

ESMA Brief - 2010

Evaluation of Japanese Legal and Supervisory Framework on Credit Rating Agencies (governance)

The given content predominantly revolves around the assessment of the Japanese legal and supervisory framework's equivalency to the EU regulatory body, focusing on credit rating agencies. The chief areas of interest are: the scope of regulation and supervision, corporate governance, management of conflicts of interest, and thorough regulations for credit rating agencies. The EU regulation's comprehensive stipulations encompass an agency's organization, necessary procedures, corporate governance, employee competency, and the publishing of ratings. When comparing the legal requirements of third-country credit rating agencies, priority lies in maintaining integrity, transparency, good governance, and the reliability of credit rating activities, resulting in equivalent protections for EU rating users. The corporate governance section pays special attention to ensuring management's accountability for independent credit ratings activities, proper conflict of interest management, and compliance with the legal requirements of the regulatory framework. In comparing corporate governance requirements outside the EU, some form of accountability within senior management is required for assessing equivalence.

Ensuring Confidentiality and Robust Management in Credit Rating Agencies (confidentiality)

The primary focus of the document is the enforcement of secure and confidential management of trade and credit rating information by agencies providing financial services. EU regulatory guidelines entrust this task specifically to credit rating agencies and their employees who deal directly with credit rating activities. To maintain confidentiality and prevent information leakage, systems and measures have been put into place for managing access and preventing unauthorized outside access. Alongside these confidentiality measures, organizational requirements such as outsourcing, record keeping, and methodology quality are also established. Credit rating agencies are also required to train employees, prevent false representation of assessment results, and appropriately manage customer complaints among other duties. This ensures the fair and adequate execution of the credit rating business. Measures to prevent conflicts of interest and remuneration policies that don't affect business execution have also been set forth. The summary of requirements results in four main categorizations: general organizational requirements, outsourcing, confidentiality, and record keeping.

Assessment of MiFID Investment Firms' Organisational Requirements and Scope (environment)

The CESR asserts the necessity for MiFID investment firms to have specific organisational requirements which will ensure the compatibility of new products and services with client needs, compliance with disclosure and suitability rules, risk containment, and regular performance reviews. Likewise, it emphasizes the need for policies to manage the risks associated with these products and services. There are considerations to retain pre-trade transparency and migrate towards a more "rule-based" approach as opposed to a "principle-

based” approach for exemptions. The CESR also recognises the potential risks presented by High-Frequency Trading (HFT) firms such as systemic risks, increased market abuse, sudden liquidity withdrawal, and price de-correlation. It contends that more comprehensive guidelines for systems and controls are required in a highly automated trading environment. This includes the necessity for a secure working environment, confidentiality, unauthorised surveillance prevention, breach notification policies, and APA service controls. It further emphasizes the need for investment firms to regularly review the distribution and performance of their products and services. The CESR is also noting the need for adjustments in trade transparency on bonds, additional obligatory and non-compulsory obligations, an emphasized focus on evaluating global regulatory environments, and commitments to the MiFID review on secondary markets.

Regulatory Oversight and Internal Controls in Investment Firms and Credit Rating Agencies (internal controls)

The content discusses the critical role of effective regulatory oversight and internal control mechanisms in investment firms and credit rating agencies (CRAs). It indicates the possibility of future guidelines concerning investment firms' supervision over tied agents. The role of intermediary monitoring in ensuring compliance and suitability is emphasized, along with how the regulatory framework ensures outsourced functions do not affect the quality of internal controls.

The role of the supervisory board, particularly independent members, in monitoring credit rating policy, the quality control system, and conflict-of-interest measures is detailed. Requirements like the prohibition of consultative services by a CRA, adherence to stringent rotation policies, and maintaining an independent compliance function are clarified. Moreover, the document specifies conditions for third country outsourced functions, ensuring outsourced functions don't impair internal controls and the authority's supervisory capability. Possible new laws are also referenced, suggesting future rules requiring credit rating agencies to adopt specific oversight procedures and improve internal controls. Lastly, it's suggested that regulatory bodies will assess and confirm the equivalence of these protective measures. This continued evaluation and monitoring of these internal control systems will serve to protect investor interests and the financial markets at large.

Confidentiality and Regulatory Compliance in Credit Rating Activities (fraud)

The focus is on the adherence to regulatory standards related to handling confidential information in credit rating activities. Both EU and U.S regulations demand that credit rating agencies protect their data and records from fraud, theft, and misuse. This includes not disclosing or incorrectly using credit rating information for trading or non-rating-related activities. The regulators also highlight the significance of deterring illicit activities to protect market integrity. Particular attention is given to the Madoff fraud case in 2008, where credit rating agencies and regulators are working to provide protection and clarity to European investors. In response to such scandals, regulators are also scrutinizing the duties and responsibilities of depositaries in an effort to further tighten security.

Management of Conflicts of Interest in EU Regulation and Recommendations for Enhancement (objectivity)

This paragraph addresses CESR's evaluation of the EU regulations concerning management of conflicts of interest in credit rating activities. The primary objectives are objectivity, independence, integrity, quality, and transparency of credit ratings to ensure investor and financial market protection. An opinion from one member state (PT) is mentioned, emphasizing that regulations would be more effective if transactions by the recommendation issuer are disclosed, allowing investors to judge the objectivity of the recommendation and potential interests of the responsible party. Concerns over threats to auditors' independence and objectivity when integrating internal audit function into external audits were noted. It calls for a stringent evaluation of objectivity, competence, and approach of internal auditors and recommends that internal auditors' work should only be used when a high degree of objectivity and competence is present.

Regulatory Compliance and Ethics in Credit Rating Agencies (ethics)

The text outlines the essential guidelines to be followed by Credit Rating Agencies (CRAs) for legal compliance and operational control systems. These include procedures for ensuring CRAs treat legal compliance as a priority for management, have established a robust policy for hiring qualified personnel with professional ethics, implemented measures to prevent misuse of non-public information and avoid conflicts of interest. CRAs are also expected to develop a code of ethics or provide reasons for its absence and these details should be made available on their application for registration as a Nationally Recognized Statistical Rating Organization (NRSRO). Further, the agencies should disclose significant information like their credit rating methodologies, performance statistics over different time periods, and policies for managing conflicts of interest. These instructions highlight the importance of transparency and adherence to ethical standards within CRAs to ensure fair and accurate credit rating activities.

Enhancing Competition and Innovation on Trading Platforms through MiFID (innovation)

MiFID's key objective is to stimulate competition leading to enhanced investor choice, innovative developments, reduced transaction cost, and efficiency in price formation across Europe. However, criticisms arise from industry players about the waivers, perceived to be excessively narrow and stifling innovation. Authorities have proposed a dynamic transparency regime that responds to innovation and market developments. The new framework covers pre-trade transparency requirements on organized markets with allowances for exceptions, and a rule-based approach for waivers to bring clarity and facilitate ongoing regulatory convergence in response to financial innovation. Flexibility remains crucial in adjusting to market changes, while over-restrictive waivers may limit innovation and market development. To improve external control, investment firms should provide periodic reports on new products and financial innovations to firms' senior management and regulators. Concerns have been raised post-MiFID implementation regarding pre- and post-trade transparency on equity markets and their impact on innovation. The pro-competitive model under MiFID encourages innovation and requires a comprehensive approach in monitoring financial innovation and associated risks. Furthermore, competent authorities should be aware of trades involving financial instruments in a globalized market. Due to emerging financial product innovations, certain financial instruments are considered a potential source for market abuse. Adjusting reporting obligations to address market innovations without resorting to revisiting the directive is deemed essential.

Strengthening Accountability and Transparency in The Credit Rating and Securities Sectors (accountability)

The pursuit of strengthening accountability, transparency, and competition in the credit rating industry is shared by both the EU and US. This goal behind reform acts and proposals like the 'Rating Agency Act', 'Restoring American Financial Stability Act', and 'Wall Street Reform and Consumer Protection Act' aim to protect investors, facilitate normal market functions, and improve credibility of enforcement process. The strategies differ, with the US focusing more on upfront disclosure and market autonomy. The supervision of senior management is emphasized with annual attestations, board approval of methodologies, and direct reporting lines to the board for compliance officers. Amendments are being proposed to enhance the accountability and independence of the compliance officer. Regulatory transparency in securities and audit firms is also urged to foster confidence in markets, and a % requirement for individual comparisons of rating performances to foster transparency and competition.

Adaptation of Investment Firms to MTF Definition and Impact on Business Models (business model)

Investment firms operating internal crossing systems in certain jurisdictions are modifying their business models to fit the Multilateral Trading Facility (MTF) definition. It's stressed that this does not indicate a skew in the waiver application but reflects the differing business models of Regulated Markets (RMs) and MTFs across member states. With its emphasis on maximum trading information disclosure, MiFID acknowledges that the same level of transparency may not suit all business models. In contrast, the definition's scope is broad and aims to encapsulate all business models, including subscription-based ones. It further lists possible conflicts of interest that may befall a credit rating agency due to its business model. Recent amendments to the SEC rules have strengthened the disclosure requirement for credit rating actions, irrespective of the business model chosen by the Nationally Recognized Statistical Rating Organization (NRSRO). Reporting this type of data breakdown is beneficial to regulators for understanding the risk profile, business model, overall exposure, and systemic risks posed by regulated financial firms. Management companies may delegate activities based on their business model, provided they comply with certain constraints.

Evolving Financial Technology and Regulatory Landscape (technology)

The text suggests a growing interest in High-Frequency Trading (HFT) due to falling costs, increased adoption of advanced trading strategies, and technological advancements, including algorithmic trading and smart order routing. It also suggests an increasing competition and consolidation among exchanges, along with improved financial technologies. Similarly, there's an observed change in the legal framework surrounding financial regulation, unveiling the weaknesses of the European system and the efforts being made towards redesigning legislation. Meanwhile, the emergence of the CESR-TECH as an IT governance expert group signifies the importance of IT governance in the sector. External factors such as trading fees, order sizes, and investments in technology have affected trading environment. Strides are also being taken in e-learning in the financial sector, such as the launch of an IFRS course by ICAI's IT committee. Key financial terminologies and principles were also enumerated. The use of information technology in executing client orders and providing portfolio management services was identified as a good practice.

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