

25 September 2014

FINANCIAL
MARKETS
LAW
COMMITTEE

Jonathan Faull
Director General, Internal Market and
Services
European Commission
1049 Brussels
Belgium

Dear Mr Faull

Credit Rating Agencies Regulation

Response to the European Securities and Markets Authority: implementation of the third EU Regulation on Credit Rating Agencies

As you are aware, the role of the Financial Markets Law Committee (the "FMLC" or the "Committee") is to identify issues of legal uncertainty, or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks, and to consider how such issues should be addressed.

The FMLC considers it important to comment on the legal uncertainties arising from the consultation paper on the implementation of Regulation (EU) No 462/2013 ("CRA3") amending Regulation (EU) No 1060/2009 on credit rating agencies ("the CRA Regulation"), a draft of which was published as part of a consultation paper on CRA3 implementation ("CP") by the European Securities and Markets Authority ("ESMA") on 11 February 2014.

The FMLC paper entitled, "Response to the European Securities and Markets Authority: implementation of the third EU Regulation on Credit Rating Agencies" ("Consultation Response") is enclosed. This paper was written as the FMLC's response to the CP and the comments are limited to the regulatory technical standards ("RTS") on structured finance instruments.

There were, of course, a number of changes between the draft RTS published on 11 February 2014 and the version of the RTS published in ESMA's Final Report dated 20 June 2014 ("Final Draft RTS"). Having reviewed the Final Draft RTS alongside comments made in the Consultation Response, the FMLC takes the view that the substantive comments made in the enclosed Consultation Response continue to apply, subject to the following comments:

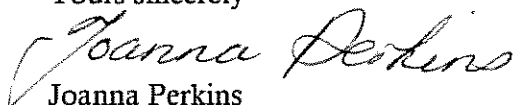
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- The "phase-in approach" described in recitals (5), (6) and (7) of the Final Draft RTS is helpful in the short term in that its practical effect would be to delay the application of transparency requirements in respect of many structured finance instruments ("SFI") that the FMLC considers outside the proper scope of the reporting requirements (as to which, please see paragraphs 2.1 to 2.11 of the Consultation Response). The Committee remains of the view that SFI ought properly to be within the scope of the reporting requirements only if they are "securities" within the meaning of the Prospectus Directive that also carry a public rating, as described in the Consultation Response. The Committee invites the Commission to examine these issues carefully when considering the Final Draft RTS.
- The revised event-based reporting requirement set out in Article 7(4) of the Final Draft RTS has made significant progress toward addressing the comments made in paragraphs 3.6 to 3.10 of the Consultation Response. The FMLC notes in particular that the exclusion of SFI covered by the market abuse regime from this standard (under Article 7(4)(a)) has the effect of eliminating the overlapping but non-identical reporting requirements about which it had expressed concern. The FMLC remains, however, of the view that the "significant change or event" test proposed in Article 7(4)(b) of the Final Draft RTS is intuitively difficult to interpret and apply to particular circumstances, leading to unfortunate legal uncertainty in the case of transactions not subject to the market abuse regime.

I and Members of the Committee would be delighted to meet with you to discuss the issues raised in this letter. Please do not hesitate to contact me to arrange such a meeting or should you require further information or assistance.

Yours sincerely



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April 2014

FINANCIAL MARKETS LAW COMMITTEE

ISSUE 169: Credit Rating Agencies Regulation

**Response to the European Securities and Markets Authority:
implementation of the third EU Regulation on Credit Rating Agencies**



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CONTENTS

1. Introduction	4
2. Scope of Application	5
3. Incompatibility with other disclosure requirements	10
4. Conclusion	12

1. INTRODUCTION

- 1.1. The role of the Financial Markets Law Committee (the “**FMLC**” or the “**Committee**”) is to identify issues of legal uncertainty, or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks and to consider how such issues should be addressed.
- 1.2. The FMLC welcomes the opportunity to respond to a consultation published by the European Securities and Markets Authority (“**ESMA**”) on 11 February 2014 (“**the CP**”) concerning the implementation of Regulation (EU) No 462/2013 (“**CRA3**”) amending Regulation (EU) No 1060/2009 on credit ratings agencies (“**the CRA Regulation**”).
- 1.3. The CP sets out three sets of regulatory technical standards in draft: (i) standards on structured finance instruments; (ii) standards on the European Rating Platform; and, (iii) standards on fees charged by credit rating agencies. These standards have been drafted pursuant to Articles 8b(3), 21(4a)(a) and 21(4a)(b), respectively, of the CRA Regulation (as amended by CRA3). The broad objectives of the legislative regime for credit rating agencies which it is sought to implement by means of these three sets of standards are, respectively, to facilitate: (i) the provision of information on structured finance instruments (“**SFIs**”) to investors; (ii) data reporting for credit rating agencies; and, (iii) fair competition among credit rating agencies as to fees.
- 1.4. The scope of this paper is restricted to issues arising from the first set of regulatory technical standards (“**the RTS**”) on the disclosure of information relating to SFIs by the issuer, originator and sponsor of the instrument in question. An SFI is defined in Article 3(1) of the CRA Regulation as “*a financial instrument or other assets resulting from a securitisation...*” (see paragraph 2.1 below).
- 1.5. Article 8b(1) of the CRA Regulation (as amended by CRA3) broadly identifies the categories of information required:

The issuer, the originator and the sponsor of a structured finance instrument established in the Union shall, on the website set up by ESMA... jointly publish information on the credit quality and performance of the underlying

assets of the structured finance instrument, the structure of the securitisation transaction, the cash flows and any collateral supporting a securitisation exposure as well as any information that is necessary to conduct comprehensive and well-informed stress tests on the cash flows and collateral values supporting the underlying exposures.

but it is left to ESMA (according to Article 8b(3)) to specify a) the information that must be published and b) the frequency with which it is to be published, as well as to develop c) a standardised disclosure template.

- 1.6. Recital (30) of CRA3 makes it clear that the purpose of the disclosure requirements is to improve the ability of investors to make an informed assessment of the creditworthiness of SFIs, to “*reduce investors’ dependence on credit ratings*” and to “*reinforce competition between credit rating agencies*” by facilitating “*an increase in the number of unsolicited credit ratings*”.
- 1.7. This paper addresses uncertainties in the RTS relating principally to:
 - a) the scope of the RTS in light of the clear meaning and intended effect of Article 8b of the CRA Regulation; and
 - b) the compatibility of the RTS with other disclosure regimes implemented in EU legislation.

2. SCOPE OF APPLICATION

Limitation to publicly rated instruments

- 2.1. The CP explains that the disclosure requirements imposed by the RTS apply to *all* SFIs that fall under the definition of Article 3(1) of the CRA Regulation,¹ i.e. to any

*financial instrument or other assets resulting from a securitisation transaction or scheme referred to in Article 4(36) of Directive 2006/48/EC.*²

¹ Paragraph 6 of the Executive Summary.

- 2.2. In keeping with this comprehensive objective, Article 2 of the RTS provides as to scope that the “*Regulation shall apply to structured finance instruments if the issuer, originator, or sponsor is established in the European Union*” and Recital (3) of the RTS amplifies this as follows:

as specified in Article 3(1) and Article 8b of Regulation (EC) No 1060/2009, this RTS should apply to all financial instruments or other assets resulting from a securitisation transaction or scheme as referred to in Article 4(61) of Regulation EU No 575/2013...this means that e.g. private and bilateral transactions are within the scope of this Regulation, as well as transactions that are not offered to the public or admitted to trading in the EU as long as either the issuer, originator and sponsor of the structured finance instrument is established in the EU.

- 2.3. The effect of this objective and these provisions is to extend the scope of the RTS well beyond the category of instruments which are the target of the regulatory regime—i.e. publicly rated SFIs—and thus beyond the intended ambit of the underlying legislation. That this is the intention of the RTS is evident from Recital (4), which states:

as specified in Article 3(1) and 8(b)³ of [the CRA Regulation], the scope of this Regulation is not limited to the issuance of structured finance instruments that qualify as securities, but also includes other financial instruments, such as money-market instruments (e.g. asset-backed commercial paper programmes). In addition, this Regulation applies to structured finance instrument (sic) with and without credit ratings assigned by an EU registered credit rating agency...

- 2.4. Recital (30) of CRA3 (see paragraph 1.6 above), however, provides important context within which to interpret the scope of the authority conferred on ESMA by Article 8b(3) of the CRA Regulation. This recital makes it clear that the purpose of the disclosure requirements for issuers, originators and sponsors, which are to be substantiated by the RTS, is to provide investors with

² Directive 2006/48/EC relates to the taking up and pursuit of the business of credit institutions and is colloquially known as the Capital Requirements Directive. It has since been largely replaced by Regulation (EU) 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms, which contains the same definition of securitisation.

³ It is a small point but this is a drafting error. There are no parentheses in “Article 8b” as inserted in the CRA Regulation by CRA3.

information against which they can independently assess the value of publicly rated SFIs and thereby to reduce investors' dependence on those ratings by making information widely available. The better view, taking this into account, is that the CRA Regulation provides a mandate for ESMA only to develop standards relating to publicly rated SFIs and that, in consequence, the scope of RTS exceeds the ambit of the legislative authority conferred by Article 8b of the CRA Regulation.

- 2.5. Once this is accepted, it is clear that the RTS should apply only to those SFIs which are the subject of credit ratings within the scope of the regulatory regime established by the CRA Regulation, i.e. are subject to credit ratings issued in the European Union which do not fall within the excluded ratings listed in Article 2(2) of the CRA Regulation.⁴
- 2.6. If the CRA Regulation (as amended by CRA3) does not contemplate the disclosure of information relating to unrated SFIs or privately rated SFIs it is difficult to see how their being subject to a delegated regulation such as the RTS can be justified.⁵ The FMLC would welcome clarification that the scope of the RTS is limited by reference to the legislative intent and scope of Article 8b of the CRA Regulation, as that intent can be inferred from Recital (30) of CRA3.
- 2.7. Related concerns are discussed below.

Limitation to Prospective Directive “securities”

- 2.8. Recital (4) of the RTS, as set out in paragraph 2.3 above, stipulates that the scope of the RTS is not limited to SFIs that qualify as securities but also includes other financial instruments such as money market instruments.
- 2.9. The FMLC takes the view, however, that Article 8b of the CRA Regulation (as amended by CRA3) confers a mandate to establish standards only in respect of SFIs that are “securities” subject to the obligation to publish a prospectus under

⁴ These include: private credit ratings; credit scores, credit scoring systems or similar assessments related to obligations arising from consumer, commercial or industrial relationships; certain credit ratings produced by export credit agencies; and, credit ratings produced by central banks within the scope of Article 2(2)(d).

⁵ Article 10(1) of Regulation (EU) No 1095/2010 establishing a European Supervisory Authority (European Securities and Markets Authority) requires that "regulatory technical standards...shall be delimited by the legislative acts on which they are based".

Directive 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading (the “**Prospectus Directive**”).

- 2.10. Article 8b(1) imposes obligations on "the issuer, the originator and the sponsor of a structured finance instrument" to disclose information. The term "issuer" is defined in Article 3 of the CRA Regulation (as amended) by reference to the Prospectus Directive and is defined in Article 2(1)(h) of that directive as "a legal entity which issues or proposes to issue securities". Thus, the reference in Article 8b(1) of the CRA Regulation to the “issuer” is clearly intended to delimit the scope of the disclosure obligation to disclosure in respect of SFIs that are "securities" within the meaning of the Prospectus Directive.
- 2.11. One consequence of this delimitation is that Article 8b(3) does not appear to confer a mandate on ESMA to develop standards in respect of money market instruments with a maturity of less than 12 months, which are expressly excluded from the definition of "securities" by Article 2(1)(a) of the Prospectus Directive. The FMLC would welcome clarification that, notwithstanding the width of the legislative ambition established in Recital (4), the disclosure obligations substantiated by the RTS do not extend beyond SFIs which are “securities” within the meaning of the Prospectus Directive.

Limitation to entities established in the EU

- 2.12. Article 1 of the CRA Regulation (as amended by CRA3) states, after defining the subject matter of the regulation with respect to credit rating activities, that the Regulation "*also lays down obligations for issuers, originators and sponsors established in the Union regarding structured finance instruments*". The subject matter of the legislation which underpins the RTS includes therefore, *inter alia*, the obligations of disclosure incumbent upon European issuers, originators and sponsors but does not include the imposition of obligations on issuers, originators or sponsors from third countries. It is as well that this limitation as to subject-matter is definitively identified in the framework legislation because related provisions of the RTS are lacking in clarity to a degree that is regrettable.

2.13. The paragraphs below principally concern the confusion which may stem from imprecise drafting in the RTS as it is intended to apply to a conventional true sale securitisation by the originator of the underlying assets. The resulting confusion is significantly exacerbated in cases of securitisations with multiple "originators" within the definition provided by Article 3 of the CRA Regulation (as amended by CRA3), which refers to the definition in Directive 2006/48/EC.⁶

2.14. Article 3(1) of the RTS provides

The issuer, originator or (sic) sponsor of a structured finance instrument so long as one of these parties is established in the Union (sic) shall comply with the requirements established by this Regulation...

2.15. This drafting fails to link, on the one hand, the party established in the Union to, on the other hand, the party or parties which "*shall comply*" with the requirements of the RTS. Absent any such link, the reader naturally infers that so long as one party is established in the Union, the disclosure obligations are intended to apply to the other parties. This is not, however, an inference which is compatible with the disjunctive "*or*" which appears in the list of parties after "*originator*" or with Article 1 of the CRA Regulation.

2.16. Recital (3) to the draft RTS is similarly unclear. It states that the disclosure obligations apply "*to all financial instruments... on condition that... the issuer, originator, or sponsor is established... in the Union*" from which one infers that the disclosure obligations are intended to apply to all parties so long only as one is established in the Union but then falls into contradiction, providing that it applies "*as long as either (sic) the issuer, originator and (sic) sponsor of the structured finance instrument is established in the EU*". Here "*either*" is incompatible with the conjunctive "*and*", the latter suggesting that all three parties must be established in the Union before the disclosure obligations will apply.

2.17. The intent of the underlying legislation is clear: disclosure obligations apply only if and when one or more of the three parties specified in Article 8b(1) of the CRA Regulation is established in the Union and apply only to that party or

⁶ See footnote 2 above.

those parties. The FMLC would welcome clarification that the RTS applies exclusively to issuers, originators and/or sponsors established in the Union.

- 2.18. A closely related point is that any provision made by the RTS as to the issuer, originator and sponsor “*jointly*” agreeing, “*jointly*” designating or to requirements “*jointly*” applying (*sic*) to these same parties, such as is found in Article 2(3), should be subject to the qualification that joint responsibility is only shared among those parties established in the Union.
- 2.19. In this regard, the FMLC notes that the Community has chosen not to embark on the very considerable task of attempting to harmonise Member States’ civil liability regimes. This may be wise, given the enormity of the undertaking, in the view of the FMLC. In the meanwhile, however, issuers, originators and sponsors located in different Member States, although formally subject to “*joint responsibility*” according to Recital (8) of the RTS, will likely be subject to different liability regimes incorporating different approaches to joint liability and even different definitions thereof. This will render any legal assessment of one party’s liability unduly complicated.
- 2.20. Finally, the complexity of the picture with regard to each party’s responsibility for disclosure and, ultimately, with regard to liability is likely to be exacerbated by the need to take account of pre-existing disclosure regimes which may be in place in EU Member States (implementing, say, legislation on regulatory capital and/or market abuse; further details are given below) or in third countries, where one or more of the parties in question is established outside the Union. The FMLC recommends that further consideration be given to the precise nature and scope of the “*joint responsibility*” which it is intended to impose under the RTS.

3. INCOMPATIBILITY WITH OTHER DISCLOSURE REQUIREMENTS

- 3.1. The FMLC notes that there are a number of disclosure regimes already legislated for at the European level that apply to securities that are also SFIs. These include the Prospectus Directive/Transparency Directive⁷ regime and the

⁷ Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market.

market abuse regime (further described below) applicable to securities generally and the CRR⁸ regime applicable specifically to securitisations.

- 3.2. *Prima facie*, it is undesirable to have overlapping yet non-coextensive disclosure regimes applicable to an issuer in respect of the same financial instruments. This approach makes conflicts between the regimes more likely and increases the scope for legal uncertainty. Where, as here, the framework legislation gives rise to a new disclosure regime which overlaps with other pre-existing regimes, it is important that every effort be made, when developing technical standards, to ensure that no unnecessary conflicts with existing rules are created and that it is possible to comply with all applicable rules.
- 3.3. The paragraphs below describe two particular conflicts that would arise from the adoption of the RTS. These should be considered as illustrative, rather than exhaustive. The FMLC would welcome a reconsideration of the RTS with a view to ensuring its consistency with existing European rules, and in particular those relating to disclosure.

Article 409 of the CRR

- 3.4. Article 409 of Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms, colloquially known as the Capital Requirements Regulation or “CRR” provides:

Institutions acting as an originator, a sponsor or original lender shall disclose to investors the level of their commitment under Article 405 to maintain a net economic interest in the securitisation. Sponsor and originator institutions shall ensure that prospective investors have readily available access to all materially relevant data on the credit quality and performance of the individual underlying exposures, cash flows and collateral supporting a securitisation exposure as well as such information that is necessary to conduct comprehensive and well informed stress tests on the cash flows and collateral values supporting the underlying exposures. For that purpose, materially relevant data shall be determined as at the date of the securitisation and where appropriate due to the nature of the securitisation thereafter.

⁸ Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms, colloquially known as the Capital Requirements Regulation or “CRR”.

3.5. There is clearly considerable overlap between this provision and Article 8b of the CRA Regulation (as inserted by CRA3), without their being co-extensive. The FMLC considers that the current draft RTS amplifies the legal uncertainty caused by the lack of harmonisation between these provisions by imposing a stringent obligation to disclose “loan-level information” under Article 4, notwithstanding Article 8b makes no reference to individual exposures. In contrast, the EBA has clarified the reference to individual exposures in the CRR by stipulating the disclosure of “*loan-level information*” may not be “*materially relevant*” in all cases and need not be disclosed where, for example, pool-level data would be material from an investor's point of view.⁹ As a result, market participants are left with the unfortunate and confusing impression that banking and securities regulators are taking divergent approaches to the same question. The FMLC considers that the requirement to disclose “*loan-level information*” should be harmonised with the approach taken under the CRR for the sake of consistency.

Conflict with the market abuse regime

3.6. Article 6(4) of the RTS requires:

Any significant change or event either likely to affect the creditworthiness or the risk characteristics of the underlying exposures or of the structured finance instrument or representing a breach of transaction documentation of the structured finance instrument shall be disclosed under the responsibility of the issuer, originator or sponsor, without delay on the website to be set up by ESMA.

3.7. One significant category of information affecting the risk characteristics and credit profile of the SFI is information concerning the issuer of the SFI. Under Article 6(1) Directive 2003/6/EC (the “**Market Abuse Directive**”) that information may also be disclosable as “*inside information*”.

⁹ Paragraph 128 of the “CEBS Guidelines on the application of Article 122a of the Capital Requirements Directive (CRD)” dated 31 December 2010, made this clear in respect of the equivalent requirement of article 122a(7) of the CRD. The CEBS Guidelines were later adopted by the EBA. The EBA maintained this position in Article 24(2) of its final draft of the RTS implementing Article 409 of the CRR. The version of that same RTS adopted by the Commission on 13 March 2014 again maintains this position in its Article 23(2)(c).

- 3.8. The Market Abuse Directive, together with its implementing directive (2003/124/EC), creates detailed rules about the requirement for reporting information concerning the issuer on the basis of whether the information would have a significant effect the price of the financial instrument or related derivatives. The test of significance ("*significant change or event*") proposed in the draft RTS is different and is intuitively more difficult to interpret and apply to particular circumstances.
- 3.9. Further, the market abuse regime provides for restrictions to, and exemptions from, the requirement to disclose developments immediately in ways that the RTS does not. For example:
- a) under Article 1(1) of the Market Abuse Directive, information is required to be precise before it is considered "*inside information*" subject to disclosure. No equivalent exemption is provided under the RTS.
 - b) Article 6(2) of the Market Abuse Directive provides that disclosure of information may be delayed so as not to prejudice the legitimate interests of the issuer, provided the public would not thereby be misled and the information remains confidential until publicly disclosed. This, too, is missing from the RTS.

These restrictions and exemptions are elaborated in Articles 1 and 3, respectively, of implementing directive 2003/124/EC.

- 3.10. The FMLC suggests that some consideration be given to aligning these two disclosure regimes for securities. In particular, the FMLC notes that the unhappy consequence of the wider requirements of the RTS may be to deprive issuers of protections afforded by primary market abuse legislation.

4. CONCLUSION

- 4.1. The FMLC welcomes ESMA's efforts to implement CRA3. It is concerned, however, that the RTS on the disclosure of information relating to SFIs give rise to a number of legal uncertainties. These uncertainties relate to: (i) the extended scope of the RTS which contrasts with the clear meaning and intended effect of Article 8b of the CRA Regulation (as amended by CRA3);

and (ii) incompatibility of the RTS with disclosure regimes in existing regulations: the Prospectus Directive, and the Market Abuse Directive. The FMLC also recommends that further consideration be given to the introduction of joint liability for the issuer, the originator and the sponsor of a structured finance instrument.

- 4.2. The FMLC would welcome confirmation that the RTS is intended: (i) to impose disclosure requirements no wider than those set out in Article 8b of the CRA Regulation (as amended by CRA3); and (ii) to operate in a manner which is compatible with other disclosure regimes in European law, particularly those in the Prospectus Directive, and the Market Abuse Directive.

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