ASIC

Australian Securities & Investments Commission

CONSULTATION PAPER 65

Licensing: Credit rating agencies

June 2005

What this paper is about

1 This consultation paper sets out our proposal for an exemption for credit rating agencies from the requirement in s911A of the *Corporations Act 2001* (Act) to hold an Australian financial services (AFS) licence.

2 We invite your comments on our proposal and the questions we have included in this paper. We would also like to receive any qualitative or quantitative information to support comments, issues or arguments you raise.

3 All submissions will be treated as public documents unless you specifically request that we treat the whole or part of your submission as confidential.

Your comments

Comments are due by 22 July 2005 and should be sent to:

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You can also contact ASIC Infoline on 1300 300 630 for information and assistance.

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Section 1: Regulation of credit rating agencies

What is a credit rating agency?

4 A credit rating agency is an organisation that provides credit ratings. A credit rating (sometimes also called a debt rating) is an opinion about whether an issuer is likely to make timely repayment of its financial obligations generally or a particular financial obligation.

5 A credit rating:

(a) does not typically include a recommendation to 'buy', 'sell' or 'hold' a financial obligation; and

(b) is not an opinion about an obligation's value.

What is ASIC's current policy?

6 A person carrying on a business of providing financial product advice in Australia must hold an AFS licence unless they have an exemption: s911A. We consider that credit ratings are financial product advice under s766B(1). Therefore, the requirement to hold an AFS licence unless exempted applies to agencies that carry on a business of providing credit ratings in Australia.

> Note 1: Section 766B(1) defines 'financial product advice' as 'a recommendation or statement of opinion, or a report of either of those things, that:
>
> (a) is intended to influence a person or persons in making a decision in relation to a financial product or class of financial products, or an interest in a particular financial product or class of financial products; or
>
> (b) could reasonably be regarded as being intended to have such an influence.'
>
> Note 2: We consider that credit ratings are general advice: s766B(4).

7 Since December 2003, the following agencies have had an exemption for their credit rating services under Class Order [CO 03/1093] *Credit rating agencies*:

(a) Moody's Investor Service Pty Limited (Moody's);

(b) Standard & Poor's (Australia) Pty Limited (Standard & Poor's); and

(c) Fitch Australia Pty Limited (Fitch).

8 We granted this interim exemption while we finalised our regulatory position on credit rating agencies under the Act (as amended by the *Financial Services Reform Act 2001*), and in light of international developments: see Information Release [IR 03/43] *ASIC provides temporary relief during period of consultation* and paragraphs 10–21 of this paper.

> Note: Prior to [CO 03/1093] credit rating agencies had the benefit of a no action position, subject to the credit rating agencies giving appropriate warnings.

9 Because [CO 03/1093] only applies to credit ratings given before 1 July 2005, we have decided to extend the exemption until 31 December 2005: see Class Order [CO 05/415] *Credit rating agencies – amendment*. This extension will allow us to consult with industry on our proposal for an ongoing exemption: see Section 2.

International developments

10 Currently, in most jurisdictions, credit rating agencies are not required to hold a licence as such to provide credit ratings. However, in recent years, the International Organisation of Securities Commissions (IOSCO), the United States and the European Union have all examined the regulation of credit rating agencies.

International Organisation of Securities Commissions (IOSCO)

11 In September 2003, IOSCO released its *Principles Regarding the Activities of Credit Rating Agencies* (the IOSCO Principles). The IOSCO Principles set out high-level objectives for credit rating agencies, securities regulators, issuers and other market participants to improve investor protection and market fairness, efficiency and transparency, and reduce systemic risk.

Note: For a copy of the IOSCO Principles, go to http://www.iosco.org/.

12 In response to comments received on the IOSCO Principles (including from credit rating agencies), IOSCO decided to develop a more detailed code of conduct for these agencies. IOSCO released its *Code of Conduct Fundamentals for Credit Rating Agencies* (IOSCO Code Fundamentals) in December 2004.

Note: For a copy of the IOSCO Code Fundamentals, go to http://www.iosco.org/.

13 The IOSCO Code Fundamentals address:

(a) the quality and integrity of the ratings process;

(b) credit rating agencies' independence and conflicts of interest;

(c) credit rating agencies' responsibilities to investors and issuers; and

(d) disclosure of credit rating agencies' codes of conduct, and communication generally with the market.

14 IOSCO recommends that individual credit rating agencies fully implement the provisions of the IOSCO Principles and IOSCO Code Fundamentals (together, the IOSCO provisions) in their own codes of conduct. Clause 4.1 of the IOSCO Code Fundamentals states:

> *[the credit rating agency] should disclose to the public its own 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 [credit rating agency]'s code of conduct deviates from the IOSCO provisions, the [credit rating agency] should explain where and why these deviations exist, and how any deviations nonetheless achieve the objectives contained in the IOSCO provisions. The [credit rating agency] 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.*

15 IOSCO also recommends that credit rating agencies and regulators consider whether additional measures may be necessary to properly implement the IOSCO Principles in a specific jurisdiction.

United States

16 In June 2003, the Securities and Exchange Commission (SEC) published and called for public comment on its *Concept Release: Rating Agencies and the Use of Credit Ratings under the Federal Securities Laws* (Concept Release).

17 The Concept Release looked at the use of credit ratings for US Federal regulatory purposes under securities laws and the designation of certain credit rating agencies as nationally recognised statistical ratings organisations (NRSROs). It called for comment on:

(a) whether ratings should continue to be used in this way;

(b) the process of designating NRSROs; and

(c) the level of oversight that should apply to these agencies.

18 On 19 April 2005, the SEC released for comment a proposed rule for NRSROs. Because the SEC may not have legal authority to regulate or impose requirements on NRSROs, the proposed rule focuses on a comprehensive definition of the term 'NRSRO'. The SEC believes the definition to 'strike a balance within the confines of the [SEC]'s existing legal authority': see 17 CFR Part 240, p 55.

19 Under the proposed definition, an NRSRO would be an entity that:

(a) issues publicly available credit ratings that are current assessments of the creditworthiness of obligors with respect to specific securities or money market instruments;

(b) is generally accepted in the financial markets as an issuer of credible and reliable ratings by the predominant users of credit ratings; and

(c) uses systematic procedures designed to ensure credible and reliable ratings, manage potential conflicts of interest and prevent the misuse of non-public information, and has sufficient financial resources to ensure compliance with those procedures.

Note: For a copy of the SEC's proposed rule, go to http://www.sec.gov/divisions/marketreg/ratingagency.htm.

European Union

20 On 10 February 2004, the European Parliament adopted a resolution requiring the European Commission (EC) to submit by 31 July 2005 its assessment of the need for legislation to deal with the regulation and conduct of credit rating agencies. The European Parliament identified four particular issues:

(a) credit rating agencies' potential conflicts of interest;

(b) transparency of credit rating agencies' methodologies;

(c) legal treatment of credit rating agencies' access to inside information; and

(d) possible lack of competition in the credit rating services market.

The Commission of European Securities Regulators (CESR) was given a reference on 27 July 2004 by the EC to provide technical advice on these issues by 1 April 2005.

21 The European Parliament's resolution in February 2004 required the EC to remain in close contact with other securities regulators and IOSCO to ensure developments in credit rating services are globally consistent. On 30 March 2005, CESR advised the EC that CESR considers that the IOSCO Code Fundamentals address the four issues raised by the EC on credit rating agencies.

Section 2: Our proposal

22 After consideration of the international developments discussed in Section 1, we propose to finalise our regulatory position on credit rating agencies by providing an exemption from the requirement to hold an AFS licence, subject to certain requirements.

23 In this section of the paper, we set out:

(a) who would be exempted under our proposal (see paragraphs 24–25); and

(b) the proposed requirements under an exemption (see paragraphs 26–33).

Your feedback

Q1 Are there any reasons ASIC should not finalise its approach to the regulation of credit rating agencies at this time?

Q2 Do you agree with our proposal to grant credit rating agencies an exemption from the requirement to hold an AFS licence?

Who would be exempted?

24 At this stage, we propose to give an ongoing exemption to Moody's, Standard & Poor's, and Fitch. This is because we understand that only these three entities are carrying on a business of providing credit ratings in Australia as described in paragraphs 4–5 of this paper.

25 Applications for an exemption by other entities that wish to carry on a business of providing credit ratings would be considered on a case-by-case basis, on the same terms as the exemption proposed for these three entities.

Your feedback

Q3 Do you agree with our proposal to limit the exemption to Moody's, Standard & Poor's, and Fitch? Should any other entities or types of entities also receive an exemption?

What are the proposed requirements?

26 Under our proposal, exempted entities would have to:

(a) comply with existing requirements under [CO 03/1093] (see paragraphs 27–28);

(b) comply with clause 4.1 of the IOSCO Code Fundamentals (see paragraphs 29–31); and

(c) publish a compliance statement (see paragraphs 32–33).

Complying with existing requirements

27 Existing requirements under [CO 03/1093] (and by extension under [CO 05/415]) specify that the exempted advice must:

(a) be part of a credit rating opinion or credit rating research;

(b) be given in the ordinary course of business of the exempted entity;

(c) include or be accompanied by statements to the effect that:

- (i) the exempted entity does not hold an AFS licence;
- (ii) the advice has been prepared without taking into account any recipient's objectives, financial situation or needs; and
- (iii) the recipient should, before acting on the advice, consider the appropriateness of the advice, given their own objectives, financial situation and needs.

28 Moody's, Standard & Poor's, and Fitch are currently subject to these requirements. We consider these requirements both necessary and appropriate constraints on the giving of credit ratings.

Your feedback

Q4 Do you consider any of these requirements to be unnecessary or inappropriate? Should we impose stricter requirements (for example, should we require the exempted entity to give additional warnings about the limitations of the credit rating)?

Complying with clause 4.1 of the IOSCO Code Fundamentals

29 Under our proposal, exempted entities would have to comply with clause 4.1 of the IOSCO Code Fundamentals: see paragraph 14 of this paper.

30 This means that an exempted entity would have to:

(a) publish its own code of conduct and describe how its code fully implements the IOSCO Principles and the IOSCO Code Fundamentals;

(b) explain any deviations from the IOSCO provisions and how these deviations nonetheless achieve the objectives of the IOSCO provisions;

(c) describe how the code is enforced; and

(d) disclose any changes to the code, its implementation and enforcement.

31 We believe that the terms of any exemption should draw upon internationally-recognised standards of credit rating agency conduct. The IOSCO Principles and IOSCO Code Fundamentals address the consumer protection and market integrity issues that credit rating services raise by setting standards for the quality and integrity of the ratings process, credit rating agencies' independence and conflicts of interest, and their responsibilities to investors and issuers. We consider that a requirement on the exempted entity to comply with clause 4.1 of the IOSCO Code Fundamentals effectively imposes these standards on the exempted entity.

Your feedback

Q5 Is our proposed requirement to comply with clause 4.1 of the IOSCO Code Fundamentals appropriate? Do you foresee any practical difficulties for exempted entities in complying with this requirement?

Publishing a compliance statement

32 Under our proposal, exempted entities would have to publicly disclose and provide to ASIC (within 30 business days after each anniversary of the date of the instrument granting the exemption) a written statement that describes and explains:

(a) the reason(s) for any material departures from the exempted entity's own code of conduct; and

(b) as the case requires:

 (i) how, nevertheless, the entity achieved the objectives of the IOSCO Principles and the IOSCO Code Fundamentals; and

 (ii) what measures have been (or are being) taken to address and prevent the recurrence of material departure(s) from the entity's code of conduct.

33 This disclosure requirement is designed to ensure that the exempted entity not only has a code of conduct that complies with the IOSCO provisions, but that it also enforces the code in its day-to-day business.

Your feedback

Q6 Is publication of a compliance statement an effective means of ensuring that an exempted entity has and enforces a code of conduct that complies with the IOSCO provisions? Would a requirement to submit the statement to ASIC alone be as (or more) effective?

Key terms

In this paper, unless a contrary intention appears, the following terms have the following meanings:

Act The *Corporations Act 2001* including regulations made for the purposes of the Act.

AFS licence An Australian financial services licence under s913B that authorises a person who carries on a financial services business.

ASIC The Australian Securities and Investments Commission.

CESR The Committee of European Securities Regulators.

clause 4.1 Clause 4.1 of the IOSCO Code Fundamentals: see paragraph 14 of this paper.

[CO 03/1093] (for example) An ASIC class order (in this example numbered 03/1093).

Note: For copies of ASIC class orders, go to www.asic.gov.au/co.

credit rating agency An agency that carries on a business of providing credit ratings in Australia, as described in paragraphs 4–5 of this paper.

EC The European Commission.

Fitch Fitch Australia Pty Limited.

IOSCO The International Organisation of Securities Commissions.

IOSCO Code Fundamentals The *Code of Conduct Fundamentals for Credit Rating Agencies* published by IOSCO in December 2004.

IOSCO Principles The *Principles Regarding the Activities of Credit Rating Agencies* published by IOSCO on 25 September 2003.

IOSCO provisions The IOSCO Principles and the IOSCO Code Fundamentals.

s911A (for example) A section of the Corporations Act (in this example numbered 911A).

Moody's Moody's Investor Service Pty Limited.

NSRSO A nationally recognised statistical organisation as designated by the SEC.

SEC The Securities Exchange Commission in the United States.

Standard & Poor's Standard & Poor's (Australia) Pty Limited.