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Proposal for a Regulatory Framework for Credit Rating Agencies (CRAs)

The CFA Institute Centre for Financial Market Integrity ("CFA Institute Centre") welcomes the opportunity to participate in the European Commission's "Consultation on a draft Directive/Regulation with respect to the authorisation, operation and supervision of credit rating agencies (CRAs)" (the "Consultation"). The CFA Institute Centre has responded separately to the Commission's related consultation on policy options to address the problem of excessive reliance on credit ratings.

The CFA Institute Centre promotes fair, open, transparent global capital markets, and advocates for investors' protection. We attach great importance to the Commission's efforts to reform the CRA business in Europe, having played an active role in the CRA consultation process and policy debate. As early as March 2006, CFA Institute publicly cited the conflicts of interest inherent in the CRAs business models, and called for more accountability by rating agencies[1].

Since this period, the CFA Institute Centre has actively engaged in discussions with CRAs about their performance and has responded to a number of regulatory initiatives. These include direct communications with CRA officials, and comments to regulators in Europe and North America[2]. Through these channels, we have proposed a number of reforms to the CRA business[3], including:

- Using a rating nomenclature/categorisation that distinguishes structured products from both corporate and commercial paper ratings to help investors recognise the differences;
- Encouraging a global best practice of prohibiting the practice of "notching", whereby a CRA unilaterally issues a rating on an entity or structure that was not sought by the issuer, and for the primary purpose of "punishing" the entity or structure for not engaging that CRA;
- Creating an executive-level compliance officer position at CRAs to ensure implementation and enforcement of the IOSCO code of conduct fundamentals for credit rating agencies;

[1] See testimony of Jeffrey J. Diermeier, CFA, CFA Institute President and CEO, to the U.S Senate in 2006 at http://www.cfainstitute.org/centre/pdf/jeff_diermeier_testimony_credit_rating_agencies.pdf
[2] See, for example, CFA Institute Centre's comment letters to IOSCO and CESR at http://www.cfainstitute.org/centre/topics/comment/2008/pdf/iosco_consultation_cras_response.pdf and http://www.cfainstitute.org/centre/topics/comment/2008/pdf/cesr_cra_response.pdf
[3] See press release at http://www.cfainstitute.org/aboutus/press/release/08releases/20080205_02.html. Full details can also be found in the comment letters to IOSCO and CESR.

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- Requiring complete adoption of the IOSCO code to claim compliance;
- Calling on CRAs to refrain from rating new structured products until the statistical data are sufficiently robust to produce a defensible rating; and
- To refine or otherwise eliminate the concept of "investment grade" wherever possible to reduce the incidence of misconception about the purpose of the CRAs' ratings.

The need for CRA reform is further supported by the results of a recent member survey conducted by CFA Institute[4]. With nearly 2,000 responses worldwide, 47% supported the idea of a different rating system for structured products (compared to 42% who did not); and 55% indicated support for CRAs grouping themselves into an international standard-setting and monitoring self-regulatory body (compared to 30% who voted against this proposal). In other findings, when asked whether they had witnessed a CRA changing its rating in response to pressure from an investor, issuer, or underwriter, 11% of respondents answered 'yes' against 55% who answered 'no'. These results highlight the urgent need for reform of the business practices of CRAs.

The Consultation addresses two main areas, namely, (1) substantive requirements to be respected by CRAs, and (2) authorisation, supervision and enforcement provisions.

The CFA Institute Centre is supportive of the proposals related to substantive requirements to be respected by CRA, as these focus on managing conflicts of interest, high standards of quality for rating methodologies and ratings, and increasing transparency of the ratings process. Many of the Commission's proposals in the draft Directive/Regulation are consistent with the proposals of CFA Institute Centre, including: a requirement that the information used in assigning a rating is of sufficient quality to support a robust rating; a requirement to make a clear distinction between credit ratings of structured finance instruments and other credit ratings; and a requirement for CRAs to provide a comprehensive justification where a CRA, in rating a structured finance instrument, has issued a lower, or "notched" rating for an issue rated by another CRA that relates to a portion of the underlying assets in the structured finance instrument.

With regards to the authorisation, supervision, and enforcement provisions for CRAs, the options put forward in the Consultation reflect the Commission's preference for a regulatory solution to the oversight of CRAs. As a point of reference, the CFA Institute Centre favours self-regulation over government-imposed regulation. Furthermore, we are concerned that some of the proposals are too prescriptive for the overall long-term health of the ratings industry and may not lead to improved ratings for investors.

However, in light of the perceived failures of CRAs to improve their standards of independence, and their levels of compliance with the IOSCO code, we recognise the Commission's desire to pursue a formal regulatory solution. Due to the reality of what options are being proposed, we would argue that the Commission include in its formal regulatory structure representatives from the investor and rating community to keep the regulatory mechanism up-to-date with the evolving structure of the ratings market. Further, these representatives could play a key role in investigating suspected / reported regulatory breaches at a pan-EU level.

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[4] See results of survey at http://www.cfainstitute.org/memresources/monthlyquestion/2008/june.html

The options proposed for the authorisation, supervision, and enforcement provisions for CRAs comprise:

i) National authorisation and supervision process, with strong coordination through the Committee of European Securities Regulators (CESR); or

ii) Community authorisation via an Agency (i.e single authorisation by a central body) combined with supervision by national regulators.

Given the options available, the CFA Institute Centre favours option ii) on the basis that a legally distinct central agency would be better placed to coordinate supervision amongst national regulatory bodies. Credit ratings are used by a range of institutions across markets and national borders throughout the EU. Therefore a *central* Agency would be best placed to coordinate the oversight of CRAs, since their output is not restricted to national borders. Under option i), whilst the delegated home Member State competent authority would have the main responsibility for supervision of the CRA, other competent authorities would still have powers to intervene, and to take action where they consider the actions of the home competent authority to be ineffective. This has the *potential* to result in confusion, whereby home competent authorities may not be fully aware of the powers – or actions – of other competent authorities to take enforcement action, resulting in overlapping regulation. Moreover, the CRAs may be confused as to who in practice is responsible for regulating them. Whilst there are measures to mitigate these risks, such as colleges of supervisors, the most effective approach would be to create a formal, central agency.

Specifically, a central agency would be better able to monitor and enforce harmonised practices by CRAs, would be able to intervene where disagreements arise between national regulators, and as the Consultation suggests, would be able to undertake certain tasks and responsibilities transferred to it from the competent authorities. Accordingly, we believe this option would best serve the interests of investors and the CRAs themselves.

We attach our response that addresses the proposals of the Consultation. Please do not hesitate to contact us should you wish to discuss any of the points raised.

Yours faithfully,

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The CFA Institute Centre is part of CFA Institute[5]. With headquarters in Charlottesville, VA, and regional offices in New York, Hong Kong, and London, CFA Institute is a global, not-for-profit professional association of more than 96,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 134 countries, of whom nearly 83,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 136 member societies in 57 countries and territories.

Our detailed comments address in turn the options proposed in the Consultation.

1. Substantive requirements to be respected by CRAs

The CFA Institute Centre is broadly supportive of the proposals relating to substantive requirements to be respected by CRAs. We do not consider the compliance costs associated with these initiatives to be significant relative to their wider benefits to market integrity.

The proposals focus on organisational structure and internal governance of CRAs, avoidance and management of conflicts of interest, quality of ratings and ratings methodology, and transparency of CRAs. In general, however, we believe that regulators should provide high-level principles and leave it to individual firms to apply in a manner that they see as appropriate for their specific circumstances. We address each of these issues in the sections that follow.

Conflicts of interest

Article 9 of the draft Directive/Regulation (p.15-16) addresses the identification, management and disclosure of conflicts of interest. Paragraph 3 sets out the following situations under which a CRA shall not issue a rating or shall withdraw an existing credit rating:

> *"a) the credit rating is issued or maintained in respect of an entity or any of its related third parties from which the credit rating agency receives 5 percent or more of its annual revenue from the issuance of credit ratings,*
>
> *b) the credit rating agency, an analyst that participated in determining a credit rating, or person approving the credit ratings, directly or indirectly owns financial instruments of, or has any other direct or indirect ownership interest in, the rated entity or any related third party,*
>
> *c) the credit rating is issued or maintained with respect to a rated entity or any related third party directly or indirectly linked to the credit rating agency by control,*
>
> *d) an analyst who participated in determining a credit rating, or person approving the credit rating is a member of the administrative, management or supervisory bodies of the rated entity or any related third party."*

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[5] CFA Institute is best known for developing and administrating the Chartered Financial Analyst curriculum and examinations and issuing the CFA Charter.

Whilst we are supportive of these provisions we make three observations. Firstly, while the 5% revenue threshold described in Article 9, para. 3(a) would provide an effective instrument for managing conflicts of interest, it also would likely act as a barrier for new entrants into the credit rating business. Large, established CRAs will reach this threshold only in rare cases given the diversity of their book of business. However, it is likely that small, new entrants into the business could bump against this threshold with very few repeat transactions from an issuer or underwriter for a period of time. This, therefore, would make it impractical for such firms to operate in such an environment.

Secondly, an interpretation of this provision to refer to revenues received from rating structures issued and/or underwritten by specific banks also could disqualify small firms from such business. In a worst-case scenario, such an interpretation could result in a large number of transactions ineligible for ratings from any firms, thus depriving investors of potentially valuable ratings and analysis. These two concerns make it such that we do not see how Article 9, para. 3(a) could be modified to both manage potential conflicts of interest while not creating significant barriers to competition from smaller, new CRA entrants to the market.

Thirdly, we do not consider the provisions of this paragraph to be exhaustive (which is how one could interpret this paragraph). For example, a situation not cited in paragraph 3 where it would be inappropriate for a CRA to issue a rating is where the analyst responsible for generating the rating is also involved in the fee negotiations. We note that this scenario ***is*** covered by Article 10 (Employees). However, Article 9 para. 3 would be clearer if worded to explain that its provisions are non-exhaustive.

In considering prohibitive situations, parallels can be drawn with the auditing profession. In an analogous fashion to CRAs, auditors provide a service to investors (they report to the shareholders), yet it is the company – not the investor – that pays for this service. In the case of the auditing profession, independence requirements generally focus on the *identification* of threats to independence, and the provision of *safeguards* thereon to reduce threats to an acceptable level. For example, a parallel requirement relates to the rotation of key personnel after providing services to the entity (i.e the audit, or in the case of a CRA, the rating) after a set number of years. This requirement for CRAs is detailed in Article 10 (Employees) para. 4, which we support. However, one safeguard from the auditing profession that has applicability to CRAs and is not covered by the provisions of Article 9 para. 3 is the inclusion of close family members in considering the financial interests of the analyst in the entity concerned.

This provision would be strengthened if extended to include the financial interests of close family members of the analyst concerned. For example, even if the analyst holds no financial instruments or ownership interest in the issuer, the analyst could still be conflicted if he/she has close family members that *do* have holdings or ownership interests in the issuer. For the avoidance of potential loopholes, we recommend that Article 9 para. 3(b) be extended in this capacity, to give due consideration to close family members.

Paragraphs 4 through 6 of Article 9 prohibit CRAs from a) providing consulting or advisory services, b) prohibits analysts from making proposals or recommendations regarding the design of structured finance instruments, and c) requires communication channels

between analysts and persons approving the ratings to be designed to ensure independence.

Deterring Recommendations on Structure.
The CFA Institute Centre appreciates the objectives of these measures, which are to deter those providing ratings from informing issuers insight into how to structure the instrument in order to receive a given rating (thus rating their own work). It also is intended to ensure that those subsequently approving ratings are independent from the analysts producing the ratings.

Whilst supportive of the proposal to prohibit recommendations regarding the design of structured finance instruments, we urge care not to deter helpful discussions regarding the assumptions and rationales underlying rating decisions. We also recognise that drawing a line between making recommendations and providing feedback is challenging. Nevertheless, the transparency benefits to be gained from open discussions regarding assumptions and rationales are sufficient to merit inclusion in the Directive/Regulation.

Given the inherent difficulty in separating discussions regarding rating assumptions from recommendations regarding the design of an instrument, we recommend the creation of an executive level compliance officer at CRAs. The compliance officer would be charged with monitoring these discussions and the overall rating process. Moreover, through also monitoring internal discussions the compliance officer could ensure that the communications channels between the analyst and the person approving the ratings do not compromise independence. This would succeed in meeting the objectives of Art. 9 para. 6 (design of communication channels to ensure independence between the analyst and approver of ratings).

Vesting oversight in a compliance officer one step removed from initial ratings process would, when combined with appropriate disclosure, help to manage any potential conflicts of interest arising from these communications and in doing so ensure that investors' interests are protected.

We offer two additional recommendations to manage this type of conflict. The first of these would have different analyst groups for determining initial ratings and for ongoing monitoring and subsequent actions. This would reduce the risk that pressure placed on the analyst providing the initial rating by the issuer or underwriter will be passed on to the analyst responsible for subsequent reviews and adjustments in ratings. The second suggestion would have CRAs rotate the analysts in each group after a number of years to allow the firms to have a fresh review of the processes and ratings at regular intervals.

Organisational structure and governance
In conjunction with the notion of an executive level compliance officer, Article 8 para. 5 goes further to propose the creation of a dedicated independent committee for monitoring and compliance issues. The paragraph states:

> *"A credit rating agency shall have a dedicated independent committee of the administrative or supervisory board which shall monitor the development of the credit rating policy, effectiveness of the credit rating agency's internal quality control system on the credit rating process and compliance and governance*

> *processes including efficiency of the review function. The committee shall be composed exclusively of non-executive members of the administrative board or of members of the supervisory board."*

Article 7 para. 2 take a similar approach in addressing compensation arrangements for the non-executive members of the administrative / supervisory board. Paragraph 2 states:

> *"…Their remuneration shall be linked to their experience and skill and to the contribution they make and are contractually expected to make to the supervision, quality, accuracy and integrity of the rating process and activity* ***and not to the growth in earnings or share price of the credit rating agency.*** *Their term of office, which shall be for a pre-agreed fixed period, shall not be renewable."*

Article 11 (Compensation arrangements) further emphasises the need to detract from short-term incentives when designing compensation policies for analysts and approvers of ratings. The Article explicitly states that such compensation policies should *"not…* [be] *contingent on the amount of revenue that the credit rating agency derives from the rated entities or related third parties…".*

Whilst the CFA Institute Centre supports the intent of these proposals, it does not believe that the Commission is in the best position to know how, in every case, firms should structure themselves, what types of reviews and analyses they should employ, or how and how much to pay their employees and board members. These are decisions best determined by individual firms as they attempt to meet the ethical and regulatory standards created either by a self-regulatory entity or, in this case, a pan-European regulator.

Rating methodology

Broadly, the CFA Institute Centre supports the provisions of Articles 12 and 13 of the draft Directive/Regulation. These focus on ensuring a high-quality rating methodology, and on ensuring appropriate public disclosures for assumptions, methodologies, and changes in each. As stated in our covering letter, the CFA Institute Centre's proposals regarding rating methodologies include:

I. Calling on CRAs to refrain from rating new structured products until the statistical data are sufficiently robust to produce a defensible rating; and
II. Encouraging a global best practice of prohibiting the practice of "notching", whereby a CRA unilaterally issues a rating on an entity or structure that was not sought by the issuer, and for the primary purpose of "punishing" the entity or structure for not engaging that CRA.

The CFA Institute Centre is encouraged by the Commission's proposals, which reflect these sentiments. For example, Article 13 reinforces point I. above, stating:

> *"In cases where the lack of robust data or the complexity of a structure of a new type,* ***and notably in the case of structure finance instruments, raise questions as to whether the credit rating agency can produce a credible credit rating,***

> ***the credit rating agency shall refrain from issuing a credit rating*** *or withdraw an existing credit rating."*

Furthermore, our position on 'notching' is broadly consistent with the provisions of Article 12 para. 2. This paragraph states that, where a CRA has relied on an existing credit rating by another agency with respect to underlying assets or structured finance instruments, it:

> *"a) shall not refuse to issue a credit rating of a financial instrument justifying its decision on the fact that a portion of the financial instrument had been previously rated by another credit rating agency;*
>
> *b) shall duly record all instances of downgrading these underlying credit ratings in its credit rating process together with a comprehensive justification for the downgrades affected."*

These provisions discourage the practice of punitive 'notching' and other anti-competitive practices. Accordingly, they facilitate the development of greater competition between CRAs, and provide issuers with more flexibility in appointing rating providers.

Annex II section B part I paragraph 4 reinforces the disclosure obligations in relation to unsolicited ratings:

> *"...Any rating not initiated at the request of the rated entity or its related third party shall be identified as such. A credit rating agency shall also disclose its policies and procedures regarding unsolicited ratings."*

We are supportive of these provisions, having regard to the transparency benefits that should arise as a consequence of its implementation.

Transparency obligations

The CFA Institute Centre's main proposal with respect to transparency obligations relates to structured finance products. Specifically, we have proposed using a rating nomenclature/categorisation that distinguishes structured products from both corporate and commercial paper ratings to help investors recognise the differences.

Article 14 para. 3 echoes these sentiments:

> *"A credit rating agency shall ensure that* ***rating categories that may be attributed to structured finance instruments are clearly differentiated*** *from rating categories that may be used to rate other financial instruments."*

Differentiating disclosures for structured products are particularly beneficial to investors. Investors need to be alerted to the fact that an instrument is a structured finance product so that they can determine whether there are underlying risks that are different from those associated with corporate debt and money market instruments. We strongly believe that many investors in structured finance instruments need this additional information to alert them to differences in the structure, cash flow, and volatility. Accordingly, we fully support measures to differentiate rating categories for structured products from more traditional corporate debt.

To this end, we also appreciate the additional disclosure obligations in relation to structured finance instruments set out in Annex II section B part II. Paragraph 1 of this section states:

> *"Where a credit rating agency rates a structured finance instrument, it shall provide in the credit rating sufficient information about loss and cash-flow analysis it has performed".*

However, the CFA Institute Centre believes that together, these disclosures should aid investors' understanding of the distinguishing cash-flow characteristics of structured finance instruments, and thus facilitate transparency in the investment decision-making process.

Central Repository

Paragraphs (21) and (24) of the preamble to the Directive/Regulation implicitly acknowledge the need for such a structure for the exchange of information and coordination amongst national regulators. Para. (21) states:

> *"For the efficiency of supervision it is necessary to envisage close coordination between the competent authorities concerned with the activity of a credit rating agency".*

Para. (24) adds:

> *"In order to limit the administrative burden and avoid duplication of tasks, **supervisory authorities should cooperate and exchange information**."*

A key element of the regulatory structure is a formal mechanism to facilitate the exchange of information amongst national supervisors, and amongst the investing public. Such mechanisms are necessary for the effective cross-border supervision of entities such as CRAs that operate in several jurisdictions.

One mechanism that CFA Institute Centre advocates is a central repository for the EU, a concept we have addressed in earlier consultations to the Committee of European Securities Regulators (CESR)[6]. This repository would act as a central facility for the collection and dissemination of relevant information amongst national competent authorities, facilitating the exchange of information, and improving coordination amongst national regulators.

Competent authorities from the relevant Member States, as well as investors, should have access to much of this information from the central repository. The benefits of such a system (set out in our January 2004 comment letter to CESR) include:

- It would eliminate the need for complicated implementing measures directing cooperation and communication among competent authorities that may not accurately consider market evolution.
- Regulators in all markets would likely create algorithms to automatically download information from the repository about firms (i.e CRAs) headquartered and/or

[6] See, for example, our comment letters on market abuse submitted to CESR in 2002, (PDF) 2004, and 2008.

registered in their home markets, thereby enhancing the efficiency of the regulatory system.

- It would make the information immediately available to all authorities at the same time, thus raising the level of communication and cooperation amongst regulators.
- Authorities would not have to make judgments about when to share information and which of their counterparts should receive it.

As set out in the preceding bullet points, the central repository would also serve as an efficient mechanism for regulatory cooperation. We envisage it serving a larger role than that implied by the draft Directive/Regulation, and therefore recommend that the relevant paragraphs (as cited above) be expanded in this capacity.

One area that we would find problematic is to use such a central repository in the manner envisaged in Article 15 para. 2, which states:

> *"Credit rating agencies shall make available in a repository open to the public all credit ratings and historical performance data."*

Depending upon how broadly this provision is interpreted, our concern with this paragraph is that could inhibit, if not prevent, CRAs from implementing an investor-paid ratings model. While we do not believe that such a CRA business model would totally eliminate conflicts of interest, we nevertheless believe it is important that CRAs be permitted to seek a business model they believe works best for them while at the same time appropriately managing and disclosing the conflicts of interests inherent in the credit-ratings business. The paragraph noted above appears to mandate that "all credit ratings and historical performance data" be made available to the public for free. Under this interpretation, it would eliminate the need for investors to buy credit ratings and therefore require that CRAs continue to solely rely upon the current issuer-paid ratings model. At the very least, we urge the Commission to amend the provision to permit the possibility for the public paying a fee for such information.

2. Authorisation, supervision, and enforcement

The Consultation puts forward two options for the authorisation, supervision, and enforcement of CRAs. These are:

i) National authorisation and supervision process, with strong coordination through the Committee of European Securities Regulators (CESR); or

ii) Community authorisation via an Agency (i.e single authorisation by a central body) combined with supervision by national regulators.

Under option i), a CRA would submit an application for authorisation to CESR which would then select the home Member State competent authority (i.e national regulator) responsible for dealing with the authorisation request and for supervision of the CRA. The authorisation would be valid throughout the EU territory.

Option ii), however, would see the establishment of a "Community Agency (CESR or a new Agency)", which would exist as a separate legal entity, financed from the EU budget. This Agency would be responsible for the authorisation process and would delegate supervision

of the CRA to the relevant Member State competent authorities. The Agency would, however, allocate responsibilities and retain the power to intervene in the supervisory process.

As noted in our covering letter, of these two, the CFA Institute Centre favours option ii). We address in turn the issues associated with authorisation, supervision and enforcement, in doing so setting out our preferences for a Community Agency.

Authorisation

Under both options, the designation of the home Member State competent authority would be based on set criteria relating to the CRAs' actual and planned activities. As the Consultation notes, for both options, these criteria may include:

> *"…the place where the applicant credit rating agency carries out or is planning to carry out the most important part or a significant part of its rating activity inside the Community. However, other factors could also be considered for designation of the home Member State competent authority, including the place where the CRA has a registered office or a principal branch."*

In our view, in determining the home competent authority, the emphasis should be on the location in which the CRA has its registered office, as opposed to the jurisdiction in which the CRA conducts a significant part of its business. This latter criterion could result in a dynamic scenario wherein a CRA switches its focus between markets as its business evolves over time. Likewise, circumstances in which the CRA's business is thinly or evenly spread out across multiple jurisdictions could result in a situation in which the "home" Member State changes as the CRA's main markets change. This could lead to confusion and a sub-optimal allocation of supervisory responsibilities. To avoid this situation, it would be more efficient to use the jurisdiction in which the CRA has its registered office as the sole criterion on which to base the determination of the home Member State competent authority.

As noted above, we favour a Community Agency to handle authorisation requests from CRAs, on the basis that a central agency can ensure a consistent application of the rules determining authorisation. Although this could also be achieved by national competent authorities, there exists a degree of risk that one competent authority could interpret the criteria for authorisation slightly differently from another competent authority. Whilst this risk could be mitigated through CESR, it would be far more efficient and less costly for a single, centralised body to deal with authorisation requests.

Supervision and enforcement

Under option i), home Member State competent authorities would ultimately be responsible for supervision. However, other competent authorities would retain the right to intervene and take enforcement action against CRAs operating in their jurisdictions, where they deem it appropriate. As the Consultation notes (p.3-4):

> *"The designation of a home competent authority does not imply that the other competent authorities in other EU Member States lose their power of intervention. […] in the case of a lack of, or ineffective, action by the home Member State competent authority, other competent authorities would retain the competence and right to take action…"*

Such a supervisory structure would only be successful via strong regulatory cooperation amongst national regulators and, moreover, through CESR taking action to resolve regulatory gaps, disputes, and overlapping responsibilities. However, there exists a real risk that this approach will result in a fragmented supervisory structure. Specifically, there exists scope for disagreements between competent authorities as each may make its own determination as to whether sufficient enforcement action has been taken against a given CRA. This would require intervention by CESR to resolve regulatory disputes. Moreover, the CRAs themselves may be confused as to exactly who is responsible for taking regulatory action against them.

Consequently, the CFA Institute Centre believes that a central Agency would be the most appropriate option for regulation of CRAs. Given that ratings are used across markets and borders throughout the EU, a central body with separate legal powers would be best placed to oversee supervision of ratings activity. As the Consultation notes (p.4):

> *"…the Community Agency… would coordinate the activities of competent authorities, ensure uniform application of the rules, give advice to Member States on supervisory issues and have the power to intervene if competent authorities disagree on supervisory measures. […]* ***Moreover, taking into consideration that this Agency would have its own legal personality, certain tasks or even responsibilities could be transferred from national regulators to the Agency..."***

We believe this to be the most effective of the proposed options for regulatory supervision, and is most likely to result in a coherent application of the provisions set out in the draft Directive/Regulation. Therefore, this approach is likely to be most successful in achieving regulatory harmonisation, which ultimately serves the best interests of investors by creating a level playing field.

Additional considerations

The supervisory structure envisaged under option ii) could be enhanced through the creation of a separate committee responsible for conducting investigations into suspected/reported regulatory breaches, and resolving conflicts in enforcement action between respective competent authorities. We envisage that this investigative role would operate in conjunction with the relevant national authority. As a pan-EU group, this investigative resource would avoid duplication of highly skilled human resources in each of the national authorities. This would result in a reduction in regulatory costs and would potentially increase the effectiveness of the regulatory body.

An important facet of this envisaged committee is that its members be representatives from industry. Industry expertise could prove crucial when conducting investigations into regulatory conflicts. Such a scenario is envisaged in Article 25 para. 1, which states:

> *"The competent authority of one Member State may request the cooperation of the competent authority of another Member State in a supervisory activity or for an on-site inspection or in an investigation."*

An investigative committee of the Community Agency comprising industry experts would be a suitable alternative to the services of another competent authority in this scenario.

Moreover, this committee, through having responsibility for all such investigations throughout the EU, would ensure a consistent approach to the resolution of such investigations and inspections.

Additionally, this committee could also assume responsibility for 'fine-tuning' regulation as financial markets, the business practices of CRAs, and the use of ratings evolve. Industry representation provides specialised input into the development of regulations and policies (i.e 'fine-tuning') that outsiders lack. Additionally, those being regulated may be more willing to comply with rules created by other members of industry, thus adding to their effectiveness.

Having regard to the envisaged benefits, we recommend that the Commission give due consideration to the creation of such a committee. As emphasised throughout, this committee should exist under the favoured structure of the central Community Agency for the authorisation, supervision and enforcement of CRAs.

26th September 2008.