joint ASIC/Treasury review report on 13 November 2008¹ and announced reforms to CRA supervision in Australia, including that:
 - (a) ASIC would require CRAs to hold an Australian financial services (AFS) licence; and
 - (b) CRAs would also be required to issue an IOSCO Code Annual Compliance Report (Compliance Report) outlining in detail to ASIC how they have complied with the updated International Organization of Securities Commissions (IOSCO) Code of Conduct Fundamentals for Credit Rating Agencies (IOSCO Code).
- 3 The IOSCO Code, published in December 2004 and updated in May 2008, is 'a set of robust, practical measures that serve as a guide to and a framework for implementing' the objectives of IOSCO's 2003 Statement of Principles Regarding the Activities of Credit Rating Agencies (Principles).² The Principles and the IOSCO Code address the quality and integrity of the rating process, CRA independence and the avoidance of conflicts of interest, and the responsibilities CRAs have to the investing public and issuers.
- 4 In his announcement about the reforms to CRA supervision, the Minister explained that the Compliance Report would relate to a CRA's activities in Australia and would cover 'each and every one of the issues identified by

¹ *Review of credit rating agencies and research houses* (REP 143), available at <http://www.asic.gov.au/reports>

² The IOSCO Code and the Principles are available at <http://www.iosco.org/library/index.cfm?section=pubdocs>

IOSCO in terms of their operational conduct'. The Minister also said that 'CRAs will have to report on issues such as the quality and integrity of their rating processes, on conflicts of interest, their responsibilities to the investing public and issuers, and a range of other checks and balances'.³

- 5 ASIC consulted with the Government, CRAs and industry groups between June and September 2009, and in November 2009 we announced⁴ that we would require CRAs to comply with the IOSCO Code (on an 'if not, why not' basis to 30 June 2010 and a mandatory basis from 1 July 2010). The AFS licences we subsequently granted to the CRAs include specially tailored conditions (CRA licence conditions) that require, among other things, that CRAs:
- (a) mandatorily comply with the IOSCO Code, subject to a small number of carve-outs where it is impractical for CRAs operating in Australia to comply; and
 - (b) lodge a Compliance Report with us—both annually and on demand as requested by us in writing—outlining how they have complied with the IOSCO Code.

Reporting required under the IOSCO Code and Corporations Act

- 6 We see establishing reporting standards for the Compliance Report, together with setting AFS licence conditions and ongoing industry-wide surveillance, as our core regulatory tools in supervising CRAs. We have no power to interfere with the content of credit rating methodologies or credit ratings.⁵ Reporting by CRAs therefore helps give us and the broader market insight into the operations of CRAs and promotes the integrity of issued credit ratings.
- 7 The Compliance Report is intended to supplement the disclosure and reporting required of CRAs under certain provisions of the IOSCO Code and the Corporations Act.
- 8 For example, a licensed CRA must annually lodge audited financial statements with us, and adherence with the IOSCO Code will require a CRA to disclose, among other things:

³ Senator Nick Sherry, Minister for Superannuation and Corporate Law, *Improved Australian controls for credit rating agencies and research houses*, Press Release No. 077 (13 November 2008).

⁴ Media Release (09-224MR) *ASIC outlines improvements to regulation of credit rating agencies in Australia* (12 November 2009).

⁵ Although, if investors raise concerns about an issued credit rating, we may be able to take action—for example, if the rating is misleading or deceptive.

- (a) sufficient information about its procedures, methodologies and assumptions so that outside parties can understand how a rating was arrived at by the CRA (provisions 3.5 and 4.3);
- (b) details of any material modification to its methodologies and significant practices, procedures, and processes (provision 3.10);
- (c) its measures for avoidance and management of conflicts of interest (provision 2.6);
- (d) the general nature of its compensation arrangements with rated entities (provision 2.7); and
- (e) sufficient information about the historical default rates of CRA rating categories and whether the default rates of these categories have changed over time (provision 3.8).

9 In addition to periodic reporting and required disclosure under the IOSCO Code, we may need to request information and documents from CRAs as part of our ongoing industry surveillance. As more information is collected through the periodic reporting framework, less information would need to be collected through our surveillance work.

Proposals for periodic compliance reporting

- 10 Under the CRA licence condition requiring a Compliance Report, we are able to specify in writing the information, statements, explanations or other matters that CRAs will need to include in their Compliance Report relating to compliance with the IOSCO Code and licence conditions concerning training and arrangements to monitor and update credit ratings.
- 11 In this consultation paper, we propose to specify matters for inclusion in the Compliance Report that will help us, together with our industry-wide surveillance, in supervising the compliance of CRAs with their obligations.
- 12 In preparing our proposal on the form and content of the Compliance Report, we have taken into account:
- (a) the information we require to help us assess a CRA's adherence to the provisions of the IOSCO Code and the CRA licence conditions;
 - (b) the likely compliance costs of preparing a Compliance Report; and
 - (c) international regulatory approaches to reporting by CRAs, where these are appropriate and not inconsistent with Australia's CRA regulation and its objectives. In particular, we have considered the European Union framework, which requires initial registration reporting together with ongoing periodic, general and transparency reports, and the United States approach, which also requires initial registration reporting together with updated reports throughout the currency of a CRA's

registration with the US Securities and Exchange Commission. We are also cognisant of approaches adopted throughout the Asia-Pacific region.

- 13 This consultation paper does not make any proposals concerning disclosure by research houses. We are conducting a review of regulatory issues in the research house industry and plan to separately report on these issues later this year.

B Proposed reporting requirements for CRAs

Key points

We propose that the required content of the Compliance Report be designed to provide ASIC with an overview of the compliance framework implemented by a CRA to meet the provisions of the IOSCO Code and CRA licence conditions:

IOSCO Code Annual Compliance Report

Proposal

B1 We propose to specify that CRAs provide a narrative description (following the instructions and in the form set out in Appendix 1) of any implemented or planned measures that have the aim of ensuring compliance with 11 groups of obligations, corresponding with the following sub-headings of the IOSCO Code and the CRA licence conditions:

IOSCO Code

- 1 Quality and Integrity of the Rating Process—Quality of the Rating Process;
- 2 Quality and Integrity of the Rating Process—Monitoring and Updating;
- 3 Quality and Integrity of the Rating Process—Integrity of the Rating Process;
- 4 CRA Independence and Avoidance of Conflicts of Interest—General;
- 5 CRA Independence and Avoidance of Conflicts of Interest—CRA Procedures and Policies;
- 6 CRA Independence and Avoidance of Conflicts of Interest—CRA Analyst and Employee Independence;
- 7 CRA Responsibilities to the Investing Public—Transparency and Timeliness of Ratings Disclosure;
- 8 CRA Responsibilities to the Investing Public—The Treatment of Confidential Information;
- 9 Disclosure of the Code of Conduct and Communication with Market Participants;

CRA licence conditions

- 10 Arrangements to Monitor and Update Credit Ratings; and
- 11 Training Requirements for Representatives.

This narrative explanation should:

- (a) for each topic, be no more than four pages in length, except where exceeding this limitation is reasonably justified by the complexity of the description or topic;
- (b) for any planned measures, explain when and how the measures will be implemented;
- (c) include an explanation of how the relevant measure will ensure compliance with the associated IOSCO Code provisions or CRA licence conditions;
- (d) describe the resources, including the internal compliance resources, allocated to the measures;
- (e) detail any testing and reviews of the measures that have been or will be conducted, and the results of those tests and reviews;
- (f) where a measure necessarily involves the disclosure of information (e.g. because the disclosure is required by the IOSCO Code), include a hyperlink to such disclosed information;
- (g) identify any failings of the measures against their aims and explain how those failings have been or will be addressed;
- (h) identify by name any existing or planned policies or similar documents;
- (i) only address any measure that has been implemented or planned, or any failing that has occurred, since the CRA's previous Compliance Report; and
- (j) address the specific instructions, if any, given for a topic (e.g. to provide a list of ancillary businesses the CRA operates).

Your feedback

B1Q1 Do you agree with the proposed content of the Compliance Report set out in Appendix 1? Should any other information be reported? Should any request for information be removed from the Compliance Report?

B1Q2 Do you agree that a CRA's Compliance Report should be signed off by a director of the CRA as well as the CRA's designated compliance officer? Should any other person be permitted to sign off on the Compliance Report?

B1Q3 Are there any aspects of the proposed Compliance Report that should not be made available to the public?

B1Q4 How many hours of work do you estimate it would take to complete the proposed Compliance Report?

- B1Q5 Do you see any merit in a Compliance Report that seeks more detailed responses for each individual IOSCO Code provision? (Note that such an approach may reduce the amount of information we need to seek through our industry-wide surveillance.)
- B1Q6 Alternatively, do you see any merit in a much simpler Compliance Report requiring certification from a CRA that it has complied with the CRA licence conditions? (Note that such an approach may increase the amount of information we need to seek through our industry-wide surveillance.)
- B1Q7 Do you see international CRAs as being able to leverage their European Union and United States compliance frameworks and functions in completing the proposed Compliance Report? Would it be preferable to require from CRAs the type of reporting that, for example, the European Union requires of CRAs?

Rationale

- 14 The Compliance Report will deliver a narrative explanation of measures designed by a CRA to ensure compliance with its obligations under each heading of the IOSCO Code and CRA licence conditions.
- 15 We consider that the information reported in the Compliance Report will provide us with a form of comfort that a CRA has measures in place designed to ensure that it complies with its obligations, at a reasonable compliance cost to CRAs.
- 16 The information we require includes the resources allocated to each measure (e.g. how many staff oversee its implementation) and what testing and reviews are conducted of the measure to ensure that it is effective. We are also interested in learning about any failings of the measures and what steps have been taken to address those failings.
- 17 We consider that the compliance costs incurred by industry in producing the Compliance Report are constrained by:
- (a) limiting the CRA's narrative description for each of the 11 groups of obligations to four pages, except where exceeding this limitation is reasonably justified by the complexity of the description or topic;
 - (b) leveraging information that CRAs must disclose in compliance with the IOSCO Code and the Corporations Act; and
 - (c) requiring reporting only on measures that have been implemented or planned, or any failing that has occurred, since the CRA's previous report.
- 18 In addition to the narrative explanations reported by CRAs in the Compliance Report, from time to time we will continue to request further

detailed information and documents from CRAs in the course of our surveillance of CRAs' compliance with their obligations.

- 19 The Compliance Report will assist our independent assessment of CRA compliance with obligations concerning quality and integrity of their rating processes, conflicts of interest and their responsibilities to the investing public and issuers.

The Quality and Integrity of the Rating Process

- 20 CRAs should explain measures designed to ensure the quality and integrity of the rating process, including measures ensuring that:
- (a) opinions are based on a thorough analysis of all information known to the CRA and are not misleading or based on insufficient information;
 - (b) the methodologies and models used by the CRA are rigorous, systematic, can be objectively based on historical validation, are consistently applied and are reviewed and updated where necessary; and
 - (c) the CRA is adequately resourced with staff who have sufficient skills to carry out high-quality assessments, including the independent review of analyst training programs.

- 21 In the Compliance Report, CRAs should explain their measures for monitoring and updating of ratings (including where there has been a material change to a methodology or material rating assumption) and measures designed to ensure that the CRA and its employees act fairly, honestly and with integrity.

CRA Independence and the Avoidance of Conflicts of Interest

- 22 CRAs should explain measures to avoid specified conflicts of interest and appropriately manage other conflicts of interest that arise in their business, including their implementation of mandatory controls and disclosures.
- 23 CRAs should explain how they ensure analyst and employee independence.

CRA Responsibilities to the Investing Public and Issuers

- 24 CRAs should explain measures that ensure transparency and timeliness of ratings disclosure, including disclosure of sufficient information about procedures, methodologies and assumptions and historical information about ratings.
- 25 The Compliance Report should also describe a CRA's measures to protect confidential information from misuse.

Appendix 1: Reporting requirements for IOSCO Code Annual Compliance Report

This document specifies the information, statements, explanations or other matters that must be included in each report made to ASIC outlining compliance with the International Organization of Securities Commissions Code of Conduct Fundamentals for Credit Rating Agencies (IOSCO Code).

Under s912A(1)(b) of the *Corporations Act 2001* (Corporations Act), you are required to comply with the conditions of your AFS licence. Under condition 3 of your AFS licence (or condition 4, if you have a key person condition), you must give to ASIC a report (i.e. an IOSCO Code Annual Compliance Report) that includes the information, statements, explanations or other matters specified by ASIC in writing relating to your compliance with certain licence conditions for the following periods:

- (a) for each financial year, at the same time the licensee is required to lodge a balance sheet under Part 7.8 of the Corporations Act; and
- (b) for any period of time ASIC requests, by the date ASIC reasonably requests in writing the report to be lodged.

We expect you to keep records to support any answer you provide as part of your IOSCO Code Annual Compliance Report. You may be required to produce such records on demand.

General instructions

Your report must address 11 topics drawn from the IOSCO Code and your AFS licence conditions, which are listed below, by describing any implemented or planned measures that have the aim of ensuring compliance with the IOSCO Code provisions or AFS licence condition under that topic.

Your description should:

- (a) for each topic, be no more than four pages in length, except where exceeding this limitation is reasonably justified by the complexity of the description or topic;
- (b) for any planned measures, explain when and how the measures will be implemented;
- (c) include an explanation of how the relevant measure will ensure compliance with the associated IOSCO Code provisions or AFS licence conditions;
- (d) describe the resources, including the internal compliance resources, allocated to the measures;

- (e) detail any testing and reviews of the measures that have been or will be conducted and the results of those tests and reviews;
- (f) where a measure necessarily involves the disclosure of information (e.g. because the disclosure is mandated by the IOSCO Code), include a hyperlink, that ASIC can access, to such disclosed information;
- (g) identify any failings of the measures against their aims and explain how those failings have been or will be addressed;
- (h) identify by name any existing or planned policies or similar documents;
- (i) only address any measure that has been implemented or planned, or any failing that has occurred, since your previous IOSCO Code Annual Compliance Report; and
- (j) address the specific instructions, if any, given for a topic.

IOSCO Code topics

- 1 Quality and Integrity of the Rating Process—Quality of the Rating Process
- 2 Quality and Integrity of the Rating Process—Monitoring and Updating
- 3 Quality and Integrity of the Rating Process—Integrity of the Rating Process
- 4 CRA Independence and Avoidance of Conflicts of Interest—General
Specific instructions: Please include a list of ancillary businesses that you consider you operate and explain the rationale for reaching this conclusion.
- 5 CRA Independence and Avoidance of Conflicts of Interest—CRA Procedures and Policies
Specific instructions: Please include, as an attachment:
 - 5.1 *any conflicts of interest policy or policies that are applicable to your business; and*
 - 5.2 *a list of any actual or potential conflicts of interest that may influence the opinions and analyses a CRA makes or the judgement and analyses of the individuals a CRA employs who have an influence on ratings decisions.*
- 6 CRA Independence and Avoidance of Conflicts of Interest—CRA Analyst and Employee Independence
- 7 CRA Responsibilities to the Investing Public—Transparency and Timeliness of Ratings Disclosure
- 8 CRA Responsibilities to the Investing Public—The Treatment of Confidential Information

- 9 Disclosure of the Code of Conduct and Communication with Market Participants

AFS licence conditions

- 10 Arrangements to Monitor and Update Credit Ratings
- 11 Training Requirements for Representatives