CONSULTATION PAPER NO. 82

03 MAY 2012

PROPOSALS TO REGULATE CREDIT RATING AGENCIES

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Why are we issuing this paper?

1. The DFSA proposes to regulate Credit Rating Agencies ("CRAs") operating in or from the DIFC by bringing the activity of providing Credit Ratings within the definition of Financial Services.

2. This proposal stems from the DFSA's policy of conforming to international regulatory standards. Poor quality credit ratings assigned by CRAs, particularly to complex structured financial products, are generally recognised as a contributor to the financial markets crisis of 2008. Credit Ratings are relied on by members of the public for investment purposes, market participants for credit assessments of their counterparties and, regulators for regulatory purposes. Therefore, in the wake of the crisis, the international standard setters, particularly the International Organisation of Securities Commissions (IOSCO), placed new emphasis on ensuring that CRAs are subject to adequate regulation and supervision.

3. The proposals in this paper are designed to meet the IOSCO standards relating to the regulation of CRAs. In designing the proposed regime, we have followed the principles based approach adopted by IOSCO, with recourse to the CRA regimes under EU Regulation 1060/2009 and those adopted by Hong Kong and Singapore where appropriate.

4. Consistently with the approach adopted under the IOSCO regime and also in the EU, the proposals in this paper do not apply to Persons providing credit scoring and assessment services generally associated with consumer lending and credit provided by institutional lenders (see paragraph 16).

Who should read this paper?

5. The proposals in this paper would be of interest to:

   (a) CRAs already established in and operating from the DIFC;

   (b) Persons intending to undertake Credit Rating Activities in or from the DIFC;

   (c) Persons providing or proposing to provide services such as legal, auditing, compliance, risk management or research and analytical services to CRAs;

   (d) Persons using or relying on Credit Ratings, such as investors, listed companies and those proposing to list, financial institutions and counterparties to financial transactions; and

   (e) other regulators who use credit ratings for regulatory purposes.

How to provide comments?

6. All comments should be in writing and sent to the address or email specified below. If sending your comments by email, please use the Consultation Paper number in the subject line. You may, if relevant, identify the organisation you represent in providing your comments. The DFSA reserves the right to publish, including on its website, any comments you provide, unless you expressly request otherwise at the time of making comments.

Comments to be addressed or emailed to:

Consultation Paper No. 82
Policy and Legal Services
DFSA
PO Box 75850
Dubai, UAE

Email: consultation@dfsa.ae

Tel: +971(0)4 3621500

What happens next?

7. The deadline for providing comments on the proposals is **12 June 2012**. Once we receive your comments, we shall consider if any further refinements are required to these proposals. We shall then proceed to enact the relevant changes to the DFSA's Rulebook. You should not act on these proposals until the relevant changes the DFSA Rulebook are made. We shall issue a notice on our website telling you when this happens.

Structure of the paper

8. The proposals in this paper to regulate CRAs will be substantially implemented through the General (GEN) module (Appendix 1) and the Conduct of Business (COB) module (Appendix 2) of the DFSA Rulebook. The key aspects of these proposals and considerations that underpin those proposals are set out as follows:

   (a) terminology – see paragraph 9;

   (b) threshold issues relating to the proposed structure of regulation for CRAs – see paragraph 10;

   (c) the proposed new Financial Service of Operating a CRA – see paragraphs 11 – 15;

   (d) proposed exclusions from regulation as a CRA – see paragraphs 16 and 17;

   (e) proportionate application to CRAs of the general requirements applicable to licensees – see paragraph 18;

   (f) proposed additional Principles for CRAs – see paragraphs 19 and 20; and

   (g) proposed licensing and on-going conduct requirements for CRAs – see paragraphs 21 – 27;

   (h) proposed fees for CRAs – see paragraph 28; and

   (i) transitional arrangements for CRAs operating in the DIFC – see paragraph 29.

Terminology in this paper

9. In this paper, defined terms are identified throughout by the capitalisation of the initial letter of a word or of each word in a phrase and are defined in GLO or in the proposed amendments in this paper. Unless the context otherwise requires, where capitalisation of the initial letter is not used, the expression has its natural meaning. Any reference in this paper to a Rule in GEN or COB, except where otherwise indicated, is a reference to the proposed new or amended GEN and COB Rules set out in Appendices 1 and 2.

Threshold issues relating to the proposed structure of regulation for CRAs

10. In formulating the proposed structure of regulation for CRAs, we addressed two threshold issues:

   (a) The first issue was whether to adhere closely to IOSCO standards relating to CRAs or to mirror the more detailed requirements for CRAs under the EU Regulation. We propose to base our regime on the IOSCO standards rather than the EU Regulation because the IOSCO Standards are less complex and prescriptive, and hence would be less burdensome to CRAs; and

(b) The second issue related to what would be the most appropriate form of regulation for CRAs. This involved an assessment of whether a CRA should be regulated as an ancillary service provider ("ASP") or as an Authorised Firm. As the ASP regime is primarily designed from the Anti-Money Laundering and Counter Terrorist Financing perspectives, the Authorised Firm approach to regulating CRAs was considered more suitable. However, as many of the regulatory requirements relating to Authorised Firms are inappropriate or disproportionate to regulation of CRAs, we have opted for the creation of a distinct category of a Financial Service (see paragraphs 11 - 15), with bespoke regulation applying to CRAs (see paragraphs 18 – 27). This approach also enables the DFSA to apply to CRAs the general supervisory and enforcement powers available to it in relation to all Financial Service providers, including its power to commence civil proceedings.

Issues for consideration

1. Do you think the adherence to IOSCO standards rather than mirroring the EU Regulation, is appropriate? If not, what are your reasons?

2. Do you have any concerns relating to the approach we have adopted in relation to regulation of CRAs as a new Financial Service attracting bespoke regulation? If so, how should they be regulated?

Proposed new Financial Service of Operating a Credit Rating Agency

11. We propose to include in GEN a new Financial Service of Operating a Credit Rating Agency – see the proposed GEN Rule 2.27.1(1). This new Financial Service is defined as follows:

> *"…Operating a Credit Rating Agency means undertaking one or more Credit Rating Activities for the purpose of producing a Credit Rating with a view to that Credit Rating being:*
>
> *(a) disseminated to the public; or*
>
> *(b) distributed to a Person by subscription,*
>
> *whether or not it is in fact disseminated or distributed."*

12. To determine the scope of the above Financial Service, further definitions are included as follows:

(a) the term "Credit Rating Activities" is defined as *"data and information analysis or the evaluation, approval, issue or review of a Credit Rating*" – see the proposed GEN Rule 2.27.1(2)(a);

(b) the term "a Credit Rating" is defined as "*an opinion expressed using an established and defined ranking system of rating categories regarding the creditworthiness of a Rating Subject*" – see the proposed GEN Rule 2.27.1(2)(b); and

(c) the term "a Rating Subject" is defined as "*a Person other than a natural person, a credit commitment or a debt or debt-like Investment*." – see the proposed GEN Rule 2.27.1(3).

13. The above definitions are designed to capture the activities which form the core of a CRA's activities that are integral to the provision of Credit Ratings.

14. Accordingly, a Person undertaking Credit Rating Activities from a place of business in the DIFC will be required to be licensed as a CRA even if the Credit Ratings it prepares are disseminated to the public or distributed by subscription by another entity, or if it undertakes some and not all the Credit Rating Activities that culminate in the production of a Credit Rating. This is consistent with the approach under the IOSCO principles and the regimes adopted in the EU, Singapore and Hong Kong.

15. As Rating Subjects are not always legal Persons and can often be a debt or debt-like Investment (see the proposed GEN Rule 2.27.1(3)(b) and (c)), we propose an application provision which provides that where a Rating Subject is not a legal Person, the relevant Person relating to that Rating Subject is the Person responsible for obtaining the Credit Rating – see the proposed COB Rule 8.1.1(2).

Issues for consideration

3. Do you think that the proposed definition of the Financial Service of Operating a Credit Rating Agency captures all the activities which warrant regulation as a Financial Service? If not, what other activities should be included within that definition?

4. Do you have any concerns relating to the proposed application provision relating to Rating Subjects which are not legal Persons? If so, what are those concerns and how should they be addressed?

5. Are there any other concerns or issues relating to the proposed new category of Financial Service? If so, what are they and how should they be addressed?

Proposed exclusions from regulation as CRAs

16. We propose to exclude from the ambit of the proposed Financial Service of Operating a Credit Rating Agency those activities which constitute credit scoring or assessment of risks associated with lending by institutions or governments to consumers – see the proposed GEN Rule 2.27.2. Such credit scoring and assessments are not relied on by the investing public or market counterparties to assess the creditworthiness of issuers of Investments or debt or debt-like Investments, and hence do not warrant regulation. This is consistent with the approach adopted in the EU, Hong Kong and Singapore.

17. We also propose to provide guidance to indicate that the provision of a Credit Rating for the exclusive use of a Person who requested it (i.e. a private Credit Rating) is not regulated as a Credit Rating Activity – see Guidance No. 4 under GEN Rule 2.27.2.

Issues for consideration

6. Do you agree with the proposed exclusion from regulation of credit scoring and credit assessment to consumers by institutional lenders? If not, what are your reasons?

7. Do you agree with the proposed exclusion from regulation of private Credit Ratings? If not, what are your reasons?

8. Do you think that there are other activities which should be excluded from regulation as the Financial Service of Operating a Credit Rating Agency? If so, what are they and why should they be excluded?

Proportionate application to CRAs of the general requirements applicable to licensees

18. As a result of the proposed new definition of the Financial Service of Operating a CRA, CRAs have to become Authorised Firms. However, some of the general requirements that apply to licensees conducting other Financial Services are found to be either too onerous or inappropriate for CRAs. Accordingly, we propose:

(a) not to prescribe capital requirements for CRAs, as applied to other Financial Service providers under PIB or PIN. Instead, we propose to apply simply the general requirement that a CRA must have adequate resources, including financial resources, to conduct its activities, thereby giving a greater degree of flexibility for CRAs to determine, on a reasonable basis, their own capital requirements. We also propose not to require a CRA to have a mandatory appointment of a Finance Officer – see the proposed exemption in GEN Rule 7.5.1(2)(a);

(b) not to require CRAs to have a mandatory appointment of a Money Laundering Reporting Officer, as a CRA's activities are generally not likely to expose it to the risks of any money laundering activities taking place within its operations – see the proposed exemption in GEN Rule 7.5.1(2)(a);

(c) not to apply the requirements to have complaints handling and dispute resolution mechanisms to CRAs, as Persons obtaining Credit Ratings from a CRA tend to be institutions and governments – see the proposed amendment to GEN Rule 9.1.1;

(d) not to require the prior DFSA approval of Controllers of CRAs; instead, to require only that a CRA notify the DFSA of certain changes to its control – see the proposed amendment to GEN Rule 11.8.1(2); and

(e) not to subject CRAs to general conduct requirements in COB such as client classification requirements; instead applying bespoke conduct requirements to suit the CRA activities - see paragraphs 19 – 27.

Issues for consideration

9. Do you agree with the above exclusions? If not, what are your reasons?

10. Specifically, is there any reason to exclude the application of the audit and auditor related requirements of GEN chapter 8 to CRAs? What are your reasons?

11. Are there any other Rules which should not apply, or should apply in a modified manner, to CRAs? If so, what are those Rules and to what extent should they be excluded or modified?

Additional Principles applicable to Credit Rating Agencies

19. We propose to apply three overarching additional Principles setting out the main objectives a CRA needs to achieve in conducting its Credit Rating Activities. These principles are premised on the IOSCO Principles relating to Credit Rating Agencies and provide as follows:

(a) Principle 1: Quality and integrity

A Credit Rating Agency must ensure its Credit Ratings are well founded and are based on a fair and thorough analysis of all relevant information – see the proposed COB Rule 8.2.1.

(b) Principle 2: Independence and conflicts of interest

A Credit Rating Agency must ensure that its decisions relating to Credit Ratings are independent and free from political or economic pressures and not affected by conflicts of interest arising due to its ownership structure or business or other activities, or conflicts of interest of its Employees – see the proposed COB Rule 8.2.2.

(c) Principle 3: Transparency and disclosure

A Credit Rating Agency must conduct its Credit Rating Activities in a transparent and responsible manner – see the proposed COB Rule 8.2.3.

20. In addition to the three proposed additional Principles, the 12 Core Principles in GEN section 4.2 would continue to apply to CRAs, with one modification relating to Core Principle 6 in GEN Rule 4.1.4. We propose to expand the Current Principle 6 by requiring a Credit Rating Agency to pay due regard to the interests of the users of Credit Ratings in complying with the obligation under that Principle – see the proposed expansion to Core Principle 6 in GEN Rule 4.1.4.

Issues for consideration

12. Do you have any concerns relating to the introduction of three new additional Principles applicable to CRAs? If so, what are they and how should they be addressed?

13. Do you have any concerns about the proposed expansion of the Core Principle 6 in GEN Rule 4.2.6? If so, what are those concerns and how should they be addressed?

Requirements to promote quality and integrity of the rating process

21. The quality of the rating process is a significant contributor to the quality and credibility of Credit Ratings that can be provided by a CRA. Therefore, we propose to introduce a number of requirements relating to those elements which underpin the quality of the rating process, as follows:

(a) Methodologies and models, including key rating assumptions, which are used by CRAs: Methodologies and models adopted by CRAs to prepare and review their Credit Ratings go to the heart of the credibility of Credit Ratings provided by them. Therefore, we propose that such methodologies and models must be rigorous and systematic and result in Credit Ratings capable of some form of objective validation and must be published – see the proposed COB Rule 8.3.2;

(b) Rating Analysts: The credibility of Credit Ratings depends on the quality of the analytical work undertaken by Rating Analysts. Therefore, we propose that a CRA must ensure its Rating Analysts have adequate and appropriate knowledge and experience to carry out the Credit Rating Activities assigned to them, have access to all the Relevant Information, apply the methodologies and models relevant to the type of Credit Rating and do so in a transparent, consistent and unbiased manner and observe high standards of integrity – see the proposed COB Rule 8.3.3;

(c) Credit Ratings: This aspect relates both to the accountability of the CRA in relation to its Credit Rating, and to the quality of its Credit Ratings. We propose to require a CRA to ensure that:

(i) its Credit Ratings are not assigned to Rating Subjects by any of its Rating Analysts, as it is the responsibility of the CRA itself to assign Credit Ratings;

(ii) the information a CRA uses to base its Credit Ratings is of sufficient quality to support a credible Credit Rating;

(iii) its Credit Ratings reflect all the Relevant Information, do not contain any misrepresentations, and are not misleading; and

(iv) if a Credit Rating is premised on limited data, warnings to that effect are included in the Credit Ratings – see the proposed COB Rule 8.3.4;

(d) On-going monitoring and review of Credit Ratings: The on-going review and update of Credit Ratings is a crucial aspect of Credit

Ratings, as investors and users rely on the on-going validity of a Credit Rating. Therefore, we propose that a CRA must monitor, review and update its Credit Ratings, as appropriate, unless it has clearly stated that they are not subject to such monitoring and review. It must also take Rating Actions promptly where appropriate - see the proposed COB Rule 8.3.5; and

(e) Systems and controls to enhance quality and integrity of the rating process: Given the importance of adequate systems, procedures and controls to promote effective compliance by a CRA of the specific requirements relating to both quality and integrity of the rating process, we propose to include specific requirements covering these two aspects – see the proposed COB Rules 8.3.1 and 8.4.1.

22. Consistently with the IOSCO and the EU approach, the proposed regime does not bring within the definition of a Rating Action certain activities of CRAs, such as placing a Credit Rating on "watch" or announcing an "outlook" (see COB Rule 8.3.5(2)). This is because we do not propose to be overly prescriptive in this regard, whilst acknowledging that such actions could have a significant impact on the market.

Issues for consideration

14. Do you have any concerns relating to the proposed requirements that are designed to ensure the quality and integrity of the rating process? If so, what are they and how should they be addressed?

15. Are there any aspects that contribute to the quality and integrity of the rating process which are not adequately covered by the proposed Rules? If so, what are they and why should they be covered?

16. Do you think that the definition of a Rating Action should cover activities of CRAs such as placing a Credit Rating on "watch" or announcing a "rating outlook"? If so, what are your reasons?

Requirements to promote independence and mitigate conflicts of interest

23. Two critical aspects that contribute to the independence and objectivity of decision making by CRAs relating to their Credit Ratings, are their ability to act free from political or economic pressures and to identify and address conflicts of interest arising from their own structures and business dealings, and also from the dealings and activities of their Employees – see the proposed overarching Principle in COB Rule 8.2.2. Therefore, we propose to introduce a number of requirements relating to these two aspects as follows:

(a) Codes of conduct/ethics: Policies and procedures for dealing with conflicts of interest are generally the subject matter for a code of conduct/ethics to be adopted by a CRA. Whilst not proposing to prescribe that each CRA must have such a code, adopting a code of conduct/ethics is one means of achieving the outcome intended by the relevant requirements. However, where a CRA does not adopt such a code, the onus is on the CRA to demonstrate how it achieves compliance with the relevant requirements through other means - see Guidance under proposed COB Section 8.1.1;

(b) The proposed prohibition against certain types of consultancy and advisory services: The provision of certain types of consultancy and advisory services by a CRA to a Rating Subject or a Related Party of a Rating Subject, can give rise to significant conflicts of interest that are not amenable to any type of mitigation. Therefore, consistent with the IOSCO and EU approach, we propose to prohibit the provision by a CRA of consultancy and advisory services relating to the corporate or legal structure, assets, liabilities or activities of a Rating Subject, or of a Related Party of a Rating Subject – see the proposed COB Rule 8.5.2(1);

(c) Safe-harbour for ancillary services: Consistent with the IOSCO and EU approach, we propose to allow a CRA to provide to a Rating Subject or its Related Party services which are ancillary to its Credit Rating Activities (such as market and economic forecasts and trends, pricing analysis and other general data analysis) subject to certain safeguards, which require that it:

(i) has adopted a clear definition of what services it considers as ancillary services;

(ii) documents why such services are considered as not giving rise to any conflicts of interest with its Credit Rating Activities; and

(iii) has in place adequate mechanisms to minimise the potential for conflicts of interest arising - see the proposed COB Rule 8.5.2(3);

(d) Fees charged by CRAs: We propose to prohibit certain types of fees, in particular fees based on particular rating outcomes or contingency fees (such as a higher Credit Rating attracting a higher fee), as such variable fees are likely to impair a CRA's objectivity – see the proposed COB Rule 8.5.3;

(e) Proprietary dealings in securities and derivatives: We also propose to prohibit a CRA from engaging in securities and derivatives transactions with, relating to, or in respect of, its Rating Subjects and Related Parties – see the proposed COB Rule 8.5.4; and

(f) Conflicts of interest of Employees: As conflicts of interest of Employees pose a key risk to the objectivity of rating decisions, we propose a number of requirements designed to address this risk. These include that a CRA:

(i) does not allow its Employees who are directly involved in preparing or reviewing a Credit Rating to be involved in the negotiation of fees and payments with the Rating Subject, or to engage in any securities or derivatives transactions relating to the Rating Subject - see the proposed COB Rule 8.6.2;

(ii) does not allow its Employees who have a material interest in a Rating Subject or a Related Party to be involved in the preparation or review of the relevant Credit Rating or to be able to influence that process - see the proposed COB Rule 8.6.3;

(iii) does not remunerate its Employees in a manner that creates potential conflicts of interest, and undertakes periodic reviews to ensure that its remuneration structure remains adequate and effective for this purpose. These requirements augment the remuneration related provisions that were recently introduced as part of the corporate governance enhancements applicable to all Authorised Firms - see the proposed COB Rules 8.6.5 - 8.6.7.

Issues for consideration

17. Do you agree with our approach in not mandating that CRAs adopt codes of conduct/ethics; instead provide flexibility to adopt such codes? If not, what are your reasons?

18. Do you have any concerns relating to the approach we have adopted relating to the prohibition of certain types of consultancy and advisory services? If so, what are they and how should they be addressed?

19. Do you have any concerns about the proposed safeguards relating to the provision of ancillary services? If so, what are they and how should they be addressed?

20. Do you agree that CRAs should be prohibited from charging certain contingency based fees? If not, what are your reasons?

21. Do you agree with our approach in prohibiting proprietary dealing in securities or derivatives of the Rating Subject or its Related Parties? If not, what are your reasons?

22. Are there other types of arrangements or transactions which should be prohibited? If so, what are they and why should they be prohibited?

23. Do you have any concerns relating to the proposed requirements to address conflicts of interest of Employees of CRAs? If so, what are they, and how should they be addressed?

Requirements to promote transparency and disclosure

24. Principle 3 – Transparency and disclosure (see COB Rule 8.2.1) requires a CRA to conduct its Credit Rating Activities in a transparent and responsible manner. Premised on this, more detailed requirements are proposed, consistently with the IOSCO and EU approach, to ensure clear communications and adequate disclosure of information by CRAs. The key aspects of these proposals include the following:

(a) Publication of Credit Ratings and relevant information: To ensure effective communication of Credit Ratings and associated information, we propose that a CRA publishes its Credit Ratings promptly and, as far as practicable, on a non-selective basis. Credit Ratings must also contain sufficient information to enable users to understand how they are arrived at, including methodologies, models and key underlying assumptions used. If the Credit Rating is unsolicited, it must state so and include the CRA's policy in undertaking unsolicited Credit Ratings – see the proposed COB Rule 8.8.1(1); and

(b) Structured financial products: As structured financial products are often complex, making it both difficult to rate them and difficult for the users to understand the basis of their Credit Ratings, we propose more specific requirements relating to such products, such as more comprehensive disclosure by the CRA – see the proposed COB Rule 8.8.3.

Issues for consideration

24. Do you have any concerns relating to the proposed requirements relating to transparency and disclosure? If so, what are they and how should they be addressed?

25. Do you agree that structured financial products warrant more detailed requirements due to their complexity? If not, what are your reasons?

Requirements relating to confidential information

25. A CRA may come to possess a wide range of information through channels of communication it has with Rating Subjects, their Related Parties and other public or non-public sources. It may also generate information that relates to Rating Subjects through analytical and other evaluative processes it applies to data relating to or affecting Rating Subjects.

26. Consistent with the IOSCO and EU approach, we propose to require a CRA to have adequate policies, procedures and controls to ensure, amongst other things, that it and its Employees do not use any confidential information for a purpose other than that for which it is given or obtained, or disclose such information to any third party without the consent of the Person to whom a duty of confidentiality is owed, unless it is legally obliged to do so – see the proposed COB Rule 8.9.1.

Issues for consideration

26. Do you have any concerns relating to the proposed confidentiality of information requirements? If so, what are they and how should they be addressed?

Requirements relating to record keeping

27. Record keeping requirements form the backbone of the measures that enable a CRA to demonstrate to the DFSA that it meets the relevant requirements. Therefore, consistently with the IOSCO and EU approach, we propose that CRAs maintain comprehensive records relating to their Credit Rating Activities – see the proposed COB Rule 8.10.1.

Issue for consideration

27. Do you have any concerns relating to the proposed record keeping requirements? If so, what are they and how should they be addressed?

Proposed fees relating to CRA licences

28. We propose to charge an initial authorisation fee of US$ 10,000 and an on-going annual fee of US$ 10,000 to CRAs – see the proposed FER Rules 2.1.1 and 3.2.1 in Appendix 3.

Issue for consideration

28. Do you have any concerns relating to the proposed fees? If so, what are they and how should they be addressed?

Proposed transitional arrangements

29. We note that there are a number of CRAs already operating from a place of business in the DIFC. Whilst these entities will need to obtain a licence from the date on which the new CRA regime, if adopted, comes into effect, we propose to allow them a maximum period of 6 months to comply with the applicable conduct standards by way of waivers.

Issue for consideration

29. Do you have any concerns relating to the proposed transitional arrangement? If so, what are they and how should they be addressed?