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Konrad Reuss
Managing Director

Unit 4, 1 Melrose Boulevard
Melrose Arch
Johannesburg,
South Africa 111112

027-11-2141-990
Konrad_reuss@standardandpoors.com

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Mr Mufimadi MP, ST on Finance

Att: Mr A Wicomb

Parliament of RSA

awicomb@parliament.gov.za

Standard & Poor's Ratings Services South Africa memorandum to the Standing Committee on Finance in relation to the Credit Rating Services Bill of 2012

In South Africa, Standard & Poor's Ratings Services operates through a branch of Standard & Poor's Credit Market Services Europe Limited ("*S&P CMS Europe*"). S&P CMS Europe is established in the United Kingdom and registered with the European Securities and Markets Authority ("*ESMA*") under Regulation (EC) 1060/2009 on Credit Rating Agencies (the "*EU CRA Regulation*"). Standard & Poor's Ratings Services is also registered and subject to supervision in key jurisdictions including Australia, Hong Kong, Japan, Singapore and the United States.

S&P South Africa (the South African branch of S&P CMS Europe) welcomes the opportunity to provide its comments to the Standing Committee on Finance in relation to the Credit Rating Services Bill of 2012 [B8-2012] (the "*Bill*"). In this memorandum, we reiterate comments initially made in response to the Credit Rating Services Bill as released for public comment by the National Treasury on 4 August 2011 ("*August 2011 Draft Bill*").

We believe that regulation can play an important part in building confidence in credit ratings and we welcome proposals that would, on a globally consistent basis, increase transparency and preserve the analytical independence of CRAs' opinions, methodologies and analytical processes.

We appreciate National Treasury's stated objective in the August 2011 Draft Bill of "*align[ing] the South African regulation of CRAs with international best standards and practice, including the IOSCO CRA Principles, G-20 countries' regulation and the EU's equivalency requirement*". We welcome that the Bill recognises the need for safeguarding the analytical independence of CRAs by prohibiting interference with credit ratings and methodologies.

However, we do not believe that all the proposals set out in the Bill are proportionate to the size of the debt market in South Africa. The proposals also do not yet satisfactorily address the situation where global CRAs operate small offices in South Africa. S&P South Africa currently has three staff, but is part of a large global CRA as we have described above. Moreover, some of the proposals as set out in the Bill are not consistent with regulatory best practice as we understand it.

More specifically, we consider that the Bill has a considerably wider scope and contains more prescriptive detail than CRA oversight frameworks in other jurisdictions such as Australia, Brazil, Canada, Hong Kong and Singapore. The CRA oversight regimes in those countries

have been deemed by ESMA to be in line with European Union rules[1] – one of the most comprehensive CRA oversight regimes.

Fit and proper requirements for employees (Chapter 2, Section (5)(1)(d))

We question the need for imposing fit and proper requirements on individual employees of CRAs as set out in Section (5)(1)(d).

The Code of Conduct Fundamentals for Credit Rating Agencies set out by the International Organization of Securities Commissions (the "*IOSCO Code*") provides that analysts should be held to high standards of integrity and a CRA should not employ individuals with demonstrably compromised integrity. S&P Ratings Services requires all employees to comply with the S&P Ratings Services Code of Conduct and related policies, procedures and guidelines. Employees are required to formally affirm their compliance with the Code and related documents. Failure to comply with company policies, procedures and guidelines may result in disciplinary action, up to and including termination of employment. S&P Ratings Services is committed to the ongoing education and development of its credit rating analysts and in 2009 we introduced an Analytical Certification Programme which all analysts must pass in order to act as a primary analyst on a rating or to vote in a rating committee.

Rather than inappropriately requiring CRA analysts and other employees to meet broad fit and proper requirements, an alternative approach is to require that CRAs demonstrate to the Registrar how analysts maintain high standards of training and how analysts and other employees are held to high standards of integrity.

Endorsement of External Credit Ratings (Chapter 4, Section 18)

An endorsement regime has been established by the EU Regulation as a mechanism for permitting the use – in the EU for regulatory purposes - of credit ratings issued in third countries, which is designed to allow a CRA established in the EU to endorse such a rating provided that certain conditions are complied with. The EU endorsement regime is particular to the EU.

We consider that the endorsement regime currently proposed in South Africa (as set out in Chapter 4) gives rise to considerable uncertainty as to its application and would be very difficult to operate in practice. If established in South Africa, it would require a registered CRA to verify and be able to demonstrate on an ongoing basis that the third country CRA conducts its credit rating activities in compliance with requirements that are "equivalent" to certain specified requirements under the Bill, including the requirements on conflicts avoidance, monitoring and reviewing its existing credit ratings and disclosures.

On an ongoing basis, whilst the endorsement is in force, endorsement will be extremely onerous as detailed compliance by the third country CRA may be difficult to ascertain, monitor and enforce by the South African CRA. In addition, the proposed endorsement regime provisions also require the third country CRA to be subject to a regulatory regime in its home country and for co-operation agreements between the third country regulator and the FSB to be in place. These requirements are entirely outside a CRA's control.

[1] Such determinations allow EU financial institutions to use credit ratings issued in those countries for regulatory purposes.

The endorsement regime will effectively promote double supervision (i.e. by the registrar and the third country regulator) which is not only unnecessary but also an inefficient use of resources. In practice, this seems to apply the Bill extra-territorially. The setting up of an operational framework to adequately address endorsement requirements would put a considerable strain on resources and is wholly disproportionate given the size of local markets including the size of S&P South Africa. This in turn could ultimately lead to inefficiencies, market dysfunctions and constraints on capital flow.

This is particularly relevant in the South African context where there is a high reliance on accessing foreign markets for funding. We can see no demonstrable benefit for adding to the regulatory burden in that way.

In all, we consider that the endorsement regime as set out in Chapter 4 of the Bill is wholly inappropriate for South Africa and contradicts the purpose of the Bill. We therefore respectfully suggest that the Standing Committee on Finance consider removing this Chapter from the Bill or amending it substantially. For substantial amendment, it could be considered for example, to allow for exemptions of this endorsement regime for a CRA such as S&P South Africa that is part of a global CRA group which is already subject to an endorsement regime elsewhere.

ESMA has now established that the CRA oversight regimes in Argentina, Australia, Brazil, Canada, Hong Kong, Japan, Mexico, Singapore and the United States are equivalent to the requirements of the EU CRA Regulation. If the National Treasury or the registrar were to determine that the requirements of EU CRA Regulation were equivalent to those of the Bill, then the credit ratings endorsed by the EU based CRA (S&P CMS Europe in our case) would automatically meet the equivalence test for South Africa. Correspondingly, it should suffice for the registrar to make an equivalence assessment of the EU CRA Regulation and to agree a cooperation agreement with ESMA, so that the registrar and the CRA can meet the objectives of Chapter 4 without substantial unnecessary burden.

Liability of credit rating agencies (Chapter 5, Section 19)

CRAs are legally accountable in the same way as other market participants. Any business that intentionally misleads or defrauds investors can be held liable under securities fraud laws, and CRAs are no exception.

CRAs should not be subject to discriminatory or higher standards of liability relative to other market participants. Otherwise, new ratings providers may be discouraged from entering the market and ratings may be restricted for riskier credits.

Any private rights of action against CRAs that may nonetheless be passed under the Draft Bill should be limited to material breaches of the applicable legislation and regulation. Inevitably, minor breaches may occur and be remedied through dialogue with the registrar. It would not be justified for any such minor breach to create a threat of potential law suit from private third parties.

Liability towards third parties should only result from a material failure to have in place appropriate processes and control systems, provided that such material breach caused a loss to the plaintiff in accordance with the general rules of South African law.

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Prohibiting limitation clauses and disclaimers is unnecessary and would be discriminatory as the principle of contractual freedom allows the parties to provide for clauses excluding or limiting their liability.

In our understanding, other participants in the finance industry are allowed to exclude or limit their liability by contract: auditors, investment banks, asset managers etc. The proposed prohibition would constitute a discrimination compared with these other sectors. It would also mean that CRAs can be sued more easily than other parties who actually participate in the underwriting and sale of debt securities, unlike CRAs who are independent opinion-givers.

Limitation of liability is also necessary, and acknowledged by other CRA regulations such as in the EU Regulations, given CRAs' reliance in rating analysis on third party information provided by issuers and their agents and advisors. CRAs do not perform an audit or verification of this information and therefore rely upon others for its accuracy or completeness. The provision of accurate and reliable information is a fundamental obligation of the issuer under the rating agreement.

Conclusion

On behalf of S&P South Africa, I appreciate the opportunity to provide our views to the Standing Committee on Finance, and regret not being able to attend in person the public hearing on 29 May 2012. Please feel free to contact me or Christopher Lake, Senior European Regulatory Counsel, on +44 20 7176 3176 or by email at christopher_lake@standardandpoors.com if you require any further information.

Yours sincerely,

Konrad Reuss,

Managing Director