

MINISTRY OF FINANCE  
CAPITAL MARKETS DIVISION

# Report of the Committee on Comprehensive Regulation for Credit Rating Agencies

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December 2009

The Chairman,  
High Level Coordination Committee on Financial Matters,

Dear Sir,

As desired by the High Level Coordination Committee on Financial Matters in its meeting held on 11<sup>th</sup> January, 2008 we submit herewith a report on Comprehensive Regulation for Credit Rating Agencies.

Yours sincerely



Dr. K.P. Krishnan  
Joint Secretary (Capital markets)



Shri C.K.G. Nair  
Director (Primary Markets),



Shri Praveen Tiwari,  
Executive Director, PFRDA



Shri P.K. Nagpal  
Executive Director, SEBI



Ms. Ranjana Sahajwala  
General Manager, RBI



Shri S.N. Jayasimhan  
Deputy Director, IRDA

# Preface

This Report is in response to the direction given by the High Level Coordination Committee on Financial Markets to reflect on the inter regulatory issues emanating from the activities of Credit Rating Agencies. Accordingly, the Committee was set up with representation from all the financial sector regulators. Since the mandate of the Committee included a long term assessment of the performance of the credit rating agencies in India, a separate research report was prepared by the National Institute of Securities Market (NISM). The Committee is grateful to Prof. Sethu, OSD In-charge of NISM and Prof. Sunder Ram Korivi and other Team Members for producing a quality report on the long term performance of the CRAs in a short time.

2. The Committee had four meetings. In addition the Committee interacted extensively with the CEOs of all the five SEBI registered Credit Rating Agencies in a meeting besides obtaining written inputs. We acknowledge their valuable contributions.

3. Every Member of the Committee, including those who left before completing the Report on account of their demitting the office, contributed significantly in the preparation of this Report. Apart from extensive discussions, all of them have given inputs in writing on the various issues analysed in the Report. I would also like to commend the contribution of Shri Anupam Mitra, Deputy Director in the Capital Markets Division in the preparation of the Report.



(Dr. K.P. Krishnan)

New Delhi.

21 December, 2009.

Joint Secretary ( Capital Markets &

Chairman of the Committee)

## Composition of the Committee

### *Chairman*

**Dr. K.P. Krishnan**      **Joint Secretary (Capital markets), Ministry of Finance**

### *Members*

**Mr. M.S Ray<sup>1</sup>**      **Securities and Exchange Board of India**

**Mr. P. R. Ravimohan<sup>2</sup>**      **Reserve Bank of India**

**Mr. S.N. Jayasimhan**      **Insurance and Regulatory Development Authority**

**Ms. Meena Chaturvedi<sup>3</sup>**      **Pension Fund Regulatory Development Authority**

### *Member Secretary*

**Mr. C.K.G Nair**      **Director (Primary Markets), Capital Markets Division**

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<sup>1</sup> Subsequently substituted by Mr. P. K. Nagpal

<sup>2</sup> Subsequently substituted by Ms. Ranjana Sahajwala

<sup>3</sup> Subsequently substituted by Mr. Praveen Tiwari

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# Chapter 1

## Terms of Reference

1. Examining scope of activities of Credit Rating Agencies and their systemic importance. Is Credit rating just an opinion or the opinion ?
2. Addressing 'conflict of interest' inherent in Credit Rating Agencies' business model.
3. A lead regulator model for Credit Rating Agencies.
4. How greater transparency can address some of the concerns of CRAs?
5. A voluntary norm of good governance of Credit Rating Agencies.
6. Pros and cons of 'Issuer pays model' with analysis of alternative models.
7. Ways and means to avoid regulatory overlaps.
8. Self Regulatory Organisation (SRO) for CRAs.
9. The Committee has entrusted National Institute of Securities Markets (NISM) to do a long term study on the soundness and robustness of CRA predictions since they started operations in India. The terms of reference of the NISM study are as follows:
  - I. Assessment of the performance of CRAs in India in terms of parameters like default and transition data
  - II. How much information asymmetry is bridged by CRAs
  - III. How far CRAs assessment helps financial regulation
  - IV. Accountability , corporate governance issues of CRAs
  - V. Disclosures of methodologies of rating
  - VI. Rating of complex products like structured obligation
  - VII. Uniformity or otherwise in definition and rating nomenclature of CRAs in India

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## Chapter 2

### Executive Summary

The High level Coordination Committee on Financial Matters (HLCCFM) in its meeting held on 11<sup>th</sup> January 2008, inter alia, decided that “the legal and policy framework for regulating the activities of CRAs should be revisited in order to take a larger view of the entire policy with respect to banking, insurance and securities market.”

Credit rating agencies play an important role in assessing risk and its location and distribution in the financial system. By facilitating investment decisions they can help investors in achieving a balance in the risk return profile and at the same time assist firms in accessing capital at low cost. CRAs can thus potentially help to allocate capital efficiently across all sectors of the economy by pricing risk appropriately. However, in view of the fact that CRAs that rate capital market instruments are regulated by SEBI<sup>4</sup> and that entities regulated by other regulators (IRDA, PFRDA and RBI) predominantly use the ratings, it was felt necessary to institute a comprehensive review of the registration, regulatory and supervisory regime for CRAs. The major motivation for the exercise was to look at inter regulatory coordination so that all interested stake holders have an institutional mechanism for providing inputs-feed back to ensure realisation of the objective behind the regulation of CRAs. Adding a further dimension to this enquiry, the sub prime crisis has attracted considerable adverse attention worldwide on the role of CRAs enhancing the need for this review.

Given that rating is only an opinion, albeit a very influential one, and regulation of gatekeeper business models is a border line ethical – regulatory issue, the committee has examined wide ranging steps to improve the functioning and accountability of CRAs including the suggestion that in the medium run regulators may move away from the mandatory rating practice at least in the capital market<sup>5</sup>. Based on the examination of the CRA business models, current regulatory activities, global experiments and the Indian context, this report aims to lay out a broad framework for strengthening the existing regulatory

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<sup>4</sup> Some other rating agencies that do not operate in the capital market (example Infometrics, MCRIL, ONICRA, SMERA) are simply registered companies under the Companies Act. There is a need for some registration and oversight mechanism for them as well.

<sup>5</sup> As recommended by Basel II external ratings are required for calibrating regulatory capital requirement. In the *standardised approach* for credit risk and market risk, the risk weight of bank exposures are aligned to the external ratings of the exposures. Even in the *advanced approach* external ratings will be used by banks for comparing their own internal assessments with those of external CRAs.

architecture for CRAs in India and incorporates the Committees' vision for new arrangements and practical steps required in this direction.

The Committee have examined the issues desired by HLCCFM in detail. The report is structured as follows:

Chapter one lists out the broad Terms of Reference of this report.

Chapter two provides a brief summary of the report.

Chapter three looks at the evolution of credit rating agencies as well as the conceptual role and rationale of rating and rating agencies.

Chapter four discusses the activities performed by credit rating agencies including non rating related activities. This chapter also examines the analytical framework used by CRAs and the limitations of credit ratings.

The current regulatory framework of CRAs in India is outlined in chapter five. In particular, this chapter discusses the extant SEBI regulations and Code of Conduct for CRAs. This chapter also brings out the inter regulatory (rating related) issues.

In the wake of the recent financial crisis the business models of CRAs have come under scanner. Chapter six deals with these and the regulatory concerns arising from the 'issuer pays' business model. It also explores the pros and cons of alternative models.

The recommendations of the Committee are contained in Chapter seven. The committee feels that prima facie there is no immediate concern about the operations and activities of CRAs in India even in the context of the recent financial crisis. However there is a need to strengthen the existing regulations by learning the appropriate lessons from the current crisis. The committee has taken note of international action in this regard and inter alia recommend that there may be greater disclosures regarding materially significant revenues received from a particular issuer/ non rating business like advisory services. A lead regulator model for CRAs may also be explored. The committee has also strongly recommended voluntary compliance with existing and emerging regulations like IOSCO Code.

The committee had commissioned a study on historical analysis of soundness and robustness of CRA predictions in India. Notwithstanding the fact that the rated universe is small in India the study brings out the relative fragility of the rating methodology as reflected in the transition data which shows high degree of ratings migration.

## Chapter 3

# Systemic Importance of Rating and Rating Agencies

### 3.1 Introduction

The institution of credit rating as a mechanism for addressing the considerable degree of information asymmetry in the financial markets has travelled a long way from the times of the US rail road companies in the mid-19<sup>th</sup> century. The need for an independent rating agency capable of assessing creditworthiness of borrowers was felt when corporates started mobilizing resources directly from savers instead of accessing it through banks which hitherto assumed the credit risk in such cases. The history of systematic credit rating, however, is a century old beginning with rating of US railroad bonds by John Moody in 1909. During this one century of growth and adaptation, CRAs progressed from rating simple debt products to rating complex derivatives to national economies and altered their business models to cover a range of activities/products. There are three major credit rating agencies operating internationally- Fitch, Standard and Poor's, Moody's Investor Services: between them they share the bulk of the \$5 billion rating business globally relegating other 60 plus local/regional players into just competitive fringes.

In India, credit ratings started with the setting up of The Credit Rating Information Services of India (now CRISIL Limited) in 1987. CRISIL was promoted by premier financial institutions like ICICI, HDFC, UTI, SBI, LIC and Asian Development Bank. Now CRISIL is an S&P company with a majority shareholding. Apart from CRISIL four more rating agencies have been registered by SEBI in India. These are ICRA, promoted by IFCI and now controlled by Moody's, CARE promoted by IDBI, Fitch India a 100% subsidiary of Fitch, and a new born Brickworks. In India, CRAs that rate capital market instruments are governed by Securities and Exchange Board of India (Credit Rating Agencies) Regulations, 1999. The regulation provides detailed requirements that a rating agency needs to fulfil to be registered with SEBI.

Table 3.1 : CRAs registered with SEBI.

Name of the CRA	Year of commencement of Operations
CRISIL	1988
ICRA	1991
CARE	1993
Fitch India	1996
Brickworks	2008

In India, revenues of the three big rating agencies, CRISIL, ICRA and CARE have shown an upward trend given the increase in the usage of ratings over time.

### 3.2 Role and Rationale

A credit rating is technically an ‘opinion’ on the relative degree of risk associated with timely payment of interest and principal on a debt instrument. It is an ‘informed’ indication of the likelihood of default of an issuer on a debt instrument, relative to the respective likelihoods of default of other issuers in the market. It is therefore an independent, easy-to-use measure of relative credit risk. Given the universal reliance on rating, and hence the *power of the opinion*, credit rating is expected to increase the efficiency of the market by reducing information asymmetry and lowering costs for both borrowers and lenders.

A simple alphanumeric symbol is normally used to convey a credit rating. Ordinarily the company which issues the debt instrument is not rated. It is the instrument which is rated by the rating agency. But the issuer company which has issued the debt instrument gets strength and credibility with the grade of rating awarded to the credit instrument it intends to issue to the public for raising funds. Though the purpose of rating is to rate instruments, a general perception may be gathered that the organisation issue a highly rated instrument is also sound and a highly rated entity. Thus, credit rating is a mechanism whereby an independent third party makes an assessment, based on different sources of information on the credit quality of the assessed.

Given the systemic *superstructure* position that the CRAs have come to occupy as *information and insight gate keepers*, they play an important role in the of modern capital markets. Their importance to various stakeholders is as follows.

### **Investors**

CRAs typically opine on the credit risk of issuers of securities and their financial obligations. Given the vast amount of information available to investors today- some of it valuable, some of it not – CRAs can play a useful role in helping investors and others sift through this information, and analyze the credit risks they face when lending to a particular borrower or when purchasing an issuer’s debt and debt like securities. CRAs also provide investors with rating reports, giving detailed information and analytical judgements on the issuer’s business and financial risk profile. This assists investors in taking more informed investment decisions, calibrated to their own risk-return preferences.

Securitised instruments are among the most complex instruments in the debt market. Securitised instruments backed by retail assets are classified as ‘Highly Complex’ by some Indian rating agencies. Given the inherent complexity in these instruments, an independent assessment of the risks involved in the instruments by a credit rating agency acts as an important input to an investor’s decision-making. Unlike most corporate bonds, where an investor can independently assess a borrower’s creditworthiness, in a securitisation transaction there will normally be little or no information in the public domain for an investor to carry out such an assessment. Understanding the nuances of different pools and analysis of the past behaviour of asset classes are areas where CRAs can play an important role. Tracking the performance of the transaction and the corresponding impact on the riskiness of the instruments is a feature where CRAs play an important *monitoring* role. These aspects have also been recognised by Indian regulators. As required by Basel capital accord risk weights are assigned to all rated rated and unrated bank exposures.

### **Issuers**

Issuers rely on credit ratings as an important tool to access investors and also to reach a wider investor base than they otherwise could. In most cases, successful placement of a significant bond issuance needs at least one rating from a recognised CRA; without a rating, the issue may be undersubscribed or the price offered by investors may not be appropriate. Further, they enable issuers to price their issues competitively. In financial markets, the price of debt is determined primarily by the rating of the debt issue.

### **Banks/ Bank loan rating**

Although credit rating is not mandatory under Basel II, banks are likely to save capital if they get their loan rated. If a bank chooses to keep some of its loans unrated, it may have to provide, as per extant

RBI instructions, a risk weight of 100 per cent for credit risk on such loans. As provided under Basel II, supervisors may increase the standard risk weight for unrated claims where a higher risk weight is warranted by the overall default experience in their jurisdiction. Further, as part of the supervisory review process, the supervisor may also consider whether the credit quality of corporate claims held by individual banks should warrant a standard risk weight higher than 100%.

In terms of RBI instructions on the 'New Capital Adequacy Framework (Basel II)' issued in April 2007, banks were required to initially assign a risk weight of 100 per cent in respect of unrated claims on corporates with the caveat that such claims would be assigned higher risk weights over time.

To begin with, for the financial year 2008-09, all fresh sanctions or renewals in respect of unrated claims on corporates in excess of Rs.50 crore were to attract a risk weight of 150 per cent, and with effect from April 1, 2009, all fresh sanctions or renewals in respect of unrated claims on corporates in excess of Rs. 10 crore were to attract a risk weight of 150 per cent. This higher risk weight of 150 per cent for unrated corporate claims was equivalent to the risk weight to be assigned to exposures rated 'BB and below'.

However, in November 2008, as a counter cyclical measure, RBI relaxed the regulatory prescription of 150 percent risk weight for unrated claims. Accordingly, all unrated claims on corporates, irrespective of the amount currently attract a uniform risk weight of 100 percent. This relaxation is temporary and will be reviewed at an appropriate time.

On the other hand, by getting loans rated, a bank can save capital on loans in the better rated categories, as shown in the illustration below.

*Table 3.2: Illustration of capital-saving potential by banks on a loan of Rs.1000 Million*

Rating	Basel I		Basel II (Standardised Approach for credit risk)		
	Risk weight	Capital required <sup>1</sup> (Rs. mn)	Risk weight	Capital required (Rs. mn)	Capital saved (Rs. mn)
AAA	100%	90	20%	18	72
AA	100%	90	30%	27	63
A	100%	90	50%	45	45
BBB	100%	90	100%	90	0
BB and below	100%	90	150%	135	(45)

Unrated	100%	90	100%	90	0
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<sup>1</sup> Capital required is computed as Loan Amount x Risk Weight x 9%

A large number of Indian companies, hitherto unrated by rating agencies, have now come forward to get their bank facilities rated. Basel-II norms hold significant potential for further development of the domestic debt markets, by introducing into the public domain easily accessible credit information about a large pool of mid-sized companies. This will not only allow these companies to explore alternative sources of funds, but, through greater visibility, also facilitate healthy competition among fund providers. For banks and other investors, it creates an information base that can be used for efficient portfolio selection. The acceptance of credit ratings by the investor community has led to investors showing increasing interest in the bank loan rating portfolio. Investors have also begun to consider offering a suite of market-linked borrowing products (including non-convertible debentures, commercial paper, and MIBOR-linked short-term debt instruments) to rated mid-sized companies.

## **Regulators**

Regulators—typically banking regulators and capital market regulators—use credit ratings, or permit ratings to be used, for regulatory purposes. For example, under the Basel II capital framework of the Basel Committee on Banking Supervision, banking regulators can accredit credit rating agencies based on specified criteria. The ratings assigned by these accredited External Credit Assessment Institutions or ECAs are used to assign risk weights to various bank exposures in calculating capital charge for credit risk. Further, some regulators (such as IRDA and PFRDA) have incorporated ratings into the investment guidelines for the entities they regulate. Rating thus provides an additional layer of comfort to the regulators in their assessment of product risks and overall systemic risks.

## Chapter 4

# Functions and Approaches of Credit Rating Agencies

### 4.1 What does credit rating convey?

A credit rating is an ‘opinion’ on the creditworthiness or the relative degree of risk of timely payment of interest and principal on a debt instrument. Most rating agencies adopt some variation of this definition for their credit ratings. The ratings are a comment on the relative likelihood of default in comparison to other rated instruments. In other words, a rating indicates the probability of default of the rated instrument and therefore provides a benchmark for measuring and pricing credit risk. A credit rating compresses an enormous amount of diverse information into a single rating symbol. A simple alphanumeric symbol, such as ‘AAA’ or ‘P2+’, is normally used to convey a credit rating. Currently rating agencies have standardised rating nomenclatures for long term ratings, short term instruments, medium term ratings, fixed deposits, corporate/issuer credit rating, long and short term debt fund portfolios, IPO grading etc. The rating symbols for the various instruments used by the five rating agencies in India are given at **Annexure 1**.

### 4.2 Rating related products and activities

CRA in India rate a large number of financial products:

1. Bonds/ debentures- [the main product]
2. Commercial paper
3. Structured finance products
4. Bank loans
5. Fixed deposits and bank certificate of deposits
6. Mutual fund debt schemes
7. Initial Public Offers (IPOs)

CRA also undertake customised credit research of a number of borrowers in a credit portfolio, for the use of the lender. CRA use their understanding of companies’ business and operations and their expertise in building frameworks for relative evaluation, which are then applied to arrive at performance grading. For example developer gradings are carried out to assess the ability of the developers to execute

projects on a timely basis and promised quality while maritime institute gradings are carried out to assess quality of education imparted to the students vis a vis DGS (Directorate General of Shipping) objectives.

### 4.3 Non-rating related activities

CRA often undertake a variety of non rating related activities. These include the following:

1. **Economy and Company Research:** Some Indian CRAs have set up research arms to complement their rating activities. These arms carry out research on the economy, industries and specific companies, and make the same available to external subscribers for a fee. In addition, they disseminate opinions on the performance of the economy or specific industries, available through releases to the media. The research would also be used internally by the rating agencies for arriving at their rating opinions. SEBI permits CRAs to carry out this activity subject to relevant firewalls.
2. **Risk consulting:** With the application of Basel II regulations for banks, there is considerable demand for tools and products that will allow banks to compute their capital adequacy ratios under the revised guidelines. The risk consulting groups of credit rating agencies would leverage the agencies' understanding of credit risk to develop and provide the tools and data that banks would require. The products in this area include tools for internal ratings, operational risk evaluation, and overall capital calculation.
3. **Funds research:** Some CRAs have diversified from mutual fund ratings into mutual fund research. The services that are available under this head include fund rankings, performance attribution tools (to help users understand the reasons for funds' performance), desktop tools, and fixed income research.
4. **Advisory services:** CRAs offer various kinds of advisory services, usually through dedicated advisory arms. Most of this is in the nature of developing policy frameworks, bid process management, public private partnership consulting, and creating an enabling environment for business in India and globally.
5. **Knowledge Process Outsourcing:** Some Indian CRAs (CRISIL and ICRA) have KPO arms that leverage their analytical skills and other process and manpower capabilities. These arms provide services to the CRAs' affiliates in developed markets, and also to other clients outside India.

### 4.4 The rating process

Rating is a multilayered decision making process. The process of rating starts with a rating request from the issuer, and the signing of a rating agreement. The rating agreement has important clauses

like confidentiality, agreement by the issuer to share information with the CRA for the purpose of assigning the rating and thereafter on an ongoing basis when the rating is under surveillance. The rating agency undertakes discussion with the management of the issuing entity. Discussions during a management meeting are wide-ranging, covering competitive position, strategy, financial policy, historical performance, and near- and long-term financial and business outlook. Discussions with company managements help rating analysts evaluate management capability and risk appetite, which is an important aspect of the evaluation. After discussion with the issuer's management, a report is prepared detailing the analyst team's assessment of the business risk, financial risk, and management risk associated with the issuer. The report is then presented to the rating committee. This is the only aspect of the process in which the issuer does not directly participate. Drawing on the knowledge and expertise of the participants, the rating committee determines the rating. The process is an attempt to ensure objectivity of the rating, since the decision results from the collective thinking of a group of experts analysing the risks pertaining to the issuer vis-a-vis its competitors in the industry and markets in which they operate. On finalisation of a rating at the rating committee meeting, the rating decision is communicated to the issuer. As the decision to get an initial rating is at the issuer's discretion (except, in India, for public issues of debt), the global best practice is to allow the issuer to decide whether to accept the rating. If the issuer disagrees with the rating, it can also appeal for a fresh look at the rating assigned. The rating committee then discusses the information submitted; it may or may not decide to modify the rating, depending on the facts of the case. If the rating is not changed and the issuer continues to disagree with the rating, it can choose not to accept the rating, which then does not get published.

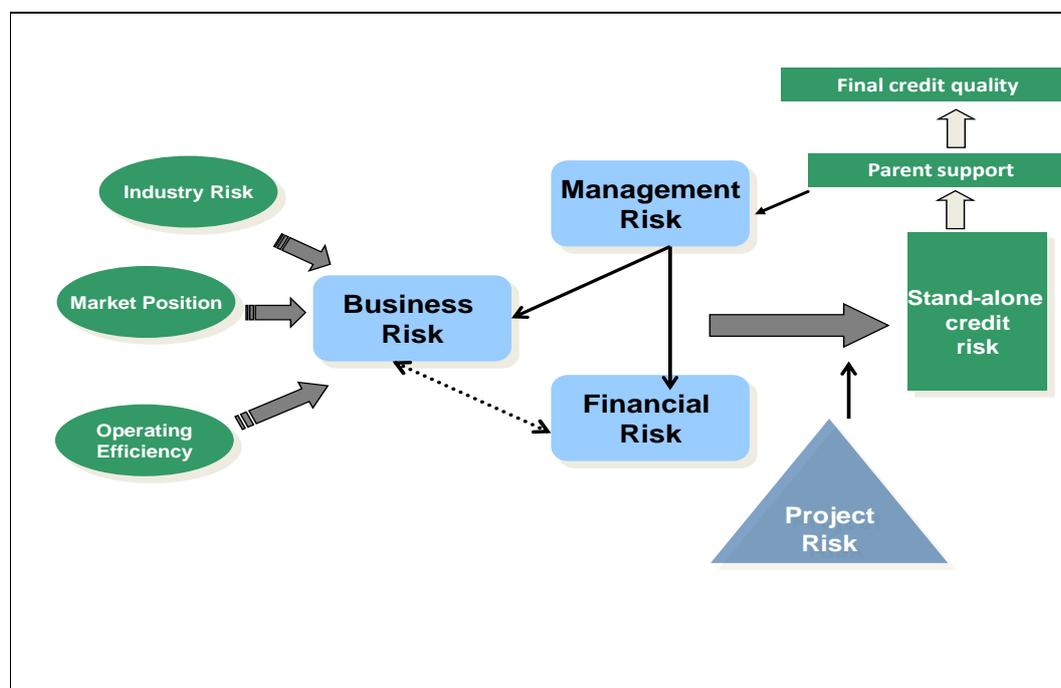
#### **4.5 Analytical framework used by CRAs**

A credit rating is an opinion on the relative credit risk (or default risk) associated with the instrument being rated, where a failure to pay even one rupee of the committed debt service payments on the due dates would constitute a default. For most instruments, the process involves estimating the cash generation capacity of the issuer through operations (primary cash flows) in relation to its requirements for servicing debt obligations over the tenure of the instrument. The analysis is based on information obtained from the issuer, and on an understanding of the business environment in which the issuer operates; it is carried out within the framework of the rating agency's criteria.

The analytical framework involves the analysis of business risk, technology risk, operational risk, industry risk, market risk, financial risk and management risk. Business risk analysis covers industry analysis, operating efficiency, market position of the company whereas financial risk covers accounting quality, existing financial position, cash flows and financial flexibility. Under management risk analysis an assessment is made of the competence and risk appetite of the management.

A sample ratings analytical framework is shown in the chart below:

Chart 4.1: Analytics behind credit rating



Source: CRISIL Ratings

In addition to the basic framework, rating agencies also have detailed criteria/methodologies for various industries which take into account the specific features of that industry.

The CRA might also look at the sufficiency of other means of servicing debt in case the primary cash flows are insufficient: for instance, in a securitised instrument, the credit enhancement and structure will be examined, while in case of a guaranteed bond the credit strength of the guarantor could drive the rating.

The quality of ratings is also affected by the timeliness of adjustment of the ratings. The issue is whether there should be aggressive rating changes – such as downgrading a rating by several notches immediately in reaction to adverse news rather than responding to a fundamental change in creditworthiness. CRAs need to balance between the dual objectives of accuracy of ratings and their stability. In other words, the point is whether ratings should reflect changes in default risk even if they are likely to be reversed within a very short period of time – whether ratings should focus on the long term or should they fluctuate with near term performance?

CRA's are known to be using Through The Cycle (TTC) methodology and Point In Time (PIT) approach for assigning credit ratings. TTC methodology has two aspects: a focus on the permanent component of default risk and rating change policy. This methodology disregards short term fluctuations in default risk. It filters out the temporary component of default risk and retains only the permanent, long term and structural component. Only substantial changes in the permanent component of default risk lead to rating migrations. In contrast, PIT approach ensures change in credit rating immediately as the fortunes change irrespective of the cause. The basic difference between these two approaches perhaps lies on the relative weight that is assigned to the temporary and permanent components of credit quality. The relative weights are influenced by the time horizons for which the rating is valid. For a one year horizon, the temporary component may get more weightage than for longer time horizon.

#### 4.6 Limitations of credit ratings

Specifically, a credit rating, in the words of the CRA's, is:

- **Not** a recommendation to buy, hold or sell any shares, bonds, debentures or other instruments issued by the rated entity, or derivatives thereof. A rating is one of the many inputs that is used by investors to make an investment decision.
- **Not** Intended to measure many other factors that debt investors must consider in relation to risk - such as yield offered, liquidity risk, pre-payment risk, interest rate risk, taxation aspects, risk of secondary market loss, exchange loss risk, etc.
- **Not** a general-purpose credit or performance evaluation of the rated entity, unless otherwise specified. The rating is usually specific to the instrument and is not the rating of the issuer.
- **Not** an opinion on associate, affiliate or group companies of the rated entity, or on promoters, directors or officers of the rated entity.
- **Not** a statutory or non-statutory audit of the rated entity
- **Not** an indication of compliance or otherwise with legal or statutory requirements
- **Not** a guarantee against default of the rated instrument. Even the highest-rated instrument faces some risk of default, although the risks associated with this are lower than lower-rated instruments.

Credit Ratings are typically ordinal in nature – for example we know that a rating of BB has a higher likelihood of default than BBB, but we do not know how much higher. It is not until each rating is assigned a probability of default that we can say how much more risky a BB rated instrument is thus

making the system cardinal. Cardinality is more useful for pricing an instrument. Translation of credit ratings to default probabilities is, however, not a straight forward task.

Some of the serious limitations of credit rating are its backward looking nature (depends on past data) which in a dynamic market framework can have serious consequences including accentuating a systemic crisis like the current global crisis, and its failure and unwillingness to capture/cover market risks. Estimating market risk can potentially make the rating exercise forward looking, could avoid sudden, multiple downgrades and reduce the pro-cyclicality of rating. A really informed forward looking rating could potentially also capture tail risks and forewarn the system to help take systemic steps well in advance to avoid panic and knee-jerk reactions. If rating is to straddle the high ground it aspires to hold rating exercise has to achieve this dynamism to really help measure all the risks of the market, rather than sticking to a partial methodology of expressing an opinion on a few aspects of the product they rate. No product can be usefully rated in a vacuum, isolated from the caprices of the market as a whole.

#### **4.7 Whither Credit Rating Agencies ?**

The informational value of credit rating and informational effect of credit ratings are matters of continuing debate. The central issue is whether institutions of credit rating are in a better position to decipher the default risk present in financial instruments than the financial markets. Empirical evidence from some countries have suggested that markets do this information processing better than credit rating institutions. Academic studies argue that by looking at the market price it would be easy to infer an effective credit rating of each instrument. Since market prices are available at near zero cost, there would appear to be no role for credit rating.

The rationale for credit rating may be expressed on the following counts:

1. If markets do not trade a particular instrument actively, then there is an informational challenge. In general impact cost on the market is lowered when more is publicly known about the securities being traded. In such cases a “good” credit rating (for eg. one which forecasts the interest rate at which bonds are traded on the secondary market. If issue A is rated above B then markets should demand a lower interest from A than B) helps reduce informational asymmetry and enhance liquidity in the market.
2. Suppose a company wants to do a primary market issue of bonds/ equity. At the time of issue, in the absence of trading, the default risk may not be clearly known to the market. This could generate a phenomenon like IPO underpricing. Hence it is optimal for the issuer to obtain a credit rating so as to place the bonds / equity at a superior price.
3. International obligations like Basel 2 require prudential provisioning of capital on the basis of risk weights attached to assets. Computation of capital required to be maintained by banks then requires rating of its assets.

In practice, by nudging more trades to the exchange platform the problem of informational challenge can be addressed. Till such time greater disclosure of reliable information can help the market in pricing the issue. Recent financial crisis has shown that ratings provided by credit rating agencies despite access to non public information have been faulty.

However where market asymmetries are strong and financial literacy low, sound credit rating can continue to bridge the information gap considerably.

# Chapter 5

## The regulatory framework for CRAs

### 5.1 SEBI Regulations

The Securities and Exchange Board of India (Credit Rating Agencies) Regulations, 1999 empower SEBI to regulate CRAs operating in India. In fact, SEBI was one of the first few regulators, globally, to put in place an effective and comprehensive regulation for CRAs. In contrast, the US market saw CRA regulations only recently (in 2007), and the European Union is still in the process of framing its regulations. SEBI's CRA regulations have been used as model by other regulators in the emerging economies. In terms of the SEBI Regulations, a CRA has been defined as a body corporate which is engaged in or proposes to be engaged in, the business of rating of securities offered by way of public or rights issue. The term "securities" has been defined under the Securities Contract (Regulation) Act, 1956. SEBI has also prescribed a Code of Conduct to be followed by the rating agencies in the CRA Regulations. However, SEBI administers the activities of CRAs with respect to their role in securities market only.

SEBI regulation for CRAs has been designed to ensure the following:

- Credible players enter this business (through stringent entry norms and eligibility criteria )
- CRAs operate in a manner that enables them to issue objective and fair opinions (through well-defined general obligations for CRAs)
- There is widespread investor access to ratings (through a clearly articulated rating dissemination process).
- The applicant should be registered as a company under the Companies Act, 1956 and possess a minimum network of Rs.5 crore.

The following are some of the General Obligations specified in the CRA regulations. CRAs are amongst the very few market intermediaries for which such detailed operating guidelines have been prescribed under the regulations. The detailed SEBI regulations for CRAs are given in **Annexure 2**.

- Code of Conduct stipulated by SEBI
- Agreement with the client
- Monitoring of ratings
- Procedure for review of rating

- Internal procedures to be framed by the CRA
- Disclosure of Rating Definitions and Rationale by the CRA
- Submission of information to the Board
- Compliance with circulars etc., issued by the Board
- Appointment of Compliance Officer
- Maintenance of Books of Accounts records, etc.
- Confidentiality
- Rating process

These regulations cover issues with respect to confidentiality of information and disclosure with respect to the rationale of the rating being assigned. Several other provisions exist, like the regulator's right to inspect a CRA. An important feature of the regulation is that CRAs are prohibited from rating their promoters and associates.

## **5.2 SEBI Code of conduct**

SEBI's code of conduct for CRAs addresses some of the basic issues relating to conflicts of interest. The Code of Conduct is designed to ensure transparent and independent functioning of CRAs.

Some of the salient provisions of the Code of Conduct are:

- A CRA shall make all efforts to protect the interests of investors.
- A CRA shall at all times exercise due diligence, ensure proper care and exercise independent professional judgment in order to achieve and maintain objectivity and independence in the rating process.
- A CRA shall have in place a rating process that reflects consistent and international rating standards.
- A CRA shall keep track of all important changes relating to the client companies and shall develop efficient and responsive systems to yield timely and accurate ratings. Further a CRA shall also monitor closely all relevant factors that might affect the creditworthiness of the issuers.
- A CRA shall disclose its rating methodology to clients, users and the public.
- A CRA shall not make any exaggerated statement, whether oral or written, to the client either about its qualification or its capability to render certain services or its achievements with regard to the services rendered to other clients.

The complete SEBI Code of Conduct may be seen at **Annexure 3**.

### **5.3 Provisions relating to conflict of interest**

Credibility is the cornerstone of acceptability of credit rating services in the market. SEBI has prescribed certain provisions in the Code of Conduct to ensure credible rating devoid of conflict of interest. The important ones are as follows.

- A CRA shall, wherever necessary, disclose to the clients, possible sources of conflict of duties and interests, which could impair its ability to make fair, objective and unbiased ratings. Further it shall ensure that no conflict of interest exists among any member of its rating committee participating in the rating analysis, and that of its client.
- A CRA or any of its employees shall not render, directly or indirectly, any investment advice about any security in the publicly accessible media.
- A CRA shall not offer fee-based services to the rated entities, beyond credit ratings and research.
- A CRA shall maintain an arm's length relationship between its credit rating activity and any other activity.
- A CRA shall develop its own internal code of conduct for governing its internal operations and laying down its standards of appropriate conduct for its employees and officers in the carrying out of their duties within the CRA and as a part of the industry. Such a code may extend to the maintenance of professional excellence and standards, integrity, confidentiality, objectivity, avoidance of conflict of interests, disclosure of shareholdings and interests, etc. Such a code shall also provide for procedures and guidelines in relation to the establishment and conduct of rating committees and duties of the officers and employees serving on such committees.

Despite maintaining a Chinese Wall between advisory services and rating services criticism persists as rating and non-rating entities have common ownership and top management. Recognising the merit in such criticism, CARE's Board decided to discontinue its advisory service business and their activities are confined to only credit rating and research activities.

CRA's in general maintain that while non rating services do pose conflict of interest challenges on one hand, revenues from other services reduce dependence on rating service revenues thereby enabling them to maintain objectivity and independence.

#### 5.4 Multiplicity of regulators

A significant portion of CRAs' revenues are from products that come under the purview of SEBI. However, there are rating agency products that are regulated by RBI (such as bank loans, fixed deposits, and commercial paper). RBI carried out a detailed and rigorous evaluation of Indian CRAs before granting them External Credit Assessment Institution status for rating of bank loans under Basel II. Further, some regulators (such as IRDA and PFRDA) have incorporated ratings into the investment guidelines for the entities they regulate. The list of various products, and the relevant regulators, are as noted below:

*Table 5.1 Products / Instruments requiring mandatory rating before issuance*

Sl. No	Instrument	Regulator
1	Public / Rights/ Listed issue of bonds	SEBI
2	IPO Grading	SEBI
3	Capital protection oriented funds	SEBI
4	Collective Investment Schemes of plantation companies	SEBI
5	Commercial Paper	RBI
6	Bank loans	RBI (Basel II capital computation for banks)
7	Security Receipts	RBI (For NAV declaration)
8	Securitised instruments (Pass Through Certificates)	RBI ((Basel II capital computation for banks)
9	Fixed Deposits by NBFCs & HFCs	RBI
10	LPG/SKO Rating	Ministry of Petroleum and Natural Gas
12	Maritime Grading	Directorate General of Shipping (for some courses)

Table 5.2 Regulatory prescription of use of ratings for investment purposes

S. No	Product	Regulator
1	Banks' investments in unrated non-SLR portfolio	RBI
2	Investments by Insurance companies	IRDA
3	Provident Fund investments	Government of India

Table 5.3 Products that are not mandated or covered

Performance gradings (non financial instruments)	Ratings (Financial instruments)
Real Estate Developer/Project rating	Privately-placed bonds and debentures
Broker grading	Short term debt/Fixed deposits invested by non-banks and bank CD's
Governance and Value Creation ratings	Bond Fund ratings (except Capital protection-oriented funds)
MFI Grading (encouraged by SIDBI, Nabard)	Financial strength ratings for insurance companies
NSIC rating for SSI/SME ratings (encouraged by NSIC)	
Contractor gradings	

## 5.5 International Regulations

IOSCO has formulated a Code of Conduct Fundamentals for the working of CRAs. The revised IOSCO Code of Conduct Fundamentals for CRAs is given at **Annexure 4**. The Code Fundamentals are designed to apply to any CRA and any person employed by a CRA in either in full time or part time capacity. The Code of Conduct focuses on transparency and disclosure in relation to CRA methodologies, conflicts of interest, use of information, performance and duties to the issuers and public, the role of CRA in structured finance transactions etc. It does not dictate business models or governance but rather seeks to provide the market with information to judge and assess CRA activities, performance and reliability. The IOSCO Code of Conduct broadly covers the following areas;

- Quality and integrity of the rating process – This includes the measures to ensure quality of the rating process and monitoring and updating by the CRAs.
- CRA's independence and avoidance of conflicts of interest – The procedures and policies to ensure the same.

- CRA's responsibilities to the investing public and issuers – These address issues such as transparency and timeliness of ratings disclosure and the treatment of confidential information.
- Disclosure of the code of conduct and communication with market participants – This requires CRAs to disclose to the public, inter alia, its code of conduct, how the code of conduct is in accordance with the IOSCO Principles regarding the activities of Credit Rating Agencies and the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies and in case of deviation, reasons for the same.

It is observed that all SEBI regulated CRAs in India have framed their internal code of conduct, which have provisions, inter alia, of conflict of interest management, avoidance and disclosures of conflict of interest situations etc. and such provisions prescribed are by and large in accordance with the IOSCO Code of Conduct Fundamentals for CRAs. The internal code of conduct formulated by the CRAs is in addition to the Code of Conduct prescribed under the SEBI(CRA) Regulations – 1999.

# Chapter 6

## Regulatory concerns about CRA business models

### 6.1 Regulatory concern

#### International

Internationally in view of the inadequacies observed in the functioning of CRAs, particularly in the wake of the sub-prime financial crisis, there is a growing concern among the regulators about the potential gap between expectation and realisation- between reliance on credit ratings and the reliability of such ratings. The concern emanates from the fact that inaccurate credit ratings could disturb the market allocation incentives, cost structures and competition. In view of the multiple activities performed by the rating agencies and the complexity of certain instruments for which the CRAs render their service, there are apprehensions about regulatory arbitrage, non-maintenance of arm's length distance, porosity of Chinese Walls, inappropriate conflict management etc arising out of the activities of the rating agencies. In short there is real regulatory (and market) apprehension that the self-regulation model of conflict regulation has failed substantively in the CRA realm and that the model of multiple businesses of CRAs is riddled with inherent conflict that cannot be solved with internal Chinese walls and codes of conduct alone. The 'gate-keepers' commercial aspirations appear to be too high so that they have become just enterprises driven by the profit / revenue only agenda like other market intermediaries, rather than the ethos of institutions.

CRAs have been highly criticized for understating the risk involved with instruments like Mortgage Backed Securities (MBS). CRAs have given investment grade ratings to securitization transactions viz. Collateralized Debt Obligations (CDOs) and MBS based on sub prime mortgage loans. Higher ratings were justified by the rating agencies by citing various credit enhancements, including over collateralization (i.e pledging collateral in excess of the debt issues). In the USA, CRAs had failed to warn the public of imminent bankruptcies in case of Enron and WorldCom, as well as the recent sub-prime loan crisis. It is alleged that the lenient standards adopted by rating agencies for MBS segment could possibly be because the rating fees were twice as high for the mortgage-backed bonds as for the corporate bonds. It is also possible that the dealers regularly sought the inputs from the CRAs when creating new issues, which effectively put the rating agencies in a position to influence the size of the market from which they drew lucrative revenues. At the same time, the dealers were shopping around for ratings, inviting a "race to the bottom", leading to inflated ratings. Mortgage-backed bonds being a relatively recent innovation, assessments of creditworthiness by the rating agencies ended up relying on data and

techniques provided by the dealers. But these were all reflections of the underlying conflicts arising from their business models-the opportunity to help structure and rate millions of complex derivative products just magnified it, exposing both the conflicts and capabilities of the CRAs.

## India

In India CRAs rate money market instruments and also play an important role in the pension and insurance sector. For example, in the context of implementation of the Basel II Framework in India, from March 2008, for the capital adequacy regime of the banks, it has been decided to adopt, initially, the Standardized Approach for determining the capital charge for the credit risk inherent in the operations of banks. The Standardized Approach relies almost entirely on the ratings assigned by the CRAs, accredited for the purpose by the RBI. These ratings are mapped into the corresponding regulatory risk weights applicable to the credit risk exposures on the counterparties, which form the basis of computation of the capital adequacy ratio of the banks. Besides, the capital charge for specific risk under the Market Risk Framework for interest rate-related instruments is also governed by the ratings assigned by the CRAs to the instrument concerned. Similarly IRDA and PFRDA recognize the ratings approved by rating agencies for prescribing their investment guidelines. SEBI regulates the CRA activities from the securities market point of view. Thus activities performed by CRAs which fall under the jurisdiction of other regulators should also be governed by appropriate guidelines and principles relevant to them.

Following are potentially the major regulatory concerns of the Indian regulators. It must be noted that some of these are generic to the industry.

1. Regulatory arbitrage resulting from activities of CRAs being governed/ used by various regulators.
2. Inadequacy of existing methodologies adopted by CRAs for structured products given their complexity, multiple tranches and their susceptibility to rapid, multiple-notch downgrades which are pro-cyclical.
3. A basic conflict of interest which is partly inherent, since the sponsor/issuer of new instruments pays the CRA for being rated.
4. A general lack of accountability as CRAs do not have a legal duty of accuracy and are often protected from liability in case of inaccurate ratings.
5. CRAs sometimes provide ancillary services in addition to credit ratings. The issuer may use the incentive of providing the CRA with more ancillary business in order to obtain higher ratings. There is a clear conflict of interest in offering advisory services or consulting services to entities rated by the CRA.

6. Oligopolistic nature of the rating industry because of natural barriers or propriety barriers of entry leading to lack of competition.

## 6.2 How do CRAs address regulatory concerns?

The following are the major areas of concern:

1. Issuer pay model
2. Inter agency coordination and regulatory arbitrage
3. Conflict of interests
4. Regulatory issues
  - a. Accountability
  - b. Methodology
  - c. Other services
  - d. Industry structure

Investor over- reliance on credit ratings has been long recognised as undesirable, although by embedding ratings in various regulations some authorities have inadvertently encouraged their overuse. For example the longstanding use of credit ratings to screen eligible collateral for various central bank liquidity backstop facilities is viewed as encouraging “rating shopping”<sup>6</sup>. Regulations relating to pension fund holdings, for example, typically restrict fixed-income investment to those with investment-grade ratings (i.e. BBB and higher). Furthermore, although the differentiation of structured credit ratings is welcome, the ratings remain based on one-dimensional metrics (default probabilities or expected losses) that fail to capture all of the risk dimensions peculiar to tranching products<sup>7</sup>. Currently rating for complex products like structured obligations are indicated by using special symbols. It also highlights the need for greater awareness generation.

CRAs follow a reputational model. Users will approach CRAs for ratings only if its opinions carry credibility with investors whom the issuers are trying to signal. Ratings which undergo frequent downgrades may not inspire confidence of the market. This incentivizes CRAs to maintain high quality of ratings. Rules, regulations, statutes as well as compliance with international covenants ensure that CRAs behave in a transparent manner. Misdemeanour can be punished through tight regulations. Regulatory arbitrage can be resolved by following lead regulatory model or greater inter agency coordination.

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<sup>6</sup> *Rating shopping involves selection of the rating agencies that will assign the highest rating to their particular issues while this has been identified as a potential problem, it has been difficult to prove that it was actual happening. Evidences accumulating that rating shopping was rampant during the period leading up to the crisis. (Global Financial Stability Report, October 2009, IMF, Washington DC)*

<sup>7</sup> *Global Financial Stability Report, October 2009, IMF, Washington DC, pages 82-83, 96-97.*

CRA's argue that advisory or consulting services are offered by different legal entities with whom physical, organizational and functional separation is maintained. CRISIL and ICRA have separated the advisory business into separate companies, managed by separate teams with separate organisation structures.

CARE though until recently carried out this business as part of its rating business, has now decided to exit advisory business. With respect to individuals, CRA's ensure that common directors do not attend rating committee meeting and disclosures to that effect are made. Further analyst compensation is not linked to rating fees. Each rating by the CRA passes through a multi-layer process and there is a team approach to avoid individual bias. Rating fees are not linked to issue success or rating level and are decided upfront and there is separation of business development and analytical teams. Another leading CRA stated that in order to avoid conflicts of interest, their advisory and consulting services division have been spun off into a separate company and has its own independent management, staff rules and personnel policies.

The SEBI CRA Regulations state that a CRA cannot rate an entity with common chairman, directors, or employee of credit rating agency or its rating committee. A CRA can rate a company with which it shares an independent director, but the existence of the common independent director and the fact that he or she did not participate in the rating process needs to be disclosed.

The entry requirements into the Credit Rating industry is stringent but does not act as a barrier to entry of new funds.

### **6.3 Pros and Cons of 'issuer pays model'**

Under 'issuer-pays-model' the entity that issues the security also pays the rating agency for the rating.

#### Quality/ accuracy of ratings:

Conceptually, the issuer-pays model may appear to imply an inherent bias which may lead to CRA's assigning higher-than-warranted ratings to issues they rate. CRA's have argued that they have several checks and balances and robust operating guidelines and procedures to ensure that the quality of ratings is high and objective. One example of this is separation of business development, analytical, criteria, and quality teams. CRA's point to a long-term track record of default and transition statistics which demonstrate that higher ratings are consistently more stable and have a lower probability of default than lower ones. Specifically it is argued that

- i) Ratings are ordinal; that is the higher the rating, the lower are the observed default levels.

ii) Ratings have been assigned across the entire rating scale, with no bias in their distribution towards higher ratings, which would be the pattern expected had the CRAs been influenced by the issuer-pays model.

iii) Rating actions are distributed across both upgrades and downgrades, which is also a different pattern from the one expected where the issuer-pays model might influence the decision to upgrade rather than downgrade and also work to prevent downgrades.

CRAs have a strong incentive to maintain the highest quality of rating, since issuers will approach a CRA for ratings only if its opinions carry credibility with investors whom they are trying to access. Nevertheless, there are questions about whether all CRAs adopt uniformly high governance and process standards.

#### Widespread availability of ratings:

This is the strength of the issuer-pays model. The goal of ratings is to reduce information asymmetry. Because issuers/borrowers pay for ratings, the market and lenders significantly benefit from the wide availability of credit ratings. Today, all ratings and rating changes are available to the entire market -- including retail investors -- free of charge, as they are widely disseminated by rating agency websites and the media. An investor can compare the ratings of a wide array of instruments before making an investment decision, and can continuously evaluate the relative creditworthiness of a wide range of issuers and borrowers.

- Other features of the issuer-pays model:

#### *Access to information enhances quality of analysis*

The issuer-pays model provides CRAs access to company managements on a regular basis. CRAs submit that this allows them to provide superior quality and depth of analysis to the market, which would be difficult under public information-based and model-driven approaches. The CRA's contract with the issuer/borrower places an obligation on the issuer's management to cooperate in sharing information, which is critical for maintaining continuous surveillance on rated credits. Because the issuer's management has commissioned the rating exercise, its level of engagement in providing information to the CRA is high. Issuer managements often provide CRAs insights into future strategy that might not be in the public domain. Moreover, interactions also help rating agencies evaluate management capabilities better. For rating structured finance issuances, the question assumes even greater criticality, since it is virtually impossible to rate these instruments without access to information from the originator of the underlying assets.

*Cost of ratings is kept low*

Currently, rating fees are the smallest element in the cost of raising money. With large and frequent issuers of debt, rating agencies typically work on the basis of fee caps (negotiated lump-sum fees as opposed to issue-by-issue or loan-by-loan pricing). Not only does this keep rating fees low, it also results in smaller issuers being, in effect, subsidised by larger ones.

#### **6.4 Pros and Cons of alternatives to 'issuer pays model'**

Besides 'Issuer Pays Model', the three other potential commercial models for rating agencies are:

1. Investor pays
2. Government/regulator pays
3. Exchange pays model

##### **6.4.1 The investor-pays model**

Under 'investor-pays-model' the user of the ratings pays for the ratings.

- Quality/accuracy of ratings:

According to CRAs this model does not eliminate the conflict of interest- it only shifts the source of conflict from issuer to investors. Under the investor-pays model, CRAs could give lower ratings than indicated by the actual credit quality of the rated debt, so that investors would get a higher yield than warranted. Pressures from investors to avoid rating downgrades would increase considerably under the investor-pays model, since downgrades result in mark-to-market losses on rated securities. In fact, even under the current issuer-pays model, CRAs face a high level of pressure from investors to not downgrade ratings. In particular, it is possible that a large investor who has a large exposure on an issuer would like to have a more favourable rating for that issuer. On the other hand, a short seller would prefer if the rating is lowered. Internationally, the experience with the investor-pays models has not been successful. Nevertheless, the potential conflicts seem substantially less severe than for the "issuer pays" model. One example of a rating agency that operates today on the basis of subscription by investors is Egan-Jones Ratings; it is now recognised by the US SEC, but its coverage and impact have been low.

- Widespread availability of ratings:

The investor-pays model is weak on this count. If investors pay for ratings, only investors who pay will get access to ratings. The goal of reduced information asymmetry is therefore compromised under this model. Investors would also not be able to benchmark the quality of their investments against other companies, since they may not be willing to pay for ratings of companies in which they do not

invest. This model also favours large investors who can afford to pay for ratings. The biggest losers are the smaller institutional investors and the retail investors, who would have had free access to all ratings under the issuer-pays model or the Government/regulator pays model (discussed later).

#### Other advantages and limitations of the investor-pays model:

##### *Greater responsiveness to investor concerns*

Under the investor-pays model CRAs could be more responsive to investor concerns and further the investor protection agenda as they would be positioned as quasi-investor representatives. Also, an investor paying for a specific rating could demand customised analysis from the rating agency which is attuned to their goals or organisational requirements.

##### *Investor is not known at the time of assigning ratings*

Issuers/borrowers intending to raise money approach CRAs for an independent evaluation, based on which they approach prospective investors. This means that typically, when the rating is assigned, the investor is not known. If the investor were to commission and pay for ratings, it would lead to huge inefficiencies and practical problems in the fund-raising programmes of issuers/borrowers.

##### *Bias against smaller issuers/borrowers*

The problem of investors not being known can be addressed by rating agencies assigning ratings *suo-moto* to large/frequent issuers and borrowers; investors can later pay for this on a subscription basis. However, this system creates a strong bias against smaller issuers which would not get rating coverage, and their funding programmes could be severely impaired. *Suo-moto* ratings also suffer the disadvantage of not getting a meaningful interaction with the management to make an assessment about them and their strategy. In fact, this is the main reason why rating agencies that operate on the investor-pays model have limited coverage and impact.

##### *Costs of ratings would increase*

Investors would choose to pay for ratings of those companies that they are interested in, and even here, only for rating specific issuances by a particular company. The benefits of fee caps as described above would be lost and the overall rating costs could go up. From the point of view of investors, it will increase information asymmetry as ratings opinion will be available only with a few large investors which is detrimental to the liquidity and development of the market.

##### *Limited access to information could affect quality of analysis*

If investors were to pay for ratings, issuers would not be contractually bound to provide rating agencies access to information and regular management interactions. This is important if the rating

agency has to carry out surveillance on an ongoing basis. Moreover, regular meetings with management and insights on company strategy enable rating agencies to make a thorough evaluation of management capabilities and risk appetite. It is hard to envisage the same level of access, information and sharing of insights as exists under the issuer-pays model. Further this may also involve rating of the same issue by multiple agencies resulting in the issuer being required to meet and share information with all agencies.

The Reserve Bank of India, under Basel II guidelines, has stipulated that even though ratings are used by the banks for determining their capital requirements, the ratings should be solicited by the companies themselves, and not by the banks.

#### **6.4.2 The Government/regulator-pays model**

In this model the Government funds the rating costs.

- Quality/accuracy of ratings:

Conceptually, this model would carry less inherent bias, since in most cases there is no incentive to provide either higher-than-warranted or lower-than-warranted ratings. The one exception that could arise would be in case of public sector enterprises; the perception could be that the government could influence rating outcomes in this case.

- Widespread availability of ratings:

This can also be easily ensured under the government/regulator pays model as they could stipulate that rating agencies make all ratings and rating changes freely available on their websites and disseminate them through the media as happens currently.

- Other positive and negative aspects of the Government/regulator pays model:

*Control over/guidance of rating agencies becomes simpler*

If Government/regulators pay for ratings, it becomes easier to monitor and control the activities of rating agencies

*Moral hazard: Rating opinions being seen as being endorsed by the Government*

This is a major limitation of the Government/regulator pays model. Investors and markets could see the opinions provided by rating agencies as having government endorsement. This carries the serious risk of expectation of Government support in the event of default by a rated entity. This risk is larger than it may seem as evident in recent actions across the globe.

### *Use of public money for companies and institutional investors who can afford to pay for ratings*

It is questionable whether paying for ratings is the best use of public funds as compared to other objectives like improving financial literacy and small investor protection. Both issuers and institutional investors can well afford to pay for ratings. As explained above, under the issuer-pays model, the small retail investor too benefits as ratings are freely available in the public domain. India has emerged as the second-largest rating market, with the widespread acceptance of rating by the regulators and the markets. The budget for supporting this industry could be quite substantial.

### *Limited access to companies could affect quality of analysis*

If Government/regulators pay the rating agencies, issuers would not be contractually bound to provide rating agencies access to information, and regular management interactions, which could affect the quality of analysis.

### *Several practical problems in implementation*

The challenge under the Government/regulator pays model is: how would the choice of rating agency for a rating a specific issuer/company be made, and by whom? How would the rating fees be decided? If a company desiring to raise money approaches the regulator to request that a rating be commissioned, would they also specify which rating agency they would prefer? This in effect, would make it an issuer-driven choice. Would companies or issues be allocated on a random basis amongst all rating agencies? This would lead to huge inefficiencies and the costs of ratings would increase from a system perspective. Adequate safeguards also need to be put in to ensure that the oversight of the work allocation to the rating agencies remains objective, lest any subversion of rating outcomes take place as a result of undue influence.

These measures could also breed complacency amongst CRAs, who will begin to see it as a steady assured business, rather than the current situation of fending for themselves. For example, if the selection of rating agencies is done on a random basis, then rating agencies will have no incentive to produce the most analytical rigorous, independent, objective rating on a timely basis which will provide best insights for investors.

### **6.4.3 The Exchange-pays model**

Under this model the exchanges pay for the ratings and recover the cost through an additional trading fee.

The major advantage of this model is that the investors would be paying for the rating thereby eliminating the conflict of interest inherent in 'issuer pays model' and at the same time the rating agencies

would not be influenced either by the rated company or the investors. The major disadvantage of this model is that this model can work only for securities that are listed.

The above discussion indicates why the issuer-pays model has prevailed over other possible alternative models. Recent regulatory initiatives in the United States and Europe aim to address the issue of conflict of interest presented by this model, but do not recommend a move to any other model. What they recognise is that rating agencies should be subject to scrutiny to ensure that conflicts of interest do not influence rating decisions. Their recommendations to manage this conflict include greater transparency and disclosures, and better governance practices to ensure independence.

# Chapter 7

## Recommendations

### 7.1 Deliberations of the Committee

The Committee had four meetings in which extensive deliberations on the various issues on CRAs were made. It also held an exclusive meeting with the senior management of all the five CRAs operating in India. The Committee is also privy to and benefited from the substantial and substantive documents provided by the CRAs, SEBI, RBI, IRDA and PFRDA, apart from the regulations and recent efforts by other jurisdictions such as the US, EU and IOSCO. In the light of these deliberations, documents and emerging themes in global academic and policy circles the Committee raises the following questions:

1. If the CRAs are agencies providing just a view/opinion on the likely default of some financial instruments, should that opinion be made mandatory?
2. Is such an opinion the result of methodologically robust research capable of making near-certain judgement on the direction of the market?
3. Is the CRA business model, with overwhelming commercial aspirations, capable of providing unbiased opinion for larger public interest, even under self imposed code and regulatory oversight? Or are CRAs performing their gate-keeper role with the expected fiduciary zeal?
4. Should regulators use opinions of CRAs for regulatory purposes?

### 7.2 Recommendations

The recommendations are based on India's own experience with the CRAs till now. India has been proactive in introducing effective and comprehensive regulations for CRAs as early as 1999. In contrast, the US market saw substantial regulations only recently in 2007, and the European Union is still in the process of framing its regulations. SEBI's CRA regulations have been used as a model by other regulators in emerging economies. SEBI's code of conduct for CRAs addresses some of the basic issues relating to conflicts of interest. The Code of Conduct is designed to ensure transparent and independent functioning of CRAs. These regulations have been reasonably effective in ensuring that credible players operate in the industry and there is widespread investor access to ratings. Nevertheless, given the recent global experiences and emerging trends in regulation there is undoubtedly a case for a re-look at the CRA business models and strengthening of regulations.

Since answers to the questions raised in Para 7.1 are 'no' or 'uncertain' as well as the CRA assertion that rating is only an opinion mandatory rating may need to be relooked at. Regulators also need to enhance their due diligence and investors need to strengthen their own information processing systems. Moreover, market participants need some time for such a migration to the world of no

mandatory rating, particularly because of the low levels of financial literacy. Accordingly all regulators felt that rating is an essential tool in the current context. The Committee therefore recommends a number of steps for enhancing the transparency of the functioning of the CRAs through greater disclosure requirements, reducing the conflict of interest in their business models and in improving their rating methodology and process. These recommendations will also provide another window of opportunity, both to the CRAs to show their capability to assimilate and absorb their fiduciary role as well as for the policy makers to see how these work which will help charting the future policy trajectory itself. The recommendations below are designed to strengthen provisions related to conflicts of interest, and improve transparency, disclosures and accountability.

### **1. A lead regulator model for Credit Rating Agencies**

As discussed before, SEBI's jurisdiction over the CRAs is with respect to their activities in Securities market and dealings of CRAs specifically in instruments categorized as "securities" as defined under Securities Contract (Regulation) Act, 1956 and does not cover the activities governed by other Regulators. Credit rating is regulated by SEBI as the primary users of credit rating are the investors in securities markets. SEBI is also entrusted with the mandate of protecting the interests of investors. In practice, credit rating is much more used by other regulators where rating advisory is often a part of the regulations. SEBI needs to factor in those users and regulators whose use impacts a larger group of investors. Therefore, prior to formulating any regulation SEBI needs to consult other regulators. Inspection should be conducted jointly with other regulators. SEBI should also have a mechanism of getting periodic feed back from other regulators. A question arises whether the existing SEBI Regulations are adequate to cover the issues and concerns put forth by other Regulators. Given that CRA Regulations already exist, it may be better to recast the existing Regulations by adding / modifying specific provisions to encompass the concerns of other Regulators, rather than building a new framework from scratch. It is proposed that a lead regulator model for credit rating agencies be followed. Under this model, SEBI would be the lead regulator and all entities carrying out the activity of credit rating would need to be registered with SEBI. The CRAs so registered with SEBI would be required to acquire further accreditation with other regulators (RBI, IRDA, PFRDA etc.) if felt necessary by them, for rating products that come in the regulatory domain of the other regulators. The respective regulators may independently frame guidelines in respect of the activities coming under their purview to help decide on the skill set requirements of the CRAs. Inspections of CRAs should be carried out by only one team, which should have representations from all concerned Regulators to oversee the area of activities governed by such Regulators.

## 2. **Restricting the scope of usage of the term” credit rating”**

Currently, there are five CRAs registered with SEBI. However, it is understood that there are other agencies such as ONICRA, SMERA etc. which also claim to provide rating services (mainly in SSI assessment, Small and Medium enterprise rating, individual credit assessment etc.) though not in securities. In view of the lead regulator model that is proposed and the need for increased inter-regulatory coordination as described above, it is proposed to restrict the scope of usage of the term” credit rating” through appropriate legislation. It is proposed that

- No entity shall bear a name having the words “credit rating” unless it is registered as a CRA with SEBI
- All existing CRAs shall incorporate the word “credit rating” in their names
- For other entities, an appropriate legislative/ regulatory framework will be thought of.

## 3. **Greater due diligence by the Regulators**

Given the concerns with the rating based approach regulators and stakeholders need to exercise greater due diligence in accepting ‘rating’ mechanically. Accordingly, they should upgrade the skills/ capabilities for greater due diligence.

## 4. **Disclosure of other activities carried out by CRAs or their subsidiaries**

Currently, the Regulations mandate that a CRA shall not offer fee-based services to the rated entities, beyond credit ratings and research. The Regulations also mandate that a credit rating agency shall maintain an arm’s length relationship between its credit rating activity and / or any other activity. In practice, CRAs float subsidiary companies for undertaking other activities such as consulting, software development, knowledge process outsourcing, research etc. Accordingly, it is proposed that while disclosing the rating / rating rationale to the general public through stock exchange/press release/web-site, a CRA shall disclose sources of conflicts of interest including

- a. Details of fees collected by the CRA from the issuer/its subsidiary due to the current rating assignment/previous rating assignment during the last 3 years
- b. Details of fees collected by the CRA/its subsidiary from the same issuer/its subsidiary due to activities other than rating during the last 3 years.
- c. Disclosure of the amount of money received by the promoters of the CRA due to any financial transaction with the issuer in the last 3 years including a brief description of the said financial transaction.

CRAs should not be allowed to enter into any business that may directly or indirectly have conflict of interest with the job of rating. Internal Chinese Walls are porous mechanisms to prevent such

conflict of interest as such other businesses such as consultancy and advisory services should not be undertaken by CRAs.

#### **5. Resolving the conflict of interest inherent in the “issuer pays model”**

It has been alleged that this model in which the entity issuing debt pays the rating agency compromises the quality of analysis and ratings assigned by the agencies. The other alternatives are ‘investor pays model’ and ‘regulator pays model’. The pros and cons of these models have been discussed in the last chapter. Globally the 'issuer pays model' is followed by CRAs. Considering that other models are not desirable/ feasible, as they lead to greater problems it is recommended to continue with the “issuer pays” model. However, greater transparency to the public regarding disclosure of conflict of interest, disclosure of fees received as described above would go some way to address these concerns.

#### **6. Norms for governance of CRAs**

Currently, the Code of Conduct prescribed in the SEBI (CRA) Regulations stipulates, inter –alia, that a credit rating agency shall ensure that good corporate policies and corporate governance practices are in place. CRAs are also required to develop their own internal code of conduct for governing its internal operations and laying down its standards of appropriate conduct for its employees and officers in carrying out of their duties within the credit rating agency and as a part of the industry. Such a code may extend to the maintenance of professional excellence and standards, integrity, confidentiality, objectivity, avoidance of conflict of interests, disclosure of shareholdings and interests, etc. Such a code shall also provide for procedures and guidelines in relation to the establishment and conduct of rating committees and duties of the officers and employees serving on such committees.

Currently, some of the registered CRAs are listed on Indian stock exchanges and are therefore subject to compliance requirements of Clause 49 of the Listing Agreement, which stipulates norms for corporate governance. However, some other CRAs are not listed and therefore are not subject to those norms.

#### **7. Requirement of process and compliance audit**

The Regulations currently do not mandate any process and compliance audit of CRA operations. It is proposed that a half yearly internal audit of CRAs be made mandatory for all CRAs. The internal audit shall examine and certify whether all the requirements stipulated in the CRA Regulations and other regulations/guidelines stipulated by other regulators (RBI/IRDA etc) are being followed by the rating agencies. A committee comprised of members of Board of Directors will oversee action taken.

## **8. Constitution of a Standing Committee**

A Standing Committee comprising representatives from various regulators be constituted for matters relating to CRAs. The Standing Committee by SEBI will take up and examine issues relating to CRAs and thereafter bring inter regulatory matter to the HLCCFM.

## **9. Diversified ownership**

While SEBI's extant regulatory framework for the credit rating agencies tries to address the issues relating to conflict of interests in their operations, it does not stipulate any restrictions regarding the ownership pattern of the rating agencies with a view to achieving a diversified ownership. Earnings driven pressures, makes a case for diversified ownership. Diversified ownership will also take care of likely abuse of dominant ownership. On the other hand too diffused an ownership pattern could lead to inadequate management leadership. Regulations should ideally try to bring people who have long term stake in the well-being and efficient function of the financial market as promoters. However there is no evidence to show that ownership issues have led to problems with rating.

For the present it is proposed that the SEBI (CRA) Regulations may be suitably amended so that any change in status or constitution in CRAs resulting in change of control, change in managing director/whole time directors etc. would require the prior approval of SEBI. If evidence of concentrated ownership leads to abuse, the issue of diversified ownership needs to be revisited.

## **10. Disclosure of compliance with IOSCO Code**

The IOSCO Code requires that a CRA should disclose to the public its code of conduct and describe how the provisions of its code of conduct fully implement the provisions of the IOSCO Principles regarding the activities of Credit Rating Agencies and the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies. If a CRA's code of conduct deviates from the IOSCO provisions, the CRA should explain where and why these deviations exist, and how any deviations nonetheless achieve the objectives contained in the IOSCO provisions. IOSCO has submitted a report on the role of Credit Rating Agencies in Structured Finance markets in May 2008 and have suggested various measures for implementation by the CRAs. It is proposed to insert an appropriate clause in the SEBI (CRA) Regulations to make it mandatory for CRAs to disclose on their web-sites their code of conduct and how it complies with the IOSCO Code and in case of any deviation, the CRAs may furnish reasons for the same.

## **11. Disclosure of default and transition studies**

In order for the public to judge the general efficiency of the CRA, they be mandated to disclose the default and transition statistics. This disclosure should also include the methodology used for this computation. The report shall point out all instances wherein the issuer had defaulted even when the latest rating of the instrument issued by the issuer indicated investment grade rating.

## **12. Unsolicited ratings**

CRA's in some countries have come under criticism for issuing unsolicited ratings. Anecdotal evidence from newspaper reports reveal that some CRA's have indulged in 'notching' – lowering their ratings or refusing to rate securities issued by certain asset pools unless a substantial part of the assets was also rated by them. It appears that there is no consensus on this point among CRA's in India. Currently CRA's in India do not provide unsolicited ratings. According to some CRA's any unsolicited rating exercise will not have the benefit of inputs obtained with the cooperation of Management and to that extent it will be incomplete. The output of such an incomplete exercise cannot be compared with that obtained from solicited ratings. In contrast others consider unsolicited ratings to be an important tool by which new rating agencies can develop their business model. According to them unsolicited ratings can combat 'rating shopping'. On balance it is recommended that if unsolicited rating is to be allowed such ratings may be issued with appropriate disclosure indicating whether issuer has participated in the rating process or only public information disclosed by the issuer, including its audited financial statements, strategic objective and investor presentation have been used in the assessment.

## **13. Greater caution in use of ratings**

Market participants on their part need to reassess the extent to which their procedures rely on ratings and consider whether this is appropriate. Over reliance on ratings by market participants have to be avoided. Firms using the ratings should use stress testing to assess the impact of a significant reduction of credit rating in their portfolio rapidly.

## **14. Other suggested areas where SEBI(CRA ) Regulations can be strengthened**

- (i) All registered rating agencies may be required to disclose publicly on their websites their shareholding pattern and the names of the owners
- (ii) A CRA or its subsidiary should not be allowed to carry out consultancy or advisory services, such as making proposals or recommendations, either formal or informal, regarding the design of a structured finance instrument and also rate the product. In general, a CRA should desist from directly or indirectly being involved with anything that compromises with the integrity of the rating.

(iii) The CRAs should clearly differentiate the ratings for structured products, improve their disclosure of rating methodologies, and assess the quality of information provided by the originators, arrangers and the issuers of such structured products. It may be made mandatory that the CRAs make a clear distinction between credit ratings of structured finance instruments and other credit ratings.

(iv) For the purpose of integrity, it is proposed that the CRA may disclose the general nature of its compensation arrangements with the rated entities.

(v) The CRAs should publish sufficient information about the assumptions underlying their rating methodologies.

(vi) The extant provisions of the CRA Regulations do not obligate the CRA to announce publicly if it had discontinued to rate an issuer or obligation. Similarly, there is no provision requiring the CRA to indicate the date when the rating was last updated and the fact that the rating is no longer being updated. This provision may be of importance considering the fact that the issuer may at any time like to unsubscribe to the services of the Rating agency owing to any business decision or otherwise. Where the issuer no more procures the services of CRA, the CRA should be required to disseminate the information as to stoppage of its services, also assigning the reasons for the same.

(vii) Rating agencies need to retain their internal records including non public information and working papers which were used to form the basis of the credit rating issued. The rationale for deviation from models or out of model adjustments need to be properly documented in the records. The actions and the decisions of the rating committee, including vote tallies if any, also needs to be properly documented. Proper documentation of committee attendees is also required. If a quantitative model is a substantial component of the credit rating process the rationale for any material difference between the credit rating implied by the model and the final credit rating issued needs to be recorded. There should be proper internal written procedure documenting the steps required for surveillance. CRAs should have comprehensive written surveillance procedure. All appropriate surveillance record should be maintained. CRAs should disclose how frequently credit ratings are reviewed, whether different criteria or models are used for rating surveillance than for determining initial rating.

(viii) There should be established policies to restrict analysts from participating in fee discussions with issuer. These policies are designed to separate those individuals who sit and negotiate fees from those employees who rate the issue, in order to mitigate the possibility or perception that a rating agency would link its ratings with the fees.

(ix) Employee involvement in the rating process should not come into conflict with ownership of equity etc. Employee code of conduct should take care of it.

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COMPARATIVE RATING SYMBOLS FOR LONG TERM RATINGS

RATINGS	CRISIL	CARE	ICRA	FITCH	BRICKWORKS
Highest degree of safety with regard to timely payment of financial obligations	AAA	CARE AAA	LAAA	AAA(Ind)	BWR AAA
High degree of safety with regard to timely payment of financial obligations.	AA	CARE AA	LAA	AA(Ind)	BWR AA
Adequate degree of safety with regard to timely payment of financial obligations. . However, changes in circumstances can adversely affect such issues more than those in the higher rating categories.	A	CARE A	LA	A(Ind)	BWR A
Moderate safety with regard to timely payment of financial obligations for the present; changing circumstances are more likely to lead to a weakened capacity to pay interest and repay principal.	BBB	CARE BBB	LBBB	BBB(Ind)	BWR BBB
Inadequate safety with regard to timely payment of financial obligations; less likely to default in the immediate future.	BB	CARE BB	LBB	BB(Ind)	BWR BB
Greater likelihood of default; while currently financial obligations are met, adverse business or economic conditions would lead to lack of ability or willingness to pay interest or principal.	B	CARE B	LB	B(Ind)	BWR B
Vulnerable to default; timely payment of financial obligations is possible only if favourable circumstances continue.	C	CARE C	LC	CCC(Ind), CC(Ind),	BWR C

				C(Ind)	
In default or are expected to default on scheduled payment dates. Such instruments are extremely speculative and returns from these instruments may be realised only on reorganisation or liquidation.	D	CARE D	LD	DDD(Ind), DD(Ind), D(Ind)	BWR D
Instruments rated 'N.M' have factors present in them, which render the rating outstanding meaningless. These include reorganisation or liquidation of the issuer, the obligation is under dispute in a court of law or before a statutory authority etc.	NM				

CRAs may apply '+' (plus) or '-' (minus) signs for ratings from 'AA' to 'C' to reflect comparative standing within the category.

**SECURITIES AND EXCHANGE BOARD OF INDIA  
(CREDIT RATING AGENCIES) REGULATIONS, 1999**

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**THE GAZETTE OF INDIA  
EXTRAORDINARY  
PART-II – SECTION 3 – SUB-SECTION (ii)  
PUBLISHED BY AUTHORITY  
MUMBAI, JULY 7, 1999  
SECURITIES AND EXCHANGE BOARD OF INDIA  
NOTIFICATION**

**SECURITIES AND EXCHANGE BOARD OF INDIA  
(CREDIT RATING AGENCIES) REGULATIONS, 1999**

S.O. 547(E) – In exercise of the powers conferred by section 30 read with section 11 c Securities and Exchange Board of India Act, 1992 (15 of 1992), the Securities and Exchange Board of India hereby makes the following regulations, namely:-

**CHAPTER I  
PRELIMINARY**

#### **Short title and commencement**

1. (1) These regulations may be called the Securities and Exchange Board of India (Credit Rating Agencies) Regulations, 1999.

(2) They shall come into force on the date of their publication in the Official Gazette.

#### **Definitions**

2 (1) In these regulations, unless the context otherwise requires, -

(a) "Act" means the Securities and Exchange Board of India Act, 1992 (15 of 1992);

(b) "associate", in relation to a credit rating agency, includes a person –

(i) who, directly or indirectly, by himself, or in combination with relatives, owns or controls shares carrying not less than ten percent of the voting rights of the credit rating agency, or

(ii) in respect of whom the credit rating agency, directly or indirectly, by itself, or in combination with other persons, owns or controls shares carrying not less than ten percent of the voting rights, or

(iii) majority of the directors of which, own or control shares carrying not less than ten percent of the voting rights of the credit rating agency, or

(iv) whose director, officer or employee is also a director, officer or employee of the credit rating agency;

(c) "Board" means the Board as defined in clause (a) of sub-section (1) of section 2 of the Act;

(d) "body corporate" means a body corporate as defined in clause (7) of section 2 of the Companies Act, 1956 (1 of 1956);

(e) "certificate" means a certificate of registration granted or renewed by the Board under these regulations;

(f) "client" means any person whose securities are rated by a credit rating agency;

(g) "company" means a company incorporated under the Companies Act, 1956 (1 of 1956);

(h) "credit rating agency" means a body corporate which is engaged in, or proposes to be engaged in, the business of rating of securities offered by way of public or rights issue;

(i) "economic offence" means an offence to which the Economic Offences (Inapplicability of Limitation) Act, 1974 (12 of 1974), is applicable for the time being;

<sup>1</sup>(j) \*\*\*

(k) "form" means any of the forms specified in the First Schedule:

(l) "fraud" has the same meaning as is assigned to it by section 17 of the Indian Contract Act, 1872 (9 of 1872);

(m) "group companies" means group companies as defined in the Monopolies and Restrictive Trade Practices Act, 1969 (54 of 1969);

(n) "inspecting officer" means any one or more persons appointed by the Board under reregulation 29:

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<sup>1</sup> Omitted by the SEBI (Procedure for Holding Enquiry by Enquiry Officer and Imposing Penalty) Regulations, 2002, w.e.f. 27.9.2002.

Prior to its omission it read as "enquiry officer" means any officer of the Board, or any other person, who is authorised by the Board under regulation 38"

- (o) "issuer" means a person whose securities are proposed to be rated by a credit rating agency;
- (p) "net-worth" means the aggregate value of the paid up equity capital and free reserves (excluding reserves created out of revaluation), reduced by the aggregate value of accumulated losses and deferred expenditure not written off, including miscellaneous expenses not written off;
- (q) "rating" means an opinion regarding securities, expressed in the form of standard symbols or in any other standardised manner, assigned by a credit rating agency and used by the issuer of such securities, to comply with a requirement specified by these regulations;
- (r) "rating committee" means a committee constituted by a credit rating agency to assign rating to a security;
- (s) "regulation" means a regulation forming part of these regulations;
- (t) "relative" means a relative as defined in section 6 of the Companies Act, 1956 (1 of 1956);
- (u) "schedule" means any of the schedules appended to these regulations; and
- (v) "securities" has the meaning assigned to it in clause (h) of section 2 of the Securities Contracts (Regulation) Act, 1956.
- (2) Words and expressions used and not defined in these regulations, but defined in the Act shall have the meanings respectively assigned to them in the Act.

## **CHAPTER II REGISTRATION OF CREDIT RATING AGENCIES**

### **Application for grant of certificate**

3. (1) Any person proposing to commence any activity as a credit rating agency on or after the date of commencement of these regulations shall make an application to the Board for the grant of a certificate of registration for the purpose.

(2) Any person, who was immediately before the said date carrying on any activity as a credit rating agency, shall make an application to the Board for the grant of a certificate within a period of three months from such date:

Provided that the Board may, where it is of the opinion that it is necessary to do so, reasons to be recorded in writing, extend the said period upto a maximum of six months from such date.

(3) An application for the grant of a certificate under sub-regulation(1) or sub-regulation(2) shall be made to the Board in Form A of the First Schedule and shall be accompanied by a non-refundable application fee, as specified in Form A of the second Schedule, to be paid in the manner specified in Part B thereof.

(4) Any person referred to in sub-regulation (2) who fails to make an application for the grant of a certificate within the period specified in that sub-regulation shall cease to carry on rating activity.

#### **Promoter of credit rating agency**

4. The Board shall not consider an application under regulation (3) unless the applicant is promoted by a person belonging to any of the following categories, namely:

(a) a public financial institution, as defined in section 4 A of the Companies Act, 1956 (1 of 1956);

(b) a scheduled commercial bank included for the time being in the second schedule to the Reserve Bank of India Act, 1934 (2 of 1934);

(c) a foreign bank operating in India with the approval of the Reserve Bank of India;

(d) a foreign credit rating agency recognised by or under any law for the time being in force in the country of its incorporation, having at least five years experience in rating securities;

(e) any company or a body corporate, having continuous net worth of minimum rupees one hundred crores as per its audited annual accounts for the previous five years prior to filing of the application with the Board for the grant of certificate under these regulations.

#### **Eligibility criteria**

5. The Board shall not consider an application for the grant of a certificate under regulation 3, unless the applicant satisfies the following conditions, namely:

(a) the applicant is set up and registered as a company under the Companies Act, 1956;

(b) the applicant has, in its Memorandum of Association, specified rating activity as one of its main objects;

(c) the applicant has a minimum net worth of rupees five crores.

Provided that a credit rating agency existing at the commencement of these regulations, with a net worth of less than rupees five crores, shall be deemed to have satisfied this condition, if it increases its net worth to the said minimum within a period of three years of such commencement.

(d) the applicant has adequate infrastructure, to enable it to provide rating services in accordance with the provisions of the Act and these regulations;

(e) the applicant and the promoters of the applicant, referred to in regulation 4 have professional competence, financial soundness and general reputation of fairness and integrity in business transactions, to the satisfaction of the Board;

(f) neither the applicant, nor its promoter, nor any director of the applicant or its promoter, is involved in any legal proceeding connected with the securities market, which may have an adverse impact on the interests of the investors;

(g) neither the applicant, nor its promoters, nor any director, of its promoter has at any time in the past been convicted of any offence involving moral turpitude or any economic offence;

(h) the applicant has, in its employment, persons having adequate professional and other relevant experience to the satisfaction of the Board;

(i) neither the applicant, nor any person directly or indirectly connected with the applicant has in the past been –

(i) refused by the Board a certificate under these regulations or

(ii) subjected to any proceedings for a contravention of the Act or of any rules or regulations made under the Act.

Explanation: For the purpose of this clause, the expression "directly or indirectly connected person" means any person who is an associate, subsidiary, inter-connected or group company of the applicant or a company under the same management as the applicant.

(j) the applicant, in all other respects, is a fit and proper person for the grant of a certificate;

(k) grant of certificate to the applicant is in the interest of investors and the securities market.

**<sup>1</sup>Applicability of Securities and Exchange Board of India (Criteria for Fit and Proper Person) Regulations, 2004.**

5A. The provisions of the Securities and Exchange Board of India (Criteria for Fit and Proper Person) Regulations, 2004 shall, as far as may be, apply to all applicants or the credit rating agencies under these regulations.

**Application to conform to the requirements**

6. Any application for a certificate, which is not complete in all respects or does not conform to the requirement of regulation 5 or instructions specified in Form A shall be rejected by the Board:

Provided that, before rejecting any such application, the applicant shall be given an opportunity to remove, within thirty days of the date of receipt of relevant communication, from the Board such objections as may be indicated by the Board.

Provided further, that the Board may, on sufficient reason being shown, extend the time for removal of objections by such further time, not exceeding thirty days, as the Board may consider fit to enable the applicant to remove such objections.

**Furnishing of information, clarification and personal representation**

7. (1) The Board may require the applicant to furnish such further information or clarification as the Board may consider necessary, for the purpose of processing of the application.

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<sup>1</sup> Inserted by SEBI (Criteria for Fit and Proper Person) Regulations, 2004, w.e.f. 10.3.2004.

(2) The Board, if it so desires, may ask the applicant or its authorised representative to appear before the Board, for personal representation in connection with the grant of a certificate.

#### **Grant of Certificate**

8. (1) The Board, on being satisfied that the applicant is eligible for the grant of a certificate of registration, shall grant a certificate in Form 'B'.

(2) The grant of certificate of registration shall be subject to the payment of the registration fee specified in Part A of the Second Schedule, , in the manner prescribed in Part B thereof.

#### **Conditions of certificate and validity period**

9. (1) The certificate granted under regulation 8 shall be, subject to the following conditions, namely:

(a) the credit rating agency shall comply with the provisions of the Act, the regulations made there under and the guidelines, directives, circulars and instructions issued by the Board from time to time on the subject of credit rating.

(b) (1) where any information or particulars furnished to the Board by a credit rating agency:

(i) is found to be false or misleading in any material particular ; or

(ii) has undergone change subsequently to its furnishing at the time of the application for a certificate;

the credit rating agency shall forthwith inform the Board in writing.

(2) the period of validity of certificate of registration shall be three years.

#### **Renewal of certificate**

10. (1) A credit rating agency, if it desires renewal of the certificate granted to it, shall make to the Board an application for the renewal of the certificate of registration.

<sup>1</sup>(1A) An application for renewal of certificate of registration made under sub-regulation (1) shall be accompanied by a non refundable application fee as specified in the Second Schedule.

(2) Such application shall be made not less than three months before expiry of the period of validity of the certificate, specified in sub-regulation(2) of regulation 9..

(3) The application for renewal made under sub-regulation (1)- –

(a) shall be accompanied by a renewal fee as specified in the second schedule and

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<sup>1</sup> Inserted by SEBI (Credit Rating Agencies)(Amendment) Regulations, 2006,w.e.f. 7-9-2006

(b) as far as may be, shall be dealt with in the same manner as if it were an application for the grant of a fresh certificate under regulation 3.

#### **Procedure where certificate is not granted**

11. (1) If, after considering an application made under regulation 3 or regulation 10 as the case may be, the Board is of the opinion that a certificate should not be granted or renewed, as the case may be, it may, after giving the applicant a reasonable opportunity of being heard, reject the application.

(2) The decision of the Board, not to grant or not to renew the certificate under sub-regulation (1) shall be communicated by the Board to the applicant within a period of thirty days of such decision, stating the grounds of the decision.

(3) Any applicant aggrieved by the decision of the Board rejecting his application under sub-regulation (1) may, within a period of thirty days from the date of receipt by him of the communication referred to in sub-regulation (2) apply to the Board in writing for re-consideration of such decision.

(4) Where an application for re-consideration is made under sub-regulation (3) the Board shall consider the application and communicate to the applicant its decision in writing, as soon as may be.

#### **Effect of refusal to grant certificate**

12. (1) An applicant referred to in sub-regulation (1) of regulation 11 whose application for the grant of a certificate has been rejected under regulation 11, shall not undertake any rating activity.

(2) An applicant referred to in sub-regulation (2) of regulation 3, whose application for the grant of a certificate has been rejected by the Board under regulation 11, shall, on and from the date of the receipt of the communication under sub-regulation (2) of regulation 11, cease to carry on any rating activity.

(3) If the Board is satisfied that it is in the interest of the investors, it may permit the credit rating agency referred to under sub-regulation (1) or (2) to complete the rating assignments already entered into by it, during the pendency of the application or period of validity of the certificate.

(4) The Board may, in order to protect the interests of investors, issue directions with regard to the transfer of records, documents or reports relating to the activities of a credit rating agency, whose application for the grant or renewal of a certificate has been rejected.

(5) The Board may, in order to protect the interests of investors, appoint any person to take charge of the records, documents or reports relating to the rating activities of a credit rating agency referred to in sub-regulation (4) and for this purpose also determine the terms and conditions of such appointment.

**CHAPTER III**  
**GENERAL OBLIGATIONS OF CREDIT RATING AGENCIES**

**Code of Conduct**

13. Every credit rating agency shall abide by the Code of Conduct contained in the Third Schedule.

**Agreement with the client**

14. Every credit rating agency shall enter into a written agreement with each client whose securities it proposes to rate, and every such agreement shall include the following provisions, namely:-

(a) the rights and liabilities of each party in respect of the rating of securities shall be defined;

(b) the fee to be charged by the credit rating agency shall be specified;

(c) the client shall agree to a periodic review of the rating by the credit rating agency during the tenure of the rated instrument;

(d) the client shall agree to co-operate with the credit rating agency in order to enable the latter to arrive at, and maintain, a true and accurate rating of the clients securities and shall in particular provide to the latter, true, adequate and timely information for the purpose.

(e) the credit rating agency shall disclose to the client the rating assigned to the securities of the latter through regular methods of dissemination, irrespective of whether the rating is or is not accepted by the client;

(f) The client shall agree to disclose, in the offer document;-

(i) the rating assigned to the client's listed securities by any credit rating agency during the last three years and

(ii) any rating given in respect of the client's securities by any other credit rating agency, which has not been accepted by the client.

(g) the client shall agree to obtain a rating from at least two different rating agencies for any issue of debt securities whose size is equal to or exceeds, rupees one hundred crores.

**Monitoring of ratings**

15. (1) Every credit rating agency shall, during the lifetime of securities rated by it continuously monitor the rating of such securities.

(2) Every credit rating agency shall disseminate information regarding newly assigned ratings, and changes in earlier rating promptly through press releases and websites, and, in the case of securities issued by listed companies, such information shall also be provided

simultaneously to the concerned regional stock exchange and to all the stock exchanges where the said securities are listed.

#### **Procedure for review of rating**

16. (1) Every credit rating agency shall carry out periodic reviews of all published ratings during the lifetime of the securities.

(2) If the client does not co-operate with the credit rating agency so as to enable the credit rating agency to comply with its obligations under regulation 15 of this regulation, the credit rating agency shall carry out the review on the basis of the best available information.

Provided that if owing to such lack of co-operation, a rating has been based on the best available information, the credit rating agency shall disclose to the investors the fact that the rating is so based.

(3) A credit rating agency shall not withdraw a rating so long as the obligations under the security rated by it are outstanding, except where the company whose security is rated is wound up or merged or amalgamated with another company.

#### **Internal procedures to be framed**

17. Every credit rating agency shall frame appropriate procedures and systems for monitoring the trading of securities by its employees in the securities of its clients, in order to prevent contravention of –

(a) the Securities and Exchange Board of India (Insider Trading) Regulations, 1992;

(b) the Securities and Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices relating to the Securities Market) Regulations, 1995; and

(c) other laws relevant to trading of securities.

#### **Disclosure of Rating Definitions and Rationale**

18. (1) Every credit rating agency –

(a) shall make public the definitions of the concerned rating, along with the symbol and,

(b) shall also state that the ratings do not constitute recommendations to buy, hold or sell any securities

(2) Every credit rating agency shall make available to the general public information relating to the rationale of the ratings, which shall cover an analysis of the various factors justifying a favourable assessment, as well as factors constituting a risk.

### **Submission of information to the Board**

19. (1) Where any information is called for by the Board from a credit rating agency for purposes of these regulations, including any report relating to its activities, the credit rating agency shall furnish such information to the Board –

- (a) within a period specified by the Board or
- (b) if no such period is specified, then within a reasonable time.

(2) Every credit rating agency shall, at the close of each accounting period, furnish the Board copies of its balance sheet and profit and loss account.

### **Compliance with circulars etc., issued by the Board**

20. Every credit rating agency shall comply with such guidelines, directives, circular instructions as may be issued by the Board from time to time, on the subject of credit rating.

### **<sup>1</sup>20A. Appointment of Compliance Officer**

(1.) Every credit rating agency shall appoint a compliance officer who shall be responsible for monitoring the compliance of the Act, rules and regulations, notifications, guidelines, circular instructions etc issued by the Board or the Central Government.

(2.) The compliance officer shall immediately and independently report to the Board any non-compliance observed by him.]

### **Maintenance of Books of Accounts records, etc.**

21. Every credit rating agency shall keep and maintain, for a minimum period of five years, the following books of accounts, records and documents, namely:

- (a) copy of its balance sheet, as on the end of each accounting period;
- (b) a copy of its profit and loss account for each accounting period;
- (c) a copy of the auditor's report on its accounts for each accounting period.
- (d) a copy of the agreement entered into, with each client;
- (e) information supplied by each of the clients;
- (f) correspondence with each client;
- (g) ratings assigned to various securities including upgradation and down gradation (if any) of the ratings so assigned.

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<sup>1</sup> Inserted by SEBI (Investment Advice by Intermediaries) (Amendment) Regulations, 2001, w.e.f.29.12.2001.

- (h) rating notes considered by the rating committee;
  - (i) record of decisions of the rating committee;
  - (i) letter assigning rating;
  - (k) particulars of fees charged for rating and such other records as the Board may specify from time to time.
- (2) Every credit rating agency shall intimate to the Board the place where the books of account, records and documents required to be maintained under these regulations are being maintained.

#### **Steps on auditor's report**

22. Every credit rating agency shall, within two month's from the date of the auditor's report, take steps to rectify the deficiencies if any, made out in the auditor's report, insofar as they relate to the activity of rating of securities.

#### **Confidentiality**

23. Every credit rating agency shall treat, as confidential, information supplied to it by the client and no credit rating agency shall disclose the same to any other person, except where such disclosure is required or permitted by under or any law for the time being in force.

#### **Rating process**

24. (1) Every credit rating agency shall –

- (a) specify the rating process;
  - (b) file a copy of the same with the Board for record; and file with the Board any modifications or additions made therein from time to time.
- (2) Every credit rating agency shall, in all cases, follow a proper rating process.
- (3) Every credit rating agency shall have professional rating committees, comprising members who are adequately qualified and knowledgeable to assign a rating.
- (4) All rating decisions, including the decisions regarding changes in rating, shall be taken by the rating committee.
- (5) Every credit rating agency shall be staffed by analysts qualified to carry out a rating assignment.
- (6) Every credit rating agency shall inform the Board about new rating instruments or symbols introduced by it.
- (7) Every credit rating agency, shall, while rating a security, exercise due diligence in order to ensure that the rating given by the credit rating agency is fair and appropriate.

(8) A credit rating agency shall not rate securities issued by it.

(9) Rating definition, as well as the structure for a particular rating product, shall not be changed by a credit rating agency, without prior information to the Board.

(10) A credit rating agency shall disclose to the concerned stock exchange through press release and websites for general investors, the rating assigned to the securities of a client, after periodic review, including changes in rating, if any.

#### **CHAPTER IV RESTRICTION ON RATING OF SECURITIES ISSUED BY PROMOTERS OR BY CERTAIN OTHER PERSONS**

##### **Definitions**

25 In this Chapter, unless the context otherwise requires;-

(a) "associate" , in relation to a promoter, includes a body corporate in which the promoter holds ten percent or more, of the share capital;

(b) "promoter" means a person who holds ten percent or more, of the shares of the credit rating agency.

##### **Securities issued by promoter**

26 (1) No credit rating agency shall rate a security issued by its promoter.

(2) In case promoter is a lending institution, its Chairman, director or employee shall not be a Chairman, director or employee of credit rating agency or its rating committee.

Provided that sub-regulation (2) shall come into force within three months from commencement of these regulations.

##### **Securities issued by certain entities, connected with a promoter, or rating agency not to be rated**

27 (1) No credit rating agency shall, rate a security issued by an entity, which is;-

(a) a borrower of its promoter; or

(b) a subsidiary of its promoter; or

(c) an associate of its promoter, if

(i) there are common Chairman, Directors between credit rating agency and these entities.

(ii) there are common employees.

(iii) there are common Chairman, Directors, Employees on the rating committee.



(2) No credit rating agency shall rate a security issued by its associate or subsidiary, if the credit rating agency or its rating committee has a Chairman, director or employee who is also a Chairman, director or employee of any such entity

<sup>1</sup>**Provided** that the Credit Rating Agency may, subject to the provisions of sub-regulations (1), rate a security issued by its associate having a common independent director with it or rating committee if,-

- (i) such an independent director does not participate in the discussion on rating decisions, and
- (ii) the Credit Rating Agency makes a disclosure in the rating announcement of such associate (about the existence of common independent director) on its Board or of its rating committee, and that the common independent director did not participate in the rating process or in the meeting of its Board of Directors or in the meeting of the rating committee, when the securities rating of such associate was discussed.

Explanation: - (1) For the purposes of this sub-regulation the expression 'independent director' means a director who, apart from receiving remuneration as a director, does not have any other material pecuniary relationship or transactions with the company, its promoters, its management or its subsidiaries, which in the judgment of the board of the company, may affect the independence of the judgment of such director.

#### **Securities already rated**

28. Nothing in this Chapter shall apply to securities whose rating has been already done by a credit rating agency before the commencement of these regulations, and such securities may, subject to the provisions of the other Chapters of these regulations, continue to be rated, without the need to comply with the restrictions imposed by the regulations contained in this chapter.

## **CHAPTER V**

### **PROCEDURE FOR INSPECTION AND INVESTIGATION**

#### **Board's right to inspect**

29. (1) The Board may appoint one or more persons as inspecting officers, to undertake inspection or investigation of the books of account, records and documents of the credit rating agencies, for any of the purposes specified in sub-regulation (2).

(2) The purposes referred to in sub-regulation (1) shall be the following, namely:

(a) to ascertain whether the books of account, records and documents are being maintained properly;

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<sup>1</sup> Inserted by the SEBI(Credit Rating Agencies)(Amendment)Regulations, 2003, w.e.f. 19-2-2003

(b) to ascertain whether the provisions of the Act and these regulations are being complied with;

(c) to investigate into complaints received from investors, clients or any other person on a matter having a bearing on activities of the credit rating agency;

(d) in the interest of the securities market or in the interest of investors.

(3) The inspections ordered by the Board under sub-regulation (1) shall not ordinarily go in an examination of the appropriateness of the assigned ratings on the merits.

(4) Inspections to judge the appropriateness of the ratings may be ordered by the Board only in case of complaints which are serious in nature.

(5) Inspections referred to in sub-regulation (4) shall be carried out either by the officers of the Board or independent experts, with relevant experience or combination of both.

#### **Notice before inspection or investigation**

30. (1) Before ordering an inspection or investigation under regulation 29, the Board shall give not less than ten days written notice to the credit rating agency for that purpose.

(2) Notwithstanding anything contained in sub-regulation (1) where the Board is satisfied that in the interest of the investors, no such notice should be given, it may, by an order in writing, direct that the inspection or investigation of the affairs of the credit rating agency be taken up without such notice.

(3) During the course of an inspection or investigation, the credit rating agency against which the inspection or investigation is being carried out shall be bound to discharge all obligations as provided in regulation 31

#### **Obligations of credit rating agency on inspection or investigation by the Board**

31. (1) It shall be the duty of every credit rating agency whose affairs are being inspected or investigated, and of every director, officer or employee thereof, to produce to the inspecting or investigating officer such books, accounts and other documents in its or his custody, control and furnish him with such statements and information relating to its rating activities as the inspecting officer may require within such reasonable period as may be specified by the said officer.

(2) The credit rating agency shall –

(a) allow the inspecting officer to have reasonable access to the premises occupied by such credit rating agency or by any other person on its behalf;

(b) extend to the inspecting officer reasonable facility for examining any books, records, documents and computer data in the possession of the credit rating agency; and

(c) provide copies of documents or other materials which, in the opinion of the inspecting officer, are relevant for the purposes of the inspection or investigation, as the case may be.

(3) The inspecting officer, in the course of inspection or investigation, shall be entitled to examine, or record the statements, of any officer, director or employee of the credit rating agency for the purposes connected with the inspection or investigation.

(4) Every director, officer or employee of the credit rating agency shall be bound to render to the inspecting officer all assistance in connection with the inspection or investigation which the inspecting officer may reasonably require.

#### **Submission of Report to the Board**

32. The inspecting officer shall, as soon as possible, on completion of the inspection or investigation, submit a report to the Board.

Provided that if directed to do so by the Board, he may submit an interim report.

#### **<sup>1</sup>33 Action on inspection or investigation report**

The Board or the Chairman shall after consideration of inspection or investigation report take such action as the Board or Chairman may deem fit and appropriate including action under the Securities and Exchange Board of India (Procedure for Holding Enquiry by Enquiry Officer and Imposing Penalty) Regulations, 2002

## **CHAPTER VI PROCEDURE FOR ACTION IN CASE OF DEFAULT**

#### **<sup>2</sup>Liability for action in case of default**

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<sup>1</sup> Substituted by SEBI (Procedure For Holding Enquiry by Enquiry officer and Imposing Penalty) Regulation, 2002 w.e.f. 27-9-2002. Prior to its substitution it read as follows.

#### **Communication of Findings etc. to the Credit Rating Agency**

33. (1) The Board shall, after consideration of the inspection report or the interim report referred to in regulation 32, communicate the findings of the inspecting officer to the credit rating agency and give it a reasonable opportunity of being heard in the matter.

(2) On receipt of the explanation, if any, from the credit rating agency, the Board may call upon the credit rating agency to take such measures as the Board may deem fit in the interest of the securities market and for due compliance with the provisions of the Act and these regulations.

<sup>2</sup> Substituted by the SEBI (Procedure for Holding Enquiry by Enquiry Officer and Imposing penalty) Regulations, 2002.w.e.f.27-9-2002.Prior to its substitution it read as follows.

#### **Liability for action in case of default**

34. (1) A credit rating agency which: -  
(a) fails to comply with any condition subject to which a certificate has been granted; or

34. A credit rating agency which -

- (a) fails to comply with any condition subject to which a certificate has been granted;
- (b) contravenes any of the provisions of the Act or these regulations or any other regulation made under the Act;

shall be dealt with in the manner provided under the Securities and Exchange Board of India (Procedure for holding Enquiry by Enquiry officer and Imposing penalty) Regulations, 20

**<sup>1</sup>35 to 42( omitted)**

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(b) contravenes any of the provisions of the Act or these regulations or any other regulations made under the Act; shall be liable to either of the penalties specified in sub-regulation (2).

(2) The penalties referred to in sub-regulation (1) are:-

- (a) suspension of registration; or
- (b) cancellation of registration.

<sup>1</sup> Substituted by SEBI (Procedure for Holding Enquiry by Enquiry officer and Imposing Penalty) Regulation, 2002 w.e.f. 27-9-2002. Prior to its omission, regulation 42 was amended by SEBI (Appellate Securities Appellate Tribunal) (Amendment) Regulations, 2000, w.e.f. 28.03.2000. Prior to omission regulation 35 to 42 read as follows.

**Suspension of registration**

35. A penalty of suspension of the certificate of registration of a credit rating agency may be imposed by the Board, if the case falls under sub-regulation (1) of regulation 34.

**Cancellation of Registration**

36. (1) A penalty of cancellation of certificate of registration of a credit rating agency may be imposed by the Board, if:

- (a) the credit rating agency is guilty of fraud, or has been convicted of an offence involving moral turpitude or an economic offence; or
- (b) in case of repeated defaults of the nature mentioned in sub-regulation (1) of regulation 34.
- (c) the credit rating agency is declared insolvent or wound up;

(2) The Board shall furnish to the credit rating agency reasons in writing for cancellation of registration.

**Manner of Making Order of Suspension and Cancellation**

37. No order of suspension or of cancellation of the certificate of registration, shall be passed by the Board except after holding an enquiry in accordance with the procedure specified in regulation 38.

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Provided that the holding of such an enquiry shall not be necessary in cases where:

- (a) the credit rating agency is declared insolvent or is wound up; or
- (b) the credit rating agency fails to pay to the Board registration fees or renewal fee as per these regulations.

Provided further that an opportunity of hearing shall be given before any action against the credit rating agency is taken.

#### **Manner of Holding enquiry before Suspension or Cancellation**

38. (1) For the purpose of holding an enquiry under regulation 37, the Board may appoint one or more enquiry officers.

(2) The enquiry officer shall issue to the credit rating agency a notice at the registered office or principal place of business of the credit rating agency, setting out the grounds on which action is proposed to be taken against it and calling upon it to show cause against such action within a period of fourteen days from the date of receipt of such notice.

(3) The credit rating agency, may, within fourteen days from the date of receipt of such notice, furnish the enquiry officer a written reply, together with copies of documentary or other evidence relied on by the credit rating agency sought by the Board from the credit rating agency.

(4) The enquiry officer shall give a reasonable opportunity of hearing to the credit rating agency, to enable it to make its submission in support of its reply made under sub-regulation (3).

(5) Before the enquiry officer, the credit rating agency may either appear in person or through any person duly authorised on this behalf.

Provided that no lawyer or advocate shall be permitted to represent the credit rating agency at the enquiry.

Provided further that where a lawyer or an advocate has been appointed by the board as a presenting officer under sub-regulation (6), it shall be lawful for the credit rating agency to present his case through a lawyer or advocate.

(6) If it is considered necessary, the enquiry officer may request the Board to appoint a presenting officer to present its case.

(7) The enquiry officer shall, after taking into account all relevant facts and submissions made by the credit rating agency, submit a report to the Board and recommend the penalty, if any to be imposed upon the credit rating agency as also the grounds on the basis of which the proposed penalty is justified.

#### **Show-cause notice and order**

39. (1) On receipt of the report from the enquiry officer, the Board shall consider the same and issue a show-cause notice to the credit rating agency, as to why the penalty as proposed by the enquiry officer should not be imposed.

(2) The credit rating agency shall, within fourteen days of the date of receipt of the show-cause notice, submit a reply to the Board.

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(3) The Board, after considering the reply of the credit rating agency to the show-cause notice, shall as soon as possible pass such order as it deems fit.

(4) Every order passed by the Board under sub-regulation (3) shall be self-contained and shall give reasons for the conclusions stated therein, including justification of the penalty if any imposed by that order.

(5) The Board shall send to the credit rating agency a copy of the order passed under sub-regulation (3).

#### **Effect of suspension and cancellation of registration of credit rating agency**

40. (1) On and from the date of suspension of the certificate of registration, the credit rating agency shall cease to carry on any rating activity during the period of suspension and shall be subject to such directions of the Board with regard to any records, documents securities or reports that may be connected with in its rating activities, as the Board may specify.

(2) On and from the date of cancellation of the certificate of registration, the credit rating agency shall: -

(a) cease to carry in any rating activity and

(b) shall be subject to such directions of the Board with regard to the transfer of records, documents, securities or reports connected with its rating activities which may be in its custody or control as the Board may specify.

(3) Notwithstanding the suspension or cancellation of certificate of a credit rating agency, if the Board is satisfied that it is in the interest of the investors to grant such permission, the Board may grant to the credit rating agency permission to carry on such activities relating its assignments undertaken prior to such suspension or cancellation, as the Board may specify.

#### **Publication of Order of Suspension or Cancellation**

41. The order of suspension or cancellation of certificate of registration, passed under sub-regulation (3) of regulation (39) shall be published by the Board in at least two daily newspapers.

#### **Appeal to the Securities Appellate Tribunal**

42. Any person aggrieved by an order of the Board made, on and after the commencement of the Securities Laws (Second Amendment) Act, 1999, (i.e., after 16th December 1999), under these regulations may prefer an appeal to a Securities Appellate Tribunal having jurisdiction in the matter  
[Prior to amendment 28.3.2000 it read as follows:

#### **Appeal to the Central Government**

Any person aggrieved by an order of the Board under these Regulations;

(a) Suspending a certificate of registration;

(b) Cancelling certificate of registration,

may prefer an appeal to the Central Government against such order, in accordance with the Securities and Exchange Board of India (Appeal to Central Government) Rules, 1993]

**FIRST SCHEDULE  
FORM A  
SECURITIES AND EXCHANGE BOARD OF INDIA  
(CREDIT RATING AGENCIES) REGULATIONS, 1999  
[REGULATION 3(3)]**

**APPLICATION FOR GRANT OF CERTIFICATE / RENEWAL OF CERTIFICATE**

NAME OF APPLICANT

CONTACT NAME :

TELEPHONE NO:

FAX NO:

INSTRUCTIONS FOR FILLING UP FORM -

1. Applicants must submit to the Board a completed application form together with appropriate supporting documents. Supporting documents should be attested as true by a notary public.
2. This application form should be filled in accordance with the regulations.
3. Application for registration will be considered, only if it is complete in all respects.
4. All answers must be typed.
5. Information which needs to be supplied in more detail may be given on separate sheets which should be attached to the application form.
6. All signatures on the application must be original.
7. Every page of the form as well as every additional sheet must be initialed by 1 authorised signatory of the applicant.

**1.0 PARTICULARS OF THE APPLICANT**

- 1.1 Name, address of the registered office, address for correspondence, telephone number(s), fax number(s) and name of the contact person of the company. Address of branch offices, if any.
- 1.2 Date of incorporation of the Applicant company (enclose certificate of incorporation and memorandum and articles of association). Specify the following:
  - (a) Objects (Main & Ancillary) of the Applicant company
  - (b) Authorised, issued, subscribed and paid up capital

1.3 Category to which the Applicant company belongs to:]

- (a) Limited company - Private/Public.
- (b) Unlimited company.

If listed, names of Stock Exchanges and latest share price to be given.

1.4 Category to which the Applicant company belongs to (refer regulation 3)

- (a) Company already in the business of undertaking rating activities
- (b) Company proposing to undertake rating activities for the first time.

## **2.0 ELIGIBILITY CRITERIA**

2.1 Category to which the promoter (s) of the Applicant company belong to (refer regulation 4).

2.2 Name the promoters and indicate their shareholding in the company.

2.3 Enclose a Chartered Accountant's certificate certifying the continuous net worth of Rs.100 crores for five years, in case the promoter referred to in regulation 4(e).

2.4 Net worth of the company as per the last audited accounts not earlier than three years from the date of application [refer regulation 5 (c)]. Enclose a Chartered Accountant's certificate certifying the same.

## **3.0 PARTICULARS OF DIRECTORS/KEY PERSONNEL**

3.1 Particulars of Directors of the company, which shall include name, qualification, experience, shareholding in the company and directorship in other companies.

3.2 Particulars of Key Personnel of the company, which shall include name, designation in the company, qualification, previous positions held, experience, date of appointment in the company and functional areas

## **4.0 INFRASTRUCTURE**

4.1 Details of infrastructure including computing facilities, facilities for research and development available with the company and whether the existing infrastructure is adequate for the rating activities proposed to be undertaken by the company. Any further requirements for additional/ improved infrastructure to be indicated.

## **5.0 MAJOR SHAREHOLDERS**

5.1 List of major shareholders (holding 5% and above of applicant directly or along with associates)

Shareholding as on : \_\_\_\_\_

Name of shareholder	No .of Shares held	% age of total paid up capital of the company

## 6.0 ASSOCIATE CONCERNS

6.1 Particulars of associate companies/concerns which shall include name, address, type of activity handled, nature of interest of the Applicant company in the associate, nature of interest of promoter(s) of the applicant in the associate.

6.2 Whether the Board has granted/ refused registration as credit rating agency to any associate of the applicant. Give the details like date of application, date of refusal/ registration, reasons for refusal etc.

## 7.0 BUSINESS INFORMATION OF THE COMPANY

7.1 History, major events and present activities. Details of Experience in Credit Rating activities and other related activities

7.2 If the company is proposing to engage in credit rating activities for the first time, business plan of the company with projected volume of activities and income for which registration is sought to be specifically given.

7.3 Securities Rating activities handled during the last three years as per the table below

Name of Client	Type of security	Size of issue	Year of Issue	Security/ Instrument rated	listed / unlisted

7.4 Details of other rating activities undertaken during last three years.

7.5 Any other information considered relevant to the nature of services rendered by the applicant.

## 8.0 FINANCIAL INFORMATION ABOUT THE APPLICANT

### 8.1 Net worth

(Rs. In Lacs)

Items	Year prior to the preceding year of the current year	Preceding year	Current year
(a) Paid-up capital			
(b) Free reserves (excluding revaluation reserves)			
Total (a) + (b)			

(c) Accumulated losses			
(d) Deferred revenue expenditure not written off			
Net worth (a)-(b)-(c)-(d)			

8.2 Please enclose audited annual accounts for the last three years. Where unaudited reports are submitted, give reasons. If minimum networth requirement has been met after last audited annual accounts, audited statement of accounts of a later date also be submitted.

8.3 Name and Address of the Principal bankers of the Applicant company .

8.4 Name and address of the Auditors.

### 9.0 OTHER INFORMATION

9.1 Details of all pending litigations against the applicant company, directors and employees:

Nature of dispute	Name of the party	Status
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9.2 Indictment or involvement in any fraud or economic offences by the applicant or any of its Directors, or key managerial Personnel, in the last three years.

### 10.0 DECLARATION

10.1 Give the following declarations signed by two directors:

I/We hereby apply for registration.

I/We warrant that I/We have truthfully and fully answered the questions above and provided all the information which might reasonably be considered relevant for the purposes of my registration.

I/We declare that the information supplied in the application form is complete and correct

For and on behalf of

\_\_\_\_\_  
(Name of Applicant)

\_\_\_\_\_  
Director

Name in Block Letters

Date

**FORM B**  
**SECURITIES AND EXCHANGE BOARD OF INDIA**  
**(CREDIT RATING AGENCIES) REGULATIONS, 1999**

[REGULATION 8 (1)]

**CERTIFICATE OF REGISTRATION**

- I. In exercise of the powers conferred by sub-section (1) of section 12 of the Securities and Exchange Board of India Act, 1992, read with the rules and regulations made thereunder the Board hereby grants a certificate of registration to \_\_\_\_\_ as a credit rating agency in accordance with and subject to the conditions in the regulations to carry out the activity of the credit rating agency:-
- II. Registration Code for the credit rating agency is CRA/ / /
- III. This certificate shall be valid from \_\_\_\_\_ to \_\_\_\_\_ and may be renewed as specified in regulation 10 of Securities and Exchange Board of India (Credit Rating Agencies) Regulations, 1999.

Place :

Date

By Order  
Sd/-  
For and on behalf of  
Securities and Exchange Board of India

**<sup>1</sup>SECOND SCHEDULE**

\_\_\_\_\_

<sup>1</sup> Substituted by SEBI ( Credit Rating Agencies) (Amendment) Regulations, 2006

Earlier it read as follows:

Application fee (Rs)	25, 000/-
Registration fee for grant of certificate (Rs)	5, 00, 000/-
Renewal fee (Rs.)	3, 00, 000/-

**SECURITIES AND EXCHANGE BOARD OF INDIA  
(CREDIT RATING AGENCY) REGULATIONS, 1999**

[REGULATION 3 (3), 8(2), 10(3)]

**FEES**

**PART A**

**Amount to be paid as fees**

Application fee (Rs)	50, 000/-
Registration fee for grant of certificate (Rs)	5, 00, 000/-
Renewal fee (Rs.)	10, 00, 000/-

**PART B**

The fees specified above shall be paid by way of a bank draft in favour of "Securities and Exchange Board of India" payable at Mumbai.

**<sup>1</sup>THIRD SCHEDULE**

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Substituted by the SEBI (Credit Rating Agencies)(Second Amendment) Regulation, 2003. Earlier it was amended by the SEBI (Investment Advise by Intermediaries) Regulations 2001, w.e.f.29-5-2001.

**THIRD SCHEDULE**

**SECURITIES AND EXCHANGE BOARD OF INDIA**

**CODE OF CONDUCT FOR CREDIT RATING AGENCIES  
(REGULATION 13)**

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- (1) A credit rating agency in the conduct of its business shall observe high standards of integrity and fairness in all its dealings with its clients.
  - (2) A credit rating agency shall fulfil its obligations in an ethical manner.
  - (3) A credit rating agency shall render at all times high standards of service, exercise due diligence to ensure proper care and exercise independent professional judgement. It shall wherever necessary, disclose to the clients, possible sources of conflict of duties and interests, while providing unbiased services.
  - (4) The credit rating agency shall avoid any conflict of interest of any member of its rating company participating in the rating analysis. Any potential conflict of interest shall be disclosed to the client.
  - (5) A credit rating agency shall not indulge in unfair competition nor shall they wean away client from other rating agency on assurance of higher rating.
  - (6) A credit rating agency shall not make any exaggerated statement, whether oral or written, to the clients either about its qualification or its capability to render certain services or its achievements in rendering services rendered to other clients.
  - (7) A credit rating agency shall always endeavor to ensure that all professional dealings are effected in a prompt and efficient manner.
  - (8) A credit rating agency shall not divulge to other clients, press or any other party any confidential information about its client, which has come to its knowledge, without making disclosure to the company / person of the rated company / client.
  - (9) A credit rating agency shall not make untrue statement or suppress any material fact in its reports, documents, reports, papers or information furnished to the Board or to public or to stock exchange.
  - (10) A credit rating agency shall not generally and particularly in respect of issue of securities rated by it be party to -
    - (a) creation of false market;
    - (b) passing of price sensitive information to brokers, members of the stock exchanges, other players in the capital market or to any other person or take any other action which is unethical or unfair to the investors.
  - (11) A credit rating agency shall maintain an arm's length relationship between its credit rating and any other activity.
  - (12) A credit rating agency shall abide by the provisions of the Act, regulations and circulars which are applicable and relevant to the activities carried on by the credit rating agency.

[Inserted on 25-9-2001 (11 A) (a) A credit rating agency or any of his employees shall not render, directly or indirectly any investment advice about any security in the publicly accessible media, whether real time or non-real time, unless a disclosure of his interest including long or short position in the said security has been made, while rendering such advice.

SECURITIES AND EXCHANGE BOARD OF INDIA (CREDIT  
RATING AGENCIES) REGULATIONS, 1999

[Regulation 13]

**CODE OF CONDUCT**

1. A credit rating agency shall make all efforts to protect the interests of investors.
2. A credit rating agency, in the conduct of its business, shall observe high standards of integrity, dignity and fairness in the conduct of its business.
3. A credit rating agency shall fulfill its obligations in a prompt, ethical and professional manner.
4. A credit rating agency shall at all times exercise due diligence, ensure proper care and exercise independent professional judgment in order to achieve and maintain objectivity and independence in the rating process.
5. A credit rating agency shall have a reasonable and adequate basis for performing rating evaluations, with the support of appropriate and in depth rating researches. It shall also maintain records to support its decisions.
6. A credit rating agency shall have in place a rating process that reflects consistent and international rating standards.
7. A credit rating agency shall not indulge in any unfair competition nor shall it wean away the clients of any other rating agency on assurance of higher rating.
8. A credit rating agency shall keep track of all important changes relating to the client companies and shall develop efficient and responsive systems to yield timely and accurate ratings. Further a credit rating agency shall also monitor closely all relevant factors that might affect the creditworthiness of the issuers.
9. A credit rating agency shall disclose its rating methodology to clients, users and the public.
10. A credit rating agency shall, wherever necessary, disclose to the clients, possible sources of conflict of duties and interests, which could impair its ability to make fair, objective and unbiased ratings. Further it shall ensure that no conflict of interest exists between any member of its rating committee participating in the rating analysis, and that of its client.
11. A credit rating agency shall not make any exaggerated statement, whether oral or written, to the client either about its qualification or its capability to render certain services or its achievements with regard to the services rendered to other clients.
12. A credit rating agency shall not make any untrue statement, suppress any material fact or make any misrepresentation in any documents, reports, papers or information furnished to the board, stock exchange or public at large.
13. A credit rating agency shall ensure that the Board is promptly informed about any action, legal proceedings etc., initiated against it alleging any material breach or non-compliance by it, of any law, rules, regulations and directions of the Board or of any other regulatory body.

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(b) In case an employee of the credit rating agency is rendering such advice, he shall also disclose the interest of is dependent family members and the employer including their long or short position in the said security, while rendering such advice.]

14. A credit rating agency shall maintain an appropriate level of knowledge and competence and abide by the provisions of the Act, regulations and circulars, which may be applicable and relevant to the activities carried on by the credit rating agency. The credit rating agency shall also comply with award of the Ombudsman passed under the Securities and Exchange Board of India (Ombudsman) Regulations, 2003.
15. A credit rating agency shall ensure that there is no misuse of any privileged information including prior knowledge of rating decisions or changes.
16. (a) A credit rating agency or any of his employees shall not render, directly or indirectly any investment advice about any security in the publicly accessible media.  
(b) A credit rating agency shall not offer fee-based services to the rated entities, beyond credit ratings and research.
17. A credit rating agency shall ensure that any change in registration status/any penal action taken by board or any material change in financials which may adversely affect the interests of clients/investors is promptly informed to the clients and any business remaining outstanding is transferred to another registered person in accordance with any instructions of the affected clients/investors.
18. A credit rating agency shall maintain an arm's length relationship between its credit rating activity and any other activity.
19. A credit rating agency shall develop its own internal code of conduct for governing its internal operations and laying down its standards of appropriate conduct for its employees and officers in the carrying out of their duties within the credit rating agency and as a part of the industry. Such a code may extend to the maintenance of professional excellence and standards, integrity, confidentiality, objectivity, avoidance of conflict of interests, disclosure of shareholdings and interests, etc. Such a code shall also provide for procedures and guidelines in relation to the establishment and conduct of rating committees and duties of the officers and employees serving on such committees.
20. A credit rating agency shall provide adequate freedom and powers to its compliance officer for the effective discharge of his duties.
21. A credit rating agency shall ensure that the senior management, particularly decision makers have access to all relevant information about the business on a timely basis.
22. A credit rating agency shall ensure that good corporate policies and corporate governance are in place.
23. A credit rating agency shall not, generally and particularly in respect of issue of securities rated by it, be party to or instrumental for—
  - (a) creation of false market;
  - (b) price rigging or manipulation; or
  - (c) dissemination of any unpublished price sensitive information in respect of securities which are listed and proposed to be listed in any stock exchange, unless required, as part of rationale for the rating accorded.

**CODE OF CONDUCT FUNDAMENTALS FOR CREDIT RATING  
AGENCIES**



**THE TECHNICAL COMMITTEE OF THE  
INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS**

**REVISED MAY 201**

## CODE OF CONDUCT FUNDAMENTALS FOR CREDIT RATING AGENCIES

### INTRODUCTION

Credit rating agencies (CRAs) can play an important role in modern capital markets. CRAs typically opine on the credit risk of issuers of securities and their financial obligations. Given the vast amount of information available to investors today – some of it valuable, some of it not – CRAs can play a useful role in helping investors and others sift through this information, and analyze the credit risks they face when lending to a particular borrower or when purchasing an issuer’s debt and debt-like securities.<sup>1</sup>

In September 2003, IOSCO’s Technical Committee published a Statement of Principles Regarding the Activities of Credit Rating Agencies.<sup>2</sup> The Principles were designed to be a useful tool for securities regulators, rating agencies and others wishing to articulate the terms and conditions under which CRAs operate and the manner in which opinions of CRAs should be used by market participants. Because CRAs are regulated and operate differently in different jurisdictions, the Principles laid out high-level objectives that rating agencies, regulators, issuers and other market participants should strive toward in order to improve investor protection and the fairness, efficiency and transparency of securities markets and reduce systemic risk. The Principles were designed to apply to all types of CRAs operating in various jurisdictions. However, to take into account the different market, legal and regulatory circumstances in which CRAs operate, and the varying size and business models of CRAs, the manner in which the Principles were to be implemented was left open. The Principles contemplated that a variety of mechanisms could be used, including both market mechanisms and regulation.

Along with the Principles, IOSCO’s Technical Committee also published a Report on the Activities of Credit Rating Agencies that outlined the activities of CRAs, the types of regulatory issues that arise relating to these activities, and how the Principles address these issues.<sup>3</sup> The CRA Report highlighted the growing and sometimes controversial importance placed on CRA assessments and opinions, and found that, in some cases, CRAs activities are not always well understood by investors and issuers alike. Given this lack of understanding, and because CRAs typically are subject to little formal regulation or oversight in most jurisdictions, concerns have been raised regarding the manner in which CRAs protect the integrity of the rating process, ensure that investors and issuers are treated fairly, and safeguard confidential material information provided them by issuers.

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<sup>1</sup> CRAs typically provide credit ratings for different types of debts and financial obligations — including, for example, private loans, publicly and privately traded debt securities, preferred shares and other securities that offer a fixed or variable rate of return. For simplicity’s sake, the term “debt and debt-like securities” is used herein to refer to debt securities, preferred shares, and other financial obligations of this sort that CRAs rate.

<sup>2</sup> This document can be downloaded from IOSCO’s On-Line Library at [www.iosco.org](http://www.iosco.org) (IOSCOPD151).

<sup>3</sup> This document can be downloaded from IOSCO’s On-Line Library at [www.iosco.org](http://www.iosco.org) (IOSCOPD153).

Following publication of the CRA Principles, some commenters, including a number of CRAs, suggested that it would be useful if IOSCO were to develop a more specific and detailed code of conduct giving guidance on how the Principles could be implemented in practice. The following Code of Conduct Fundamentals for Credit Rating Agencies is the fruition of this exercise. As with the Principles, with which it should be used, the Code Fundamentals were developed out of discussions among IOSCO members, CRAs, representatives of the Basel Committee on Banking Supervision, the International Association of Insurance Supervisors, issuers, and the public at large.<sup>4</sup>

The Code Fundamentals offer a set of robust, practical measures that serve as a guide to and a framework for implementing the Principles' objectives. These measures are the fundamentals which should be included in individual CRA codes of conduct, and the elements contained in the Code Fundamentals should receive the full support of CRA management and be backed by thorough compliance and enforcement mechanisms. However, the measures set forth in the Code Fundamentals are not intended to be all-inclusive: CRAs and regulators should consider whether or not additional measures may be necessary to properly implement the Principles in a specific jurisdiction, and the Technical Committee may revisit the Code Fundamentals in the future should experience dictate that modifications are necessary. Further, the Code Fundamentals are not designed to be rigid or formulaistic. They are designed to offer CRAs a degree of flexibility in how these measures are incorporated into the individual codes of conduct of the CRAs themselves, according to each CRA's specific legal and market circumstances.

IOSCO Technical Committee members expect CRAs to give full effect to the Code Fundamentals. In order to promote transparency and improve the ability of market participants and regulators to judge whether a CRA has satisfactorily implemented the Code Fundamentals, CRAs should disclose how each provision of the Code Fundamentals is addressed in the CRA's own code of conduct. CRAs should explain if and how their own codes of conduct deviate from the Code Fundamentals and how such deviations nonetheless achieve the objectives laid out in the Code Fundamentals and the IOSCO CRA Principles. This will permit market participants and regulators to draw their own conclusions about whether the CRA has implemented the Code Fundamentals to their satisfaction, and to react accordingly. In developing their own codes of conduct, CRAs should keep in mind that the laws and regulations of the jurisdictions in which they operate vary and take precedence over the Code Fundamentals. These laws and regulations may include direct regulation of CRAs and may incorporate elements of the Code Fundamentals itself.

Finally, the Code Fundamentals only address measures that CRAs should adopt to help ensure that the CRA Principles are properly implemented. The Code Fundamentals do not address the equally important obligations issuers have of cooperating with and providing accurate and complete information to the marketplace and the CRAs they solicit to provide ratings. While aspects of the Code Fundamentals deal with a CRA's duties to issuers, the essential purpose of the Code

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<sup>4</sup> A consultation draft of the Code Fundamentals was published for public comment in October 2004. This document (IOSCOPD173) and a list of public comments IOSCO received on the consultation draft (IOSCOPD177) can be downloaded from IOSCO's On-Line Library at [www.iosco.org](http://www.iosco.org). The online version of the list of public comments includes hyperlinks to the comment letters themselves.

Fundamentals is to promote investor protection by safeguarding the integrity of the rating process. IOSCO members recognize that credit ratings, despite their numerous other uses, exist primarily to help investors assess the credit risks they face when making certain kinds of investments. Maintaining the independence of CRAs vis-à-vis the issuers they rate is vital to achieving this goal. Provisions of the Code Fundamentals dealing with CRA obligations to issuers are designed to improve the quality of credit ratings and their usefulness to investors. These provisions should not be interpreted in ways that undermine the independence of CRAs or their ability to issue timely ratings opinions.

Like the IOSCO CRA Principles, the objectives of which are reflected herein, the Code Fundamentals are also intended to be useful to all types of CRAs relying on a variety of different business models. The Code Fundamentals do not indicate a preference for one business model over another, nor are the measures described therein designed to be used only by CRAs with large staffs and compliance functions. Accordingly, the types of mechanisms and procedures CRAs adopt to ensure that the provisions of the Code Fundamentals are followed will vary according to the market and legal circumstances in which the CRA operates.

Structurally, the Code Fundamentals are broken into three sections and draw upon the organization and substance of the Principles themselves:

- ♦ The Quality and Integrity of the Rating Process;
- ♦ CRA Independence and the Avoidance of Conflicts of Interest; and,
- ♦ CRA Responsibilities to the Investing Public and Issuers.

#### **TERMS**

The Code Fundamentals are designed to apply to any CRA and any person employed by a CRA in either a full-time or part-time capacity. A CRA employee who is primarily employed as a credit analyst is referred to as an “analyst.” For the purposes of the Code Fundamentals, the terms “CRA” and “credit rating agency” refer to those entities whose business is the issuance of credit ratings for the purposes of evaluating the credit risk of issuers of debt and debt-like securities.

For the purposes of the Code Fundamentals, a “credit rating” is an opinion regarding the creditworthiness of an entity, a credit commitment, a debt or debt-like security or an issuer of such obligations, expressed using an established and defined ranking system. As described in the CRA Report, credit ratings are not recommendations to purchase, sell, or hold any security.

#### **THE IOSCO CODE OF CONDUCT FUNDAMENTALS FOR CREDIT RATING AGENCIES**

As described in the IOSCO CRA Principles, CRAs should endeavor to issue opinions that help reduce the asymmetry of information that exists between borrowers and debt and debt-like securities issuers, on one side, and lenders and the purchasers of debt and debt-like securities on the other. Rating analyses of low quality or produced

through a process of questionable integrity are of little use to market participants. Stale ratings that fail to reflect changes to an issuer's financial condition or prospects may mislead market participants. Likewise, conflicts of interest or other undue factors – internal and external – that might, or even appear to, impinge upon the independence of a rating decision can seriously undermine a CRA's credibility. Where conflicts of interest or a lack of independence is common at a CRA and hidden from investors, overall investor confidence in the transparency and integrity of a market can be harmed. CRAs also have responsibilities to the investing public and to issuers themselves, including a responsibility to protect the confidentiality of some types of information issuers share with them.

To help achieve the objectives outlined in the CRA Principles, which should be read in conjunction with the Code Fundamentals, CRAs should adopt, publish and adhere to a Code of Conduct containing the following measures:

## **1. QUALITY AND INTEGRITY OF THE RATING PROCESS**

### **A. Quality of the Rating Process**

- 1.1 A CRA should adopt, implement and enforce written procedures to ensure that the opinions it disseminates are based on a thorough analysis of all information known to the CRA that is relevant to its analysis according to the CRA's published rating methodology.*
- 1.2 A CRA should use rating methodologies that are rigorous, systematic, and, where possible, result in ratings that can be subjected to some form of objective validation based on historical experience.*
- 1.3 In assessing an issuer's creditworthiness, analysts involved in the preparation or review of any rating action should use methodologies established by the CRA. Analysts should apply a given methodology in a consistent manner, as determined by the CRA.*
- 1.4 Credit ratings should be assigned by the CRA and not by any individual analyst employed by the CRA; ratings should reflect all information known, and believed to be relevant, to the CRA, consistent with its published methodology; and the CRA should use people who, individually or collectively (particularly where rating committees are used) have appropriate knowledge and experience in developing a rating opinion for the type of credit being applied.*
- 1.5 A CRA should maintain internal records to support its credit opinions for a reasonable period of time or in accordance with applicable law.*
- 1.6 A CRA and its analysts should take steps to avoid issuing any credit analyses or reports that contain misrepresentations or are otherwise misleading as to the general creditworthiness of an issuer or obligation.*
- 1.7 A CRA should ensure that it has and devotes sufficient resources to carry out high-quality credit assessments of all obligations and issuers it rates.*

*When deciding whether to rate or continue rating an obligation or issuer, it should assess whether it is able to devote sufficient personnel with sufficient skill sets to make a proper rating assessment, and whether its personnel likely will have access to sufficient information needed in order to make such an assessment. A CRA should adopt reasonable measures so that the information it uses in assigning a rating is of sufficient quality to support a credible rating. If the rating involves a type of financial product presenting limited historical data (such as an innovative financial vehicle), the CRA should make clear, in a prominent place, the limitations of the rating.*

- 1.7-1 A CRA should establish a review function made up of one or more senior managers with appropriate experience to review the feasibility of providing a credit rating for a type of structure that is materially different from the structures the CRA currently rates.*
- 1.7-2 A CRA should establish and implement a rigorous and formal review function responsible for periodically reviewing the methodologies and models and significant changes to the methodologies and models it uses. Where feasible and appropriate for the size and scope of its credit rating services, this function should be independent of the business lines that are principally responsible for rating various classes of issuers and obligations.*
- 1.7-3 A CRA should assess whether existing methodologies and models for determining credit ratings of structured products are appropriate when the risk characteristics of the assets underlying a structured product change materially. In cases where the complexity or structure of a new type of structured product or the lack of robust data about the assets underlying the structured product raise serious questions as to whether the CRA can determine a credible credit rating for the security, CRA should refrain from issuing a credit rating.*
- 1.8 A CRA should structure its rating teams to promote continuity and avoid bias in the rating process.*

## **B. Monitoring and Updating**

- 1.9 A CRA should ensure that adequate personnel and financial resources are allocated to monitoring and updating its ratings. Except for ratings that clearly indicate they do not entail ongoing surveillance, once a rating is published the CRA should monitor on an ongoing basis and update the rating by:
  - a. regularly reviewing the issuer's creditworthiness;*
  - b. initiating a review of the status of the rating upon becoming aware of any information that might reasonably be expected to result in a rating action (including termination of a rating), consistent with the applicable rating methodology; and,**

- c. *updating on a timely basis the rating, as appropriate, based on the results of such review.*

*Subsequent monitoring should incorporate all cumulative experience obtained. Changes in ratings criteria and assumptions should be applied where appropriate to both initial ratings and subsequent ratings.*

- 1.9-1 *If a CRA uses separate analytical teams for determining initial ratings and for subsequent monitoring of structured finance products, each team should have the requisite level of expertise and resources to perform their respective functions in a timely manner.*
- 1.10 *Where a CRA makes its ratings available to the public, the CRA should publicly announce if it discontinues rating an issuer or obligation. Where a CRA's ratings are provided only to its subscribers, the CRA should announce to its subscribers if it discontinues rating an issuer or obligation. In both cases, continuing publications by the CRA of the discontinued rating should indicate the date the rating was last updated and the fact that the rating is no longer being updated.*

### **C. Integrity of the Rating Process**

- 1.11 *A CRA and its employees should comply with all applicable laws and regulations governing its activities in each jurisdiction in which it operates.*
- 1.12 *A CRA and its employees should deal fairly and honestly with issuers, investors, other market participants, and the public.*
- 1.13 *A CRA's analysts should be held to high standards of integrity, and a CRA should not employ individuals with demonstrably compromised integrity.*
- 1.14 *A CRA and its employees should not, either implicitly or explicitly, give any assurance or guarantee of a particular rating prior to a rating assessment. This does not preclude a CRA from developing prospective assessments used in structured finance and similar transactions.*
- 1.14-1 *A CRA should prohibit its analysts from making proposals or recommendations regarding the design of structured finance products that a CRA rates.*
- 1.15 *A CRA should institute policies and procedures that clearly specify a person responsible for a CRA's and a CRA's employees' compliance with the provisions of a CRA's code of conduct and with applicable laws and regulations. This person's reporting lines and compensation should be independent of a CRA's rating operations.*
- 1.16 *Upon becoming aware that another employee or entity under common control with the CRA is or has engaged in conduct that is illegal, unethical or contrary to the CRA's code of conduct, a CRA employee should report such information immediately to the individual in charge of compliance or*

*an officer of the CRA, as appropriate, so proper action may be taken. A CRA's employees are not necessarily expected to be experts in the law. Nonetheless, its employees are expected to report the activities that a reasonable person would question. Any CRA officer who receives such a report from a CRA employee is obligated to take appropriate action, as determined by the laws and regulations of the jurisdiction and the rules and guidelines set forth by the CRA. CRA management should prohibit retaliation by other CRA staff or by the CRA itself against any employees who, in good faith, make such reports.*

## **CRA INDEPENDENCE AND AVOIDANCE OF CONFLICTS OF INTEREST**

### **A. General**

- 2.1 *A CRA should not forbear or refrain from taking a rating action based on the potential effect (economic, political, or otherwise) of the action on the CRA, an issuer, an investor, or other market participant.*
- 2.2 *A CRA and its analysts should use care and professional judgment to maintain both the substance and appearance of independence and objectivity.*
- 2.3 *The determination of a credit rating should be influenced only by factors relevant to the credit assessment.*
- 2.4 *The credit rating a CRA assigns to an issuer or security should not be affected by the existence of or potential for a business relationship between the CRA (or its affiliates) and the issuer (or its affiliates) or any other party, or the non-existence of such a relationship.*
- 2.5 *A CRA should separate, operationally and legally, its credit rating business and CRA analysts from any other businesses of the CRA, including consulting businesses, that may present a conflict of interest. A CRA should ensure that ancillary business operations which do not necessarily present conflicts of interest with the CRA's rating business have in place procedures and mechanisms designed to minimize the likelihood that conflicts of interest will arise. A CRA should also define what it considers, and does not consider, to be an ancillary business and why.*

### **B. CRA Procedures and Policies**

- 2.6 *A CRA should adopt written internal procedures and mechanisms to (1) identify, and (2) eliminate, or manage and disclose, as appropriate, any actual or potential conflicts of interest that may influence the opinions and analyses a CRA makes or the judgment and analyses of the individuals a CRA employs who have an influence on ratings decisions. A CRA's code of conduct should also state that the CRA will disclose such conflict avoidance and management measures.*

- 2.7 *A CRA's disclosures of actual and potential conflicts of interest should be complete, timely, clear, concise, specific and prominent.*
- 2.8 *A CRA should disclose the general nature of its compensation arrangements with rated entities.*
- a. *Where a CRA receives from a rated entity compensation unrelated to its ratings service, such as compensation for consulting services, a CRA should disclose the proportion such non-rating fees constitute against the fees the CRA receives from the entity for ratings services.*
  - b. *A CRA should disclose if it receives 10 percent or more of its annual revenue from a single issuer, originator, arranger, client or subscriber (including any affiliates of that issuer, originator, arranger, client or subscriber).*
  - c. *CRAs as an industry should encourage structured finance issuers and originators of structured finance products to publicly disclose all relevant information regarding these products so that investors and other CRAs can conduct their own analyses independently of the CRA contracted by the issuers and/or originators to provide a rating. CRAs should disclose in their rating announcements whether the issuer of a structured finance product has informed it that it is publicly disclosing all relevant information about the product being rated or if the information remains non-public.*
- 2.9 *A CRA and its employees should not engage in any securities or derivatives trading presenting conflicts of interest with the CRA's rating activities.*
- 2.10 *In instances where rated entities (e.g., governments) have, or are simultaneously pursuing, oversight functions related to the CRA, the CRA should use different employees to conduct its rating actions than those employees involved in its oversight issues.*

### **C. CRA Analyst and Employee Independence**

- 2.11 *Reporting lines for CRA employees and their compensation arrangements should be structured to eliminate or effectively manage actual and potential conflicts of interest.*
- a. *A CRA's code of conduct should also state that a CRA analyst will not be compensated or evaluated on the basis of the amount of revenue that the CRA derives from issuers that the analyst rates or with which the analyst regularly interacts.*
  - b. *A CRA should conduct formal and periodic reviews of compensation policies and practices for CRA analysts and other employees who participate in or who might otherwise have an effect on the rating*

*process to ensure that these policies and practices do not compromise the objectivity of the CRA's rating process.*

- 2.12 *A CRA should not have employees who are directly involved in the rating process initiate, or participate in, discussions regarding fees or payments with any entity they rate.*
- 2.13 *No CRA employee should participate in or otherwise influence the determination of the CRA's rating of any particular entity or obligation if the employee:*
- a. Owns securities or derivatives of the rated entity, other than holdings in diversified collective investment schemes;*
  - b. Owns securities or derivatives of any entity related to a rated entity, the ownership of which may cause or may be perceived as causing a conflict of interest, other than holdings in diversified collective investment schemes;*
  - c. Has had a recent employment or other significant business relationship with the rated entity that may cause or may be perceived as causing a conflict of interest;*
  - d. Has an immediate relation (i.e., a spouse, partner, parent, child, or sibling) who currently works for the rated entity; or*
  - e. Has, or had, any other relationship with the rated entity or any related entity thereof that may cause or may be perceived as causing a conflict of interest.*
- 2.14 *A CRA's analysts and anyone involved in the rating process (or their spouse, partner or minor children) should not buy or sell or engage in any transaction in any security or derivative based on a security issued, guaranteed, or otherwise supported by any entity within such analyst's area of primary analytical responsibility, other than holdings in diversified collective investment schemes.*
- 2.15 *CRA employees should be prohibited from soliciting money, gifts or favors from anyone with whom the CRA does business and should be prohibited from accepting gifts offered in the form of cash or any gifts exceeding a minimal monetary value.*
- 2.16 *Any CRA analyst who becomes involved in any personal relationship that creates the potential for any real or apparent conflict of interest (including, for example, any personal relationship with an employee of a rated entity or agent of such entity within his or her area of analytic responsibility), should be required to disclose such relationship to the appropriate manager or officer of the CRA, as determined by the CRA's compliance policies.*

- 2.17 *A CRA should establish policies and procedures for reviewing the past work of analysts that leave the employ of the CRA and join an issuer the CRA analyst has been involved in rating, or a financial firm with which the CRA analyst has had significant dealings as part of his or her duties at the CRA.*

### **3. CRA RESPONSIBILITIES TO THE INVESTING PUBLIC AND ISSUERS**

#### **A. Transparency and Timeliness of Ratings Disclosure**

- 3.1 *A CRA should distribute in a timely manner its ratings decisions regarding the entities and securities it rates.*
- 3.2 *A CRA should publicly disclose its policies for distributing ratings, reports and updates.*
- 3.3 *A CRA should indicate with each of its ratings when the rating was last updated. Each rating announcement should also indicate the principal methodology or methodology version that was used in determining the rating and where a description of that methodology can be found. Where the rating is based on more than one methodology, or where a review of only the principal methodology might cause investors to overlook other important aspects of the rating, the CRA should explain this fact in the ratings announcement, and indicate where a discussion of how the different methodologies and other important aspects factored into the rating decision.*
- 3.4 *Except for “private ratings” provided only to the issuer, the CRA should disclose to the public, on a non-selective basis and free of charge, any rating regarding publicly issued securities, or public issuers themselves, as well as any subsequent decisions to discontinue such a rating, if the rating action is based in whole or in part on material non-public information.*
- 3.5 *A CRA should publish sufficient information about its procedures, methodologies and assumptions (including financial statement adjustments that deviate materially from those contained in the issuer’s published financial statements and a description of the rating committee process, if applicable) so that outside parties can understand how a rating was arrived at by the CRA. This information will include (but not be limited to) the meaning of each rating category and the definition of default or recovery, and the time horizon the CRA used when making a rating decision.*
- a. *Where a CRA rates a structured finance product, it should provide investors and/or subscribers (depending on the CRA’s business model) with sufficient information about its loss and cash-flow analysis so that an investor allowed to invest in the product can understand the basis for the CRA’s rating. A CRA should also disclose the degree to which*

*it analyzes how sensitive a rating of a structured finance product is to changes in the CRA's underlying rating assumptions.*

- b. A CRA should differentiate ratings of structured finance products from traditional corporate bond ratings, preferably through a different rating symbology. A CRA should also disclose how this differentiation functions. A CRA should clearly define a given rating symbol and apply it in a consistent manner for all types of securities to which that symbol is assigned.*
  - c. A CRA should assist investors in developing a greater understanding of what a credit rating is, and the limits to which credit ratings can be put to use vis-à-vis a particular type of financial product that the CRA rates. A CRA should clearly indicate the attributes and limitations of each credit opinion, and the limits to which the CRA verifies information provided to it by the issuer or originator of a rated security.*
- 3.6 When issuing or revising a rating, the CRA should explain in its press releases and reports the key elements underlying the rating opinion.*
- 3.7 Where feasible and appropriate, prior to issuing or revising a rating, the CRA should inform the issuer of the critical information and principal considerations upon which a rating will be based and afford the issuer an opportunity to clarify any likely factual misperceptions or other matters that the CRA would wish to be made aware of in order to produce an accurate rating. A CRA will duly evaluate the response. Where in particular circumstances the CRA has not informed the issuer prior to issuing or revising a rating, the CRA should inform the issuer as soon as practical thereafter and, generally, should explain the reason for the delay.*
- 3.8 In order to promote transparency and to enable the market to best judge the performance of the ratings, the CRA, where possible, should publish sufficient information about the historical default rates of CRA rating categories and whether the default rates of these categories have changed over time, so that interested parties can understand the historical performance of each category and if and how rating categories have changed, and be able to draw quality comparisons among ratings given by different CRAs. If the nature of the rating or other circumstances make a historical default rate inappropriate, statistically invalid, or otherwise likely to mislead the users of the rating, the CRA should explain this. This information should include verifiable, quantifiable historical information about the performance of its rating opinions, organized and structured, and, where possible, standardized in such a way to assist investors in drawing performance comparisons between different CRAs.*
- 3.9 For each rating, the CRA should disclose whether the issuer participated in the rating process. Each rating not initiated at the request of the issuer should be identified as such. A CRA should also disclose its policies and procedures regarding unsolicited ratings.*

3.10 *Because users of credit ratings rely on an existing awareness of CRA methodologies, practices, procedures and processes, the CRA should fully and publicly disclose any material modification to its methodologies and significant practices, procedures, and processes. Where feasible and appropriate, disclosure of such material modifications should be made prior to their going into effect. A CRA should carefully consider the various uses of credit ratings before modifying its methodologies, practices, procedures and processes.*

## **B. The Treatment of Confidential Information**

3.11 *A CRA should adopt procedures and mechanisms to protect the confidential nature of information shared with them by issuers under the terms of a confidentiality agreement or otherwise under a mutual understanding that the information is shared confidentially. Unless otherwise permitted by the confidentiality agreement and consistent with applicable laws or regulations, the CRA and its employees should not disclose confidential information in press releases, through research conferences, to future employers, or in conversations with investors, other issuers, other persons, or otherwise.*

3.12 *A CRA should use confidential information only for purposes related to its rating activities or otherwise in accordance with any confidentiality agreements with the issuer.*

3.13 *CRA employees should take all reasonable measures to protect all property and records belonging to or in possession of the CRA from fraud, theft or misuse.*

3.14 *CRA employees should be prohibited from engaging in transactions in securities when they possess confidential information concerning the issuer of such security.*

3.15 *In preservation of confidential information, CRA employees should familiarize themselves with the internal securities trading policies maintained by their employer, and periodically certify their compliance as required by such policies.*

3.16 *CRA employees should not selectively disclose any non-public information about rating opinions or possible future rating actions of the CRA, except to the issuer or its designated agents.*

3.17 *CRA employees should not share confidential information entrusted to the CRA with employees of any affiliated entities that are not CRAs. CRA employees should not share confidential information within the CRA except on an "as needed" basis.*

3.18 *CRA employees should not use or share confidential information for the purpose of trading securities, or for any other purpose except the conduct of the CRA's business.*

**4. DISCLOSURE OF THE CODE OF CONDUCT AND COMMUNICATION WITH MARKET PARTICIPANTS**

- 4.1 *A CRA should disclose to the public its code of conduct and describe how the provisions of its code of conduct fully implement the provisions of the IOSCO Principles Regarding the Activities of Credit Rating Agencies and the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies. If a CRA's code of conduct deviates from the IOSCO provisions, the CRA should explain where and why these deviations exist, and how any deviations nonetheless achieve the objectives contained in the IOSCO provisions. A CRA should also describe generally how it intends to enforce its code of conduct and should disclose on a timely basis any changes to its code of conduct or how it is implemented and enforced.*
- 4.2 *A CRA should establish a function within its organization charged with communicating with market participants and the public about any questions, concerns or complaints that the CRA may receive. The objective of this function should be to help ensure that the CRA's officers and management are informed of those issues that the CRA's officers and management would want to be made aware of when setting the organization's policies.*
- 4.3 *A CRA should publish in a prominent position on its home webpage links to (1) the CRA's code of conduct; (2) a description of the methodologies it uses; and (3) information about the CRA's historic performance data.*



