Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets

As Required by
Section 702(b) of the
Sarbanes-Oxley Act of 2002

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REPORT ON THE ROLE AND FUNCTION OF CREDIT RATING AGENCIES IN THE OPERATION OF THE SECURITIES MARKETS

As Required by Section 702(b) of the Sarbanes-Oxley Act of 2002

EXECUTIVE SUMMARY

The Securities and Exchange Commission ("Commission" or "SEC") has prepared this Report on the role and function of credit rating agencies in the operation of the securities markets in response to the Congressional directive contained in the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley Act").[1] The Report is designed to address each of the topics identified for Commission study in the Sarbanes-Oxley Act, including the role of credit rating agencies and their importance to the securities markets, impediments faced by credit rating agencies in performing that role, measures to improve information flow to the market from rating agencies, barriers to entry into the credit rating business, and conflicts of interest faced by rating agencies. As the report called for by the Sarbanes-Oxley Act coincided with a review of credit rating agencies already underway at the Commission, the Report addresses certain issues regarding rating agencies, such as allegations of anticompetitive or unfair practices, the level of diligence of credit rating agencies, and the extent and manner of Commission oversight, that go beyond those specifically identified in the Sarbanes-Oxley Act.

While the Commission has made significant progress in its review of credit rating agencies, and identified a wide range of issues that deserve further study, much work remains to be done. Accordingly, the Commission plans to publish a concept release within 60 days of this Report to address concerns related to credit rating agencies and expects to issue proposed rules, after reviewing and evaluating the comments received on the concept release, within a reasonable period of time after the close of the comment period.[2] The Commission hopes to elicit extensive comments on these issues, from market participants, other regulators, and the public at large.

The issues to be studied by the Commission in more depth include the following:

<u>Information Flow</u>

- Whether rating agencies should disclose more information about their ratings decisions.

- Whether there should be improvements to the extent and quality of disclosure by issuers (including disclosures relating to ratings triggers).

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[1] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 702(b), 116 Stat. 745 (2002).

[2] The Commission is mindful that some of the concepts discussed in this report may raise questions about the limits of the Commission's authority. We will, of course, consider those issues carefully.

Potential Conflicts of Interest

- Whether rating agencies should implement procedures to manage potential conflicts of interest that arise when issuers pay for ratings.

- Whether rating agencies should prohibit (or severely restrict) direct contacts between rating analysts and subscribers.

- Whether rating agencies should implement procedures to manage potential conflicts of interest that arise when rating agencies develop ancillary fee-based businesses.

Alleged Anticompetitive or Unfair Practices

- The extent to which allegations of anticompetitive or unfair practices by large credit rating agencies have merit and, if so, possible Commission action to address them.

Reducing Potential Regulatory Barriers to Entry

- Whether the current regulatory recognition criteria for rating agencies should be clarified.

- Whether timing goals for the evaluation of applications for regulatory recognition should be instituted.

- Whether rating agencies that cover a limited sector of the debt market, or confine their activity to a limited geographic area, should be recognized for regulatory purposes.

- Whether there are viable alternatives to the recognition of rating agencies in Commission rules and regulations.

Ongoing Oversight

- Whether more direct, ongoing oversight of rating agencies is warranted and, if so, the appropriate means for doing so (and whether it is advisable to ask Congress for specific legislative oversight authority).

- Whether rating agencies should incorporate general standards of diligence in performing their ratings analysis, and with respect to the training and qualifications of credit rating analysts.

I. INTRODUCTION

Section 702 of the Sarbanes-Oxley Act requires the Commission to conduct a study of the role and function of credit rating agencies in the operation of the securities markets, and to submit a report on that study to the President, the Committee on Financial Services of the House of Representatives, and the Committee on Banking, Housing, and Urban Affairs of the Senate not later than January 26, 2003. This Report has been prepared in response to that requirement.

A primary purpose of the Sarbanes-Oxley Act is to assure the integrity of the United States capital markets and restore investor confidence in the wake of recent financial scandals.[3] Among other things, the Sarbanes-Oxley Act directs the Commission to examine the following:

(A) the role of credit rating agencies in the evaluation of issuers of securities;

(B) the importance of that role to investors and the functioning of the securities markets;

(C) any impediments to the accurate appraisal by credit rating agencies of the financial resources and risks of issuers of securities;

(D) any barriers to entry into the business of acting as a credit rating agency, and any measures needed to remove such barriers;

(E) any measures which may be required to improve the dissemination of information concerning such resources and risks when credit rating agencies announce credit ratings; and

(F) any conflicts of interest in the operation of credit rating agencies and measures to prevent such conflicts or ameliorate the consequences of such conflicts.

Congress itself also has been reviewing issues relating to credit rating agencies. In March 2002, for example, the Senate Committee on Governmental Affairs ("Senate Committee") held hearings to determine how the credit rating agencies could have rated Enron Corporation ("Enron") as a good credit risk until just four days before the company declared bankruptcy.[4] In October 2002, the staff of the Senate Committee issued a report (the "Staff Report")[5] containing the results of its investigation into, among

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[3] *See* Letter from Paul S. Sarbanes, Chairman, U.S. Senate Committee on Banking, Housing, and Urban Affairs, to President George W. Bush (October 18, 2002).

[4] *Rating the Raters: Enron and the Credit Rating Agencies, Hearings Before the Senate Committee on Governmental Affairs,* 107th Cong. 471 (March 20, 2002) [hereinafter the "Enron Hearings"].

[5] Report of the Staff of the Senate Committee on Governmental Affairs: "Financial Oversight of Enron: The SEC and Private-Sector Watchdogs," S. Prt. 107-75 (October 7, 2002).

other things, the actions of certain credit rating agencies that monitored the financial activities of Enron in the years prior to its collapse. The Staff Report concluded that, in the case of Enron, the credit rating agencies displayed a disappointing lack of diligence in their coverage and assessment of that company. In addition, the Staff Report found that, because the credit rating agencies are subject to little formal regulation or oversight, and their liability traditionally has been limited by regulatory exemptions and First Amendment protections, there is little to hold them accountable for future poor performance. As a result, the Staff Report recommended that the Commission, among other things, require recognized rating agencies to comply with specified performance and training standards and regularly monitor their compliance with those standards.

The issues reviewed in the Staff Report, as well as the study required by the Sarbanes-Oxley Act, are consistent with recent Commission initiatives to review the role of rating agencies in the U.S. securities markets and their regulatory treatment.[6] The Commission recognized that, in recent years, the importance of credit ratings to investors and other market participants had increased significantly, impacting an issuer's access to and cost of capital, the structure of financial transactions, and the ability of fiduciaries and others to make particular investments. In light of this increased importance, the Commission had commenced a review of the use of credit ratings in federal securities laws, the process of determining which credit ratings should be used for regulatory purposes, and the level of oversight to apply to recognized rating agencies.

The Commission pursued several approaches, both formal and informal, to conduct a thorough and meaningful study of credit rating agencies. These efforts included informal discussions with credit rating agencies and market participants, formal examinations of credit rating agencies, and public hearings, where market participants were given the opportunity to offer their views on credit rating agencies and their role in the capital markets.

Part II of this Report contains a background discussion of credit rating agencies, and how credit ratings have become incorporated into the current regulatory framework. Part III describes in more detail recent Congressional and Commission initiatives to review the role of credit rating agencies in the U.S. securities markets. A detailed discussion of each of the topics Congress directed the Commission to examine in Section 702 of the Sarbanes-Oxley Act is contained in Part IV. Finally, Part V sets forth a range of issues regarding the role and function of credit rating agencies in the operation of the securities markets that the Commission intends to explore in more depth.

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[6] *See* Enron Hearings, *supra* note 4 (testimony of Commissioner Isaac C. Hunt, Jr.).

II. BACKGROUND

A. General

In essence, a credit rating reflects a rating agency's opinion, as of a specific date, of the creditworthiness of a particular company, security, or obligation. For almost a century, credit rating agencies have been providing opinions on the creditworthiness of issuers of securities and their financial obligations. During this time, the importance of these opinions to investors and other market participants, and the influence of these opinions on the securities markets, have increased significantly. This is due in part to the increase in the number of issuers and the advent of new and complex financial products, such as asset-backed securities and credit derivatives. The globalization of the financial markets also has served to expand the role of credit ratings to countries other than the United States, where the reliance on credit ratings largely was confined for the first half of the twentieth century. Today, credit ratings affect securities markets in many ways, including an issuer's access to capital, the structure of transactions, and the ability of fiduciaries and others to make particular investments.

During the past 30 years, regulators, including the Commission, have increasingly used credit ratings to help monitor the risk of investments held by regulated entities, and to provide an appropriate disclosure framework for securities of differing risks. Since 1975, the Commission has relied on ratings by market-recognized credible rating agencies for distinguishing among grades of creditworthiness in various regulations under the federal securities laws. These "nationally recognized statistical rating organizations," or "NRSROs," are recognized as such by Commission staff through the no-action letter process. There currently are three NRSROs – Moody's Investors Service, Inc. ("Moody's"), Fitch, Inc. ("Fitch"), and the Standard and Poor's Division of the McGraw-Hill Companies Inc. ("S&P"). Although the Commission originated the use of the term "NRSRO" in regulation, ratings by NRSROs today are widely used as benchmarks in federal and state legislation, rules issued by financial and other regulators, foreign regulatory schemes, and private financial contracts.

In recent years, the Commission and Congress have reviewed a number of issues regarding credit rating agencies and, in particular, the need for greater regulatory oversight of them. As discussed in detail in Section II.C. below, in 1994, the Commission issued a Concept Release soliciting public comment on the appropriate role of ratings in the federal securities laws, and the need to establish formal procedures for recognizing and monitoring the activities of NRSROs.[7] That Concept Release led to a rule proposal in 1997 which, among other things, would have defined the term "NRSRO" in Rule 15c3-1 under the Securities Exchange Act of 1934 ("Exchange Act"),[8] the

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[7] *See* Nationally Recognized Statistical Rating Organizations, Release No. 34-34616 (August 31, 1994), 59 FR 46314 (September 7, 1994) [hereinafter the "Concept Release"].

[8] *See* Capital Requirements for Brokers or Dealers Under the Securities Exchange Act of 1934, Release No. 34-39457 (December 17, 1997), 62 FR 68018 (December 30, 1997) [hereinafter the "Proposing Release"].

Commission's net capital rule (the "Net Capital Rule"). However, due to concerns regarding, among other things, the standards defining the term "NRSRO," and the initiation of broad-based Commission and Congressional reviews of credit rating agencies, the Commission has not acted upon its rule proposal.

B. Regulatory Use of Credit Ratings

The term "NRSRO" was originally adopted by the Commission in 1975 solely for determining capital charges on different grades of debt securities under the Net Capital Rule.[9] The Net Capital Rule requires broker-dealers, when computing net capital, to deduct from their net worth certain percentages of the market value of their proprietary securities positions. A primary purpose of these "haircuts" is to provide a margin of safety against losses that might be incurred by broker-dealers as a result of market fluctuations in the prices of, or lack of liquidity in, their proprietary positions. The Commission determined that it was appropriate to apply a lower haircut to securities held by a broker-dealer that were rated investment grade by a credit rating agency of national repute, because those securities typically were more liquid and less volatile in price than securities that were not so highly rated.[10] The requirement that the credit rating agency be "nationally recognized" was designed to ensure that its ratings were credible and reasonably relied upon by the marketplace.

Over time, as marketplace and regulatory reliance on credit ratings increased, the use of the NRSRO concept became more widespread. Today, NRSRO ratings are widely used for distinguishing among grades of creditworthiness in federal and state legislation, rules issued by financial and other regulators, and even in some foreign regulations. The Commission itself has incorporated the NRSRO concept into additional areas of the federal securities laws. Several regulations issued by the Commission pursuant to the Securities Act of 1933,[11] the Exchange Act,[12] and the Investment Company Act of

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[9] *See* Adoption of Amendments to Rule 15c3-1 and Adoption of Alternative Net Capital Requirement for Certain Brokers and Dealers, Release No. 34-11497 (June 26, 1975), 40 FR 29795 (July 16, 1975). At the time the Commission adopted the term "NRSRO," certain securities exchanges, including the New York Stock Exchange, utilized credit ratings for calculating haircuts for purposes of their respective net capital rules. *See, e.g.*, NYSE Rule 325(c)(5) and (c)(6), 2 CCH NYSE GUIDE, ¶ 2325 (1971). Further, a number of states used the concept of ratings to limit the investment discretion of certain fiduciaries and, in so doing, generally relied only on ratings that were assigned by rating agencies designated as reliable by the state.

[10] *See* 17 CFR § 240.15c3-1(c)(2)(vi)(E) (haircuts applicable to commercial paper), 17 CFR § 240.15c3-1(c)(2)(vi)(F) (haircuts applicable to nonconvertible debt securities), and 17 CFR § 240.15c3-1(c)(2)(vi)(H) (haircuts applicable to cumulative nonconvertible preferred stock). The term NRSRO is also used in appendices to the Net Capital Rule. *See* 17 CFR § 240.15c3-1a(b)(1)(i)(C) (defining the term "major market foreign currency") and 17 CFR § 240.15c3-1f(d) (determining the capital charge for credit risk arising from certain OTC derivatives transactions).

[11] *See* Regulation S-B (17 CFR § 228.10(e)) and Regulation S-K (17 CFR § 229.10(c)) (both of which were also adopted under the authority of the Exchange Act); Rule 134 (communications not deemed a prospectus) (17 CFR § 230.134(a)(14)); Rule 436 (consents required in certain cases) (17 CFR § 230.436(g)); Form S-3 (17 CFR § 239.13); Form F-2 (17 CFR § 239.32); and Form F-3 (17 CFR § 239.33).

1940,[13] utilize the term "NRSRO" and cross-reference to the Net Capital Rule. For example, Rule 2a-7 under the Investment Company Act of 1940 limits money market funds to investing in only high quality short-term instruments, and NRSRO ratings are used as benchmarks for establishing minimum quality investment standards. Under Rule 2a-7, a money market fund is limited to investing in securities rated by an NRSRO in the two highest ratings categories for short-term debt (or unrated securities of similar quality), and there are limitations on the amount of securities the fund can hold that are not rated in the highest rating category (or are not unrated securities of similar quality).[14] In addition, in regulations adopted by the Commission under the Securities Act of 1933, offerings of certain nonconvertible debt, preferred securities, and asset-backed securities that are rated investment grade by at least one NRSRO can be registered on Form S-3 – the Commission's "short-form" registration statement – without the issuer satisfying a minimum public float test.[15]

In addition, Congress has incorporated the NRSRO concept into a wide range of financial legislation.[16] For example, when Congress defined the term "mortgage related

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[12] *See* Rule 3a1-1 (exemption from the definition of "exchange" under Section 3(a)(1) of the Exchange Act) (17 CFR § 240.3a1-1(b)(3)); Rule 10b-10 (confirmation of transactions) (17 CFR § 240.10b-10(a)(8)); Rules 101 (activities by distribution participants) and 102 (activities by issuers and selling security holders during a distribution) of Regulation M (17 CFR §§ 242.101(c)(2) and 242.102(d), respectively); and Rule 300 of Regulation ATS (definitions of "investment grade corporate debt security" and "non-investment grade corporate debt security") (17 CFR §§ 242.300(k)(3) and (*l*)(3)).

[13] *See* Rule 2a-7 (money market funds) (17 CFR § 270.2a-7(a)(10)); Rule 3a-7 (issuers of asset-backed securities) (17 CFR § 270.3a-7(a)(2); Rule 5b-3 (acquisition of repurchase agreement or refunded security treated as acquisition of underlying securities) (17 CFR § 270.5b-3(c)); and Rule 10f-3 (exemption for the acquisition of securities during the existence of an underwriting or selling syndicate) (17 CFR § 270.10f-3(a)(3)).

[14] Investment Company Act of 1940 Rule 2a-7(c)(3) (limiting a money market fund to acquiring "Eligible Securities") (17 CFR § 270.2a-7(c)(3)); Rule 2a-7(a)(10) (defining "Eligible Security" as a "rated security" that has received a rating from the "Requisite NRSROs" in one of the two highest short-term ratings categories) (17 CFR § 270.2a-7(a)(10)); and Rule 2a-7(c)(4)(C) (limiting a money market fund to investing no more than one percent of its assets in any individual security and no more than five percent of its total assets in all securities that are "Second Tier" securities) (17 CFR § 270.2a-7(c)(4)(C)). Under Rule 2a-7, NRSRO ratings are minimum requirements; fund advisers must also make an independent determination that the security presents "minimal credit risks." Rule 2a-7(c)(3)(i). In addition, some regulations incorporate NRSRO ratings indirectly by, for example, permitting investment only in funds regulated as money market funds under the Investment Company Act of 1940. *See, e.g.*, 17 CFR § 1.25(a)(vii) (permitting futures commission merchants to invest customer funds in money market funds).

[15] Form S-3 (17 CFR § 239.13).

[16] *See, e.g.*, 15 U.S.C. § 78c(a)(41) (defining the term "mortgage related security"); 15 U.S.C. § 78c(a)(53)(A) (defining the term "small business related security"); and 15 U.S.C. § 80a-6(a)(5)(A)(iv)(I) (exempting certain companies from the provisions of the Investment Company Act of 1940"); Gramm-Leach-Bliley Act, Pub. L. No. 106-102 (1999); Transportation Equity Act for the 21st Century, Pub. L. No. 105-178 (1998); Reigle Community Development and Regulatory Improvement Act of 1994, Pub. L. No. 103-325 (1994); Department of Commerce, Justice, and State, The Judiciary, and Related Agencies Appropriations Act, FY2001, Pub. L. No. 106-553 (2000); Higher Education Amendments of 1992, Pub. L. No. 102-325 (1992); Housing and Community Development Act of 1992, Pub. L. No. 102-550 (1992);

security" in Section 3(a)(41) of the Exchange Act,[17] as part of the Secondary Mortgage Market Enhancement Act of 1984,[18] it required, among other things, that such securities be rated in one of the two highest rating categories by at least one NRSRO. Further, in 1989, Congress added the NRSRO concept to the Federal Deposit Insurance Act, prescribing that corporate debt securities are not "investment grade" unless they are rated in one of the four highest categories by at least one NRSRO.[19]

Finally, a number of other federal, state, and foreign laws and regulations today employ the NRSRO concept. For example, the U.S. Department of Education uses ratings from NRSROs to set standards of financial responsibility for institutions that wish to participate in student financial assistance programs under Title IV of the Higher Education Act of 1965, as amended (Title IV).[20] In addition, several state insurance codes rely, directly or indirectly, on NRSRO ratings in determining appropriate investments for insurance companies.[21] And the use of the NRSRO concept has occurred in foreign jurisdictions.[22]

C. Recognition of NRSROs

In 1975, when NRSRO ratings first were incorporated in the Net Capital Rule, the Commission staff, in consultation with the Commission, determined that the ratings of S&P, Moody's, and Fitch were used nationally, and that these firms should be considered

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Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242 (1991); and Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-72 (1989).

17 15 U.S.C. § 78c(a)(41).

18 Pub. L. No. 98-440, § 101, 98 Stat. 1689 (1984).

19 12 U.S.C. § 1831e(d)(4)(A).

20 20 U.S.C. § 1070 *et seq.* and 42 U.S.C. § 2751 *et seq.*, 34 CFR §§ 668.15(b)(7)(ii) and (8)(ii).

21 For example, the California Insurance Code relies on NRSRO ratings in allowing California-incorporated insurers to invest excess funds in certain types of investments. Specifically, Section 1192.10 of the California Insurance Code requires that certain investments by an insurer be rated in one of the three highest rating categories by at least one NRSRO approved by the Commission, and within one of the two highest rating categories established by the Securities Valuation Office ("SVO") of the National Association of Insurance Commissioners. *See* Cal. Ins. Code § 1192.10. Insurance codes in a number of states refer to credit ratings by NRSROs as defined by the SVO. *See, e.g.*, Tex. Ins. Code art. 2.10-4 and N.J. Stat. § 17:24-29. The SVO, in turn, defines the term "NRSRO" in its Purposes and Procedures Manual as a rating organization designated as an NRSRO by the SEC which has applied to, and whose NRSRO status has been confirmed by, the SVO. Among other things, the SVO is responsible for the day-to-day credit quality assessment and valuation of securities owned by state-regulated insurance companies. These assessments and valuations are then used to help monitor the financial condition of insurance companies.

22 In El Salvador, for example, a rating agency can register as a "classifier of risk" under the country's securities laws if the rating agency is an NRSRO as recognized by the SEC. *See* Law of the Securities Market, El Salvador, Title VI, Chapter II, Section 88(a). D.L. Not. 374, Published in the Official Newspaper No. 149, Volume 340 of August 14, 1998.

NRSROs for purposes of the Net Capital Rule.[23] Since 1975, the Commission staff has issued no-action letters with respect to NRSRO status to four additional rating agencies: (1) Duff and Phelps, Inc.;[24] (2) McCarthy Crisanti & Maffei, Inc.;[25] (3) IBCA Limited and its subsidiary, IBCA, Inc.;[26] and (4) Thomson BankWatch, Inc.[27] Each of these firms has since merged with or been acquired by other NRSROs, with the result that presently only the three original NRSROs remain. A number of requests from additional rating agencies for recognition of NRSRO status currently are under review by Commission staff, however, so that the number of NRSROs may very well increase in the foreseeable future.

1. NRSRO Recognition Criteria

Commission staff initially did not adopt specific standards for determining which credit rating agencies were nationally recognized for their services, preferring instead to address the question on a case-by-case basis. But through the subsequent no-action letter process, Commission staff developed a number of objective criteria for assessing national recognition. As a result, under current practice, Commission staff reviews the rating agency's operations, position in the marketplace, and other specific factors to determine whether it should be considered an NRSRO.[28]

The single most important factor in the Commission staff's assessment of NRSRO status is whether the rating agency is "nationally recognized" in the United States as an issuer of credible and reliable ratings by the predominant users of securities ratings. The staff also reviews the operational capability and reliability of each rating organization. Included within this assessment are: (1) the organizational structure of the rating organization; (2) the rating organization's financial resources (to determine, among other things, whether it is able to operate independently of economic pressures or control from the companies it rates); (3) the size and quality of the rating organization's staff (to determine if the entity is capable of thoroughly and competently evaluating an issuer's credit); (4) the rating organization's independence from the companies it rates; (5) the

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[23] *See, e.g.*, Letter from Gregory C. Yadley, Staff Attorney, Division of Market Regulation, SEC, to Ralph L. Gosselin, Treasurer, Coughlin & Co., Inc. (November 24, 1975).

[24] *See* Letter from Nelson S. Kibler, Assistant Director, Division of Market Regulation, SEC, to John T. Anderson, Esquire, of Lord, Bissell & Brook, on behalf of Duff & Phelps, Inc. (February 24, 1982).

[25] *See* Letter from Michael A. Macchiaroli, Assistant Director, Division of Market Regulation, SEC, to Paul McCarthy, President, McCarthy, Crisanti & Maffei, Inc. (September 13, 1983).

[26] *See* Letter from Michael A. Macchiaroli, Assistant Director, Division of Market Regulation, SEC, to Robin Monro-Davies, President, IBCA Limited (November 27, 1990) and Letter from Michael A. Macchiaroli, Assistant Director, Division of Market Regulation, SEC, to David L. Lloyd, Jr., Dewey Ballentine, Bushby, Palmer & Wood (October 1, 1990).

[27] *See* Letter from Michael A. Macchiaroli to Gregory A. Root, President, Thomson BankWatch, Inc. (August 6, 1991) and Letter from Michael A. Macchiaroli to Lee Pickard, Pickard and Djinis LLP (January 25, 1999).

[28] *See supra* notes 24-27.

rating organization's rating procedures (to determine whether it has systematic procedures designed to produce credible and accurate ratings); and (6) whether the rating organization has internal procedures to prevent the misuse of nonpublic information and whether those procedures are followed. The staff also recommends that the agency become registered as an investment adviser.

If the Commission staff determines that a rating agency can be considered an NRSRO, it issues a "no-action" letter stating that it will not recommend enforcement action to the Commission if ratings from the rating agency are considered by registered broker-dealers to be ratings from an NRSRO for purposes of applying the relevant portions of the Net Capital Rule. On the other hand, if the staff concludes that a rating agency should not be considered an NRSRO, it may issue a letter denying a request for no-action relief.[29]

2. Recent Initiatives

In recent years, the Commission and Congress have reviewed a number of issues regarding credit rating agencies and the need for greater regulatory oversight of them. Several of the instances in which the Commission and Congress reviewed the regulatory treatment of credit rating agencies coincided with a large scale credit default, such as those of Orange County, California, and the Washington Public Power Supply System. Ten years ago, for example, the Commission considered a number of alternatives in an attempt to determine the appropriate regulatory treatment of rating agencies for purposes of the federal securities laws.[30] The three primary alternatives considered by the Commission were: (a) eliminating reliance on NRSRO ratings for purposes of Commission rules; (b) retaining the use of NRSRO ratings in Commission rules and the current method for designating rating agencies as NRSROs; and (c) implementing more direct and expanded oversight of credit rating agencies, given their growing importance in the financial and regulatory scheme. The Commission did not reach a consensus on the need for change at that time, however, and so by not taking action the existing system of NRSRO recognition and oversight was retained.

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[29] *See* Letters from Annette L. Nazareth, Director, Division of Market Regulation, SEC, to Dr. Barron H. Putnam, LACE Financial Corp. (April 14, 2000, and October 16, 2000).

[30] *See* Letters from John D. Dingell, Chairman, Committee on Energy and Commerce, U.S. House of Representatives, to Richard C. Breeden, Chairman, SEC (April 28, 1992 and July 9, 1992); Letter from Richard C. Breeden, Chairman, SEC, to the Honorable John D. Dingell, Chairman, Committee on Energy and Commerce, U.S. House of Representatives (July 23, 1992); Letter from J. Carter Beese, Jr., Commissioner, SEC, to the Honorable John D. Dingell, Chairman, Committee on Energy and Commerce, U.S. House of Representatives (August 12, 1992); and Letter from Mary L. Schapiro and Richard Y. Roberts, Commissioners, SEC, to the Honorable John D. Dingell, Chairman, Committee on Energy and Commerce, U.S. House of Representatives (August 12, 1992).

a. 1994 Concept Release

In 1994, the Commission issued a Concept Release[31] soliciting public comment on the Commission's use of NRSRO ratings. Because of the expanded role played by credit ratings in Commission rules, a number of domestic and foreign rating agencies had been prompted to seek NRSRO status. Concerns had been expressed about the fact that Commission rules did not define "NRSRO," and that there was no formal mechanism for monitoring the activities of NRSROs. As a result, the Commission believed it appropriate to solicit public comment on the appropriate role of ratings in the federal securities laws, and the need to establish formal procedures for designating NRSROs and monitoring their activities. Specifically, comment was solicited on: (1) whether the Commission should continue to use the NRSRO concept and, if so, whether the term "NRSRO" explicitly should be defined in Commission rules; and (2) whether the existing no-action letter process for recognizing NRSROs was satisfactory and, if not, the alternative procedures to be established.

The Commission received 25 comment letters in response to the Concept Release and, in general, they supported the continued use of the NRSRO concept. Among other things, commenters believed the use of NRSRO ratings had become an integral part of the Net Capital Rule, and a vital ingredient in the Commission's efforts to safeguard the capital markets against risks arising from fluctuations in the proprietary positions of securities firms.[32] A few commenters suggested the Commission discontinue the use of the NRSRO concept and instead employ statistical models or historical spreads to determine the level of risk associated with a particular instrument.[33]

Most comment letters received in response to the Concept Release recommended that the Commission adopt a formalized process for approving NRSROs. The commenters generally shared the view that the no-action procedures in place at that time did not contain sufficient guidance on how to submit an application for NRSRO recognition and the types of information that should be included in the application. Specifically, commenters recommended that the Commission formalize the current no-action letter criteria for recognizing NRSROs in a Commission rule.[34] A few

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31 Concept Release, *supra* note 7.

32 *See, e.g.*, Letter from Jeffrey C. Bernstein, Chairman, Capital Committee, Securities Industry Association, to Jonathan G. Katz, Esq., Secretary, SEC (December 6, 1994).

33 *See, e.g.*, Letter from Kenneth Lehn, Professor of Business Administration, University of Pittsburgh, to Jonathan G. Katz, Secretary, SEC (December 5, 1994) [hereinafter the "Lehn Letter"]. The Commission subsequently invited further comment on practical approaches to the use of statistical models in the context of determining the credit risk of individual financial instruments. *See* Proposing Release, *supra* note 8. Four commenters to the Proposing Release discussed the use of statistical models for purposes of the NRSRO concept, and all generally agreed that quantitative, statistically-derived credit scores were not as useful or as reliable as analytically-derived credit ratings. *See infra* note 42.

34 *See, e.g.*, Letter from Walter J. Schroeder, President, Dominion Bond Rating Service Limited, to Jonathan G. Katz, Secretary, SEC (December 20, 1994) ("[W]e strongly urge the Commission to codify its NRSRO review procedures in a Commission rule."); Letter from John M. Liftin, Vice-Chair, Committee on

commenters set forth suggested criteria for the Commission to consider in determining whether a rating agency is an NRSRO.[35] In general, however, commenters opposed formal regulatory oversight of NRSROs, particularly to the extent regulation might interfere with a rating agency's credit rating process or rating judgments.[36]

b. 1997 Rule Proposal

As a response to the Concept Release and the comments received thereon, the Commission, in 1997, proposed to amend the Net Capital Rule to define the term "NRSRO."[37] The proposed amendments set forth criteria to be considered by the Commission in recognizing rating organizations as NRSROs, and establish an application process for NRSRO recognition. An NRSRO would be defined as an entity that: (1) issues ratings that are current assessments of the creditworthiness of obligors with respect to specific securities or money market instruments; (2) is registered as an investment

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Federal Regulation of Securities, American Bar Association, to Jonathan G. Katz, Secretary, SEC (December 5, 1994) [hereinafter the "Liftin Letter"] ("[W]e advocate the adoption of a more formalized process for designation that would be based on the definition of 'NRSRO,' would utilize the existing factors currently recognized as relevant by the Commission, and would preserve the independent judgment of the Commission in any future grant of NRSRO designation."); Letter from Brian I. Neysmith, Canadian Bond Rating Service, Inc., to Jonathan G. Katz, Secretary, SEC (November 10, 1994) ("[T]he criteria or parameters required to obtain [NRSRO] designation must be well defined, reasonable, and distinguishable."); and Letter from Itsuo Yamamoto, Managing Director, Nippon Investors Service Inc., to Jonathan G. Katz, Secretary, SEC (December 1, 1994) [hereinafter the "Yamamoto Letter"] (advocating "implementation of clear objective standards").

[35] NRSRO recognition criteria suggested in response to the Concept Release included certain minimum, objective criteria. *See, e.g.*, the Yamamoto Letter, *supra* note 34, recommending, among other things, that NRSROs have at least $50 million in paid-in-capital, that they rate at least 100 issuers on a periodic basis, and that they have at least 30 full-time analysts. The Commission subsequently invited further comment on whether objective criteria should be used to determine NRSRO recognition and the types of objective criteria that should be considered. *See* Proposing Release, *supra* note 8. There was no substantial support for adding minimum objective standards to the NRSRO criteria. *See infra* note 41.

[36] *See, e.g.*, the Liftin Letter, *supra* note 34 ("The Commission should not attempt to regulate the process by which NRSROs assign ratings. The market itself effectively and efficiently regulates NRSROs."); Letter from Patrick M. Frawley, Director, Regulatory Relations Group, NationsBank Corporation, to Jonathan Katz, Secretary, SEC (December 5, 1994) ("Setting standards for NRSROs, and designating them as such after an application process, is sufficient to ensure quality rating services."); Letter from Brian J. Heidtke, Vice President, Finance and Treasurer, Colgate-Palmolive Company, to Jonathan G. Katz, Secretary, SEC ("[O]fficial regulations uniformly applied to rating agencies as a formally defined group will erode the market-determined forces which help ensure the independence and impartiality vital to sound credit analysis and judgment."); Letter from Clifford J. Grum, Temple-Inland Inc., to Jonathan G. Katz, Secretary, SEC (December 1, 1994) ("[Regulation of NRSROs would] cause significant practical difficulties, cost burdens, and the potential for reducing the objectivity of the ratings process."); and Letter from John C. Sargent, Vice President and Treasurer, E.I. du Pont de Nemours and Company, to Jonathan G. Katz, Secretary, SEC (December 5, 1994) ("[I]mposing a regulatory framework or establishing rating standards could jeopardize the integrity and independence of a system which does not seem to warrant any 'mid-course' correction or government intervention.").

[37] Proposing Release, *supra* note 8.

adviser under the Investment Advisers Act of 1940; and (3) is designated an NRSRO by the Commission.

In determining whether to recognize a rating organization as an NRSRO, the proposed amendments provided that the Commission would consider five specific attributes of the applicant, which are substantially similar to those reviewed by the staff as part of the no-action letter process. Specifically, the Commission would consider: (1) national recognition (*i.e.*, whether the rating organization is recognized as an issuer of credible and reliable ratings by the predominant users of securities ratings in the United States); (2) adequate staffing, financial resources, and organizational structure to ensure that it can issue credible and reliable ratings of the debt of issuers (including the ability to operate independently of economic pressures or control by companies it rates and a sufficient number of staff members qualified in terms of education and experience to thoroughly and competently evaluate an issuer's credit); (3) use of systematic rating procedures that are designed to ensure credible and accurate ratings; (4) extent of contacts with the management of issuers (including access to senior level management of the issuers); and (5) internal procedures to prevent misuse of nonpublic information and compliance with these procedures.

In addition, the proposed amendments effectively would establish a formal Commission process for recognizing NRSROs. Rating organizations seeking NRSRO designation would file an application with the Director of the Commission's Division of Market Regulation that provides detailed information explaining how the rating organization satisfies each of the required attributes. Commission staff would approve or reject an application for NRSRO status, pursuant to delegated authority. Finally, an NRSRO would be required to notify the Commission of any material changes in the information set forth in its application, and if the Commission determined the NRSRO no longer satisfied all of the requisite attributes, the rating agency's NRSRO recognition could be revoked or withdrawn.

The rule proposal also solicited further comment on whether NRSROs should be prohibited from charging issuers fees based upon the size of a transaction, as several commenters to the Concept Release expressed concern that such a fee structure could compromise a rating organization's objectivity in large transactions.[38] The rule proposal

[38] This topic was addressed by six commenters, five of whom disagreed with the concerns raised in response to the Concept Release. *See* Letter from Leo C. O'Neill, President and Chief Rating Officer, S&P, to Jonathan Katz, Secretary, SEC (February 27, 1998) [hereinafter the "O'Neill Letter"] ("The ongoing value of a rating organization's business is wholly dependent on continued investor confidence in the credibility and reliability of its ratings, and no single fee or group of fees could be important enough to the organization to jeopardize its future business."); Letter from Mari-Anne Pisarri, Pickard and Djinis LLP, to Jonathan G. Katz, Secretary, SEC (March 2, 1998) [hereinafter the "Pisarri Letter"] ("While [Thomson BankWatch, Inc. ('TBW')] does not believe that charging issuers *per se* has an untoward effect on the quality of the ratings produced, TBW believes that such charges should be based on the time and effort that goes into the rating process and not on the size of the transaction."); Letter from Matthew C. Molé, Vice President & General Counsel, Moody's, to Jonathan G. Katz, Secretary, SEC (March 2, 1998) [hereinafter the "Molé Letter"] ("The SEC should not attempt to substitute its judgment as to the value of such services for that of issuers or the investors who, by accepting lower yields from issuers, ultimately pay the agency's fees."); Letter from Neil D. Baron, Vice Chairman and General Counsel, Fitch, to Jonathan G.

also invited comments on: (1) whether a specific time period should be established for the Commission to act on an application for NRSRO recognition (*e.g.*, a range of 180 to 365 calendar days);[39] (2) whether NRSROs should be required to make their ratings generally available to the public (as opposed to restricting their distribution to subscribers);[40] (3) whether objective criteria should be used to determine NRSRO recognition and, if so, the types of objective criteria that should be considered;[41] and (4)

Katz, Secretary, SEC (March 13, 1998) [hereinafter the "Baron Letter"] ("[A]n unjustifiably favorable rating on any issue is destructive to our most important asset – or reputation – and therefore to our business. Unjustifiably favorable ratings are even more visible, and therefore more destructive to reputation, when they are assigned to larger issues."); and Letter from Barron H. Putnam Ph.D., Financial Economist/President, LACE Financial Corporation, to Jonathan G. Katz, Secretary, SEC (received on April 23, 1998) [hereinafter the "Putnam Letter"] ("[F]ees should be set by the marketplace and not by the government."). One commenter, however, disagreed with the practice of charging issuers for ratings, commenting that there is an inherent conflict of interest when a rating agency is compensated by a firm whose securities are being rated by the rating agency. *See* Letter from Sean J. Egan, Managing Director, Egan-Jones Ratings Company, to Jonathan G. Katz, Secretary, SEC (March 2, 1998 revised) [hereinafter the "Egan Letter"] ("[W]e believe being compensated for ratings by issuers makes it difficult to point out that the 'emperor has no clothes.'").

[39] Three commenters addressed the topic of whether a specific time period should be established for the Commission to act on requests to be recognized as an NRSRO. Each commenter stated that a specific time period should be established. *See* the Egan Letter, *supra* note 38 ("180 days or less"); the Pisarri Letter, *supra* note 38 ("[A] decision on an NRSRO application should be made within 45-60 calendar days after submission."); and Letter from Douglas L. Getter, Esq., Dewey Ballantine LLP, and David B.H. Martin, Jr., Esq., Hogan & Hartson L.L.P., to Jonathan G. Katz, Secretary, SEC (February 13, 1998) [hereinafter the "Getter/Martin Letter"] ("within 90 days after submission").

[40] Five commenters addressed the topic of whether NRSROs should be required to provide their ratings to the public. Four commenters generally supported the view that NRSROs must make their ratings available to the public in order for their ratings to be recognized for regulatory purposes. These commenters differed, however, as to which ratings they believed should be made publicly available and when. *See* Letter from Ernest T. Elsner, Executive Vice President and General Counsel, Duff & Phelps Credit Rating Co., to Jonathan G. Katz, Secretary, SEC (February 28, 1998) [hereinafter the "Elsner Letter"] ("The market should have access to [ratings] and, more importantly, the underlying data to support the 'rationale' of the rating."); the Pisarri Letter, *supra* note 38 ("[R]atings on publicly issued debt should be made available to the public, whereas the distribution of other ratings (such as on private placements or the issuers themselves) might properly be restricted to paid subscribers."); the Molé Letter, *supra* note 38 ("[R]atings of an NRSRO that are eligible for use for regulatory purposes need to be publicly available on an historical basis to permit statistical testing of correlation and congruence."); and the Baron Letter, *supra* note 38 ("We believe that NRSRO ratings of securities that are expected to be traded in the secondary market should be publicly available through release on the newswire services."). The fifth commenter did not believe that NRSROs should be required to provide their ratings to the public. *See* the Egan Letter, *supra* note 38 ("[R]equiring that a firm make its ratings available at no charge to be recognized as an NRSRO creates an insurmountable barrier [to entry].").

[41] The Commission received nine comment letters responding to its request on whether objective criteria should be used to recognize NRSROs, and proposing types of objective criteria that should be considered. *See, e.g.*, Letter from Nobuhiro Saito, Managing Director, Japan Credit Rating Agency, Ltd., to Jonathan G. Katz, Secretary, SEC (February 18, 1998) ("[W]e believe [rules for recognizing NRSROs] should be more objective and transparent to the rating agencies."); the O'Neill Letter, *supra* note 38 ("[T]he [Net Capital Rule], if amended, should include but one standard for designation: a pre-existing national recognition and use of a rating organization's ratings in the financial marketplace."); the Egan Letter, *supra* note 38 ("Regarding the use of objective standards, we believe the main criteria should be

whether there are practical approaches to the use of statistical models for determining the credit risk of individual financial instruments, that might serve as a regulatory substitute for NRSRO credit ratings.[42]

Although commenters were generally pleased with the Commission's attempt to define the requirements necessary for a rating agency to be designated as an NRSRO, due to concerns regarding, among other things, the standards defining the term "NRSRO," and the initiation of broad-based Commission and Congressional reviews of credit rating agencies, the Commission has not acted upon the rule proposal described above.

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national recognition . . . There should [also] be recognition for timeliness."); the Elsner Letter, *supra* note 40 (proposing the following criteria: (1) consistency in the use of rating symbols or designations that are comparable with other NRSROs; (2) public disclosure of ratings and rationale for the ratings assigned; (3) publicized standards to provide the users of the ratings with sufficient information to fairly and accurately evaluate the nature of assigned ratings; (4) breadth of experience over a wide range of markets and industries in the U.S. capital markets; and (5) disclosure of ratings issued without the cooperation of the issuer and recognition for regulatory purposes of ratings only issued with contact with management of issuers); the Molé Letter, *supra* note 38 ("If not eliminated altogether, NRSRO qualifications should be determined solely by 'National Recognition' . . . [T]he fundamental determinants of 'national recognition' [are] (i) an *impact* of [a rating agency's ratings] on bond prices that is independent of the impact thereon of regulation, (ii) tight *correlation* over time between its ratings and actual default experience, and (iii) substantial *congruence* – or at least the absence of *illusory* congruence – between its rating scale and those of rating agencies that have already achieved such recognition."); Comments of the United States Department of Justice in the Matter of: File No. S7-33-97 Proposed Amendments to Rule 15c3-1 under the Securities Exchange Act of 1934 (March 6, 1998) ("The Department . . . supports the Commission's suggested criteria for making decisions on [NRSRO] applications, subject to two specific concerns. First . . . the current formulation of the Commission's 'recognition' requirement creates a problematic barrier to entry into an industry that is already highly concentrated. Second, while the Department supports the Commission's criteria concerning access to senior management and the use of systematic rating procedures, the Department notes that these criteria would best be served by a disclosure requirement for situations, such as unsolicited ratings, in which the criteria could often not be met."); the Getter/Martin Letter, *supra* note 39 ("[T]he Proposal continues to ignore important attributes, objective or otherwise, that demonstrate the recognition that a non-U.S. rating agency receives from the domestic and international financial community."); the Baron Letter, *supra* note 38 ("[T]he Amendment should place a priority on recognition by investors above recognition by other participants such as issuers and investment bankers."); and the Putnam Letter, *supra* note 38 ("We feel that quality ([education] and experience) is very important and should be part of the criteria. Size of an applicant for NRSRO status should depend on how well they rate institutions. Size should not be a determining factor.").

[42] Four comment letters discussed the use of statistical models for purposes of the NRSRO concept. All four commenters generally agreed that quantitative, statistically derived credit scores are not as useful or as reliable as analytically derived credit ratings. *See* the Pisarri Letter, *supra* note 38; the Egan Letter, *supra* note 38; the Baron Letter, *supra* note 38; and the O'Neill Letter, *supra* note 38.

III. RECENT INQUIRIES INTO THE ROLE OF CREDIT RATING AGENCIES

A. Senate Initiatives

1. Enron-Related Credit Rating Agency Hearing

In January 2002, the Senate Committee on Governmental Affairs launched a broad investigation into the Enron collapse, focusing on the role of government and private sector watchdogs, and the steps, if any, that could have been taken to detect Enron's problems or prevent its failure. On March 20, 2002, the Senate Committee held a hearing – entitled "Rating the Raters: Enron and the Credit Rating Agencies" – that focused on the role of credit rating agencies in the Enron collapse. That hearing sought to elicit information on why the credit rating agencies continued to rate Enron a good credit risk until four days before the firm declared bankruptcy, and to determine how future Enron-type calamities could be avoided. Concerns had been expressed regarding the significant market power of the three NRSROs, their privileged access to nonpublic issuer information,[43] their apparent lack of care and diligence in the Enron situation, and their very limited regulatory oversight.

The first hearing panel was composed of senior Enron analysts from each of the three NRSROs.[44] In general, they took the position that their ratings depended on the accuracy and completeness of the information furnished by Enron, its counsel, accountants and other experts. In retrospect, however, it was evident to them that Enron, in fact, provided misleading information, and failed to disclose other important facts, thereby undermining the accuracy and reliability of their ratings.[45]

The second hearing panel consisted of two academics,[46] the CEO of a credit research firm,[47] and then-SEC Commissioner Isaac C. Hunt, Jr. One of the academics was of the view that credit rating agencies do not provide useful or timely information about the creditworthiness of companies in today's markets and, accordingly, Congress should instruct the relevant regulatory authorities to abandon the use of credit ratings in

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[43] Subject to certain conditions, disclosures to rating agencies are excluded from Regulation FD. *See infra* note 60.

[44] Ronald M. Barone, Managing Director, S&P; John C. Diaz, Managing Director, Moody's; and Ralph G. Pellecchia, Senior Director, Global Power Group, Fitch.

[45] *See* Enron Hearings, *supra* note 4 (testimony of Ronald M. Barone, Managing Director, S&P, John C. Diaz, Managing Director, Moody's, and Ralph G. Pellecchia, Senior Director, Global Power Group, Fitch).

[46] Jonathan R. Macey, J. DuPratt White Professor of Law, Cornell Law School; and Steven L. Schwarcz, Professor of Law, Duke University.

[47] Glenn L. Reynolds, Chief Executive Officer, CreditSights, Inc.

regulation where possible.[48] The other academic, although skeptical of the ability of government regulation of rating agencies to improve their performance or reduce costs, took the position that some form of regulatory approval of rating agencies is appropriate to the extent credit ratings are used in regulation.[49] The credit research firm representative believed the Commission should retain the NRSRO designation, but set clear and specific criteria for NRSRO recognition. Among other things, he was of the view that: (1) rating agencies should disclose material risks they uncover in the ratings review process (even if that information has not been disclosed by the issuer in financial filings or otherwise); (2) rating agencies should report to the Commission any material risks that appear to be inadequately addressed in public disclosures; (3) rating agencies should place more weight on the analytical significance of various accounting quality issues; and (4) there should be a registration and certification program for senior rating agency analysts that have decision-making power.[50] Then-Commissioner Hunt explained the Commission's use of credit ratings in regulation, previous initiatives involving credit rating agencies, and the Commission's intent to engage in a thorough examination of the role of rating agencies in the U.S. securities markets.[51]

2. Governmental Affairs Committee Staff Report

On October 8, 2002, the staff of the Senate Committee on Governmental Affairs issued a report (the "Staff Report") entitled *Financial Oversight of Enron: The SEC and Private-Sector Watchdogs*,[52] which contains, among other things, the results of the Committee staff's investigation into the actions of the three NRSROs in the years prior to Enron's collapse. The Staff Report addresses the perceived failures of credit rating agencies to fulfill their responsibilities to prevent or warn of the impending failure of Enron, and provides recommendations with respect to how their future performance could be improved.[53]

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[48] *See* Enron Hearings, *supra* note 4 (testimony of Jonathan R. Macey, J. DuPratt White Professor of Law, Cornell Law School).

[49] *See* Enron Hearings, *supra* note 4 (testimony of Steven L. Schwarcz, Professor of Law, Duke University).

[50] *See* Enron Hearings, *supra* note 4 (testimony of Glenn Reynolds, Chief Executive Officer, CreditSights, Inc.).

[51] *See* Enron Hearings, *supra* note 4 (testimony of Commissioner Isaac C. Hunt, Jr.).

[52] Staff Report, *supra* note 5.

[53] On January 3, 2003, the staff of the Senate Committee on Governmental Affairs issued an additional Report entitled "Enron's Credit Rating: Enron's Bankers' Contacts with Moody's and Government Officials." In the course of the Senate Committee's investigation, questions had been raised, among other things, about efforts by Enron's bankers to convince Moody's not to downgrade Enron. In its Report, the staff of the Senate Committee concluded that Moody's November 8, 2001 decision not to downgrade Enron's credit rating below investment grade was not based on improper influence or pressure, but on new information presented by financial institutions and others that in Moody's view changed Enron's circumstances.

The Staff Report concluded that, in the case of Enron, the credit rating agencies failed to use their legally-sanctioned power and access[54] to the public's benefit, instead displaying a lack of diligence in their coverage and assessment of Enron. The Staff Report found that the credit rating agencies did not ask sufficiently probing questions in formulating their ratings, and in many cases merely accepted at face value what they were told by Enron officials. Further, the rating agencies apparently ignored or glossed over warning signs, and despite their mission to make long-term credit assessments, failed to sufficiently consider factors affecting the long-term health of Enron, particularly accounting irregularities and overly complex financing structures. The Staff Report also noted that, because credit rating agencies are subject to little, if any, formal regulation or oversight, and their liability traditionally has been limited both by regulatory exemptions and First Amendment protections afforded them by the courts, little exists to hold them accountable for future poor performance.

As a result, the Staff Report recommended that the Commission, in consultation with other agencies that reference NRSRO ratings in their regulations (*e.g.*, the banking agencies), set specific conditions on the NRSRO designation through additional regulation, to ensure that the reliance of the public on credit rating agencies is not misplaced. The recommended conditions would include: (a) standards and considerations to be used by credit rating agencies in deriving their ratings, such as those addressing accounting issues; and (b) standards for training levels of credit rating analysts (including training on the information contained in periodic SEC and other regulatory filings and training in basic forensic accounting). The Staff Report also recommended that the Commission monitor compliance with these requirements and, in the event of a future corporate meltdown such as Enron, conduct an investigation to ensure that the applicable credit ratings were derived in accordance with those standards.

B. Commission Initiatives

1. Broad-Based Commission Review

The issues addressed by the Staff Report, as well as the study required by the Sarbanes-Oxley Act, were consistent with work previously undertaken by the

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In addition, on July 23, 2002, representatives of Moody's and S&P testified before the Senate Permanent Subcommittee on Investigations regarding the assistance major financial institutions gave Enron with respect to its use of misleading complex transactions. *See The Role of the Financial Institutions in Enron's Collapse, Hearings Before the Senate Permanent Subcommittee on Investigations*, 107th Cong. 618 (2002) (testimony of John C. Diaz, Managing Director, Power & Energy Group, Moody's, Pamela M. Stumpp, Managing Director, Chief Credit Officer, Corporate Finance Group, Moody's, and Ronald M. Barone, Managing Director, S&P). That hearing focused on how Enron used certain structured finance transactions to obtain billions of dollars in financing without showing any additional debt on its books. During the hearings, representatives of S&P and Moody's indicated they were unaware of the existence of Enron's prepaid forward and related swap transactions and, had the transactions been disclosed as loans, such disclosures would have exerted downward pressure on Enron's credit rating.

[54] Subject to certain conditions, disclosures to rating agencies are excluded from Regulation FD. *See infra* note 60.

Commission to review the role of rating agencies in the U.S. securities markets and the need for greater regulation in this area. The Commission recognized that, in recent years, the importance of credit ratings to investors and other market participants had increased significantly, impacting an issuer's access to and cost of capital, the structure of financial transactions, and the ability of fiduciaries and others to make particular investments. In light of these changes, the Commission had commenced a review of the use of credit ratings in the federal securities laws, the process of determining which credit ratings should be used for regulatory purposes, and the level of oversight to apply to recognized rating agencies.

The Commission pursued several approaches, both formal and informal, to conduct a thorough and meaningful study of these issues. Commission efforts included informal discussions with credit rating agencies and market participants, formal examinations of each of the NRSROs, and public hearings that offered a broad cross-section of market participants the opportunity to communicate their views on credit rating agencies and their role in the capital markets.

On March 19, 2002, the Commission issued an Order directing investigation, pursuant to Section 21(a) of the Exchange Act, into the role of rating agencies in the U.S. securities markets.[55] The purpose of the Order was to ascertain facts, conditions, practices, and other matters relating to the role of rating agencies in the U.S. securities markets, and to aid the Commission in assessing whether to continue to use credit ratings in its regulations under the federal securities laws and, if so, the categories of acceptable credit ratings and the appropriate level of regulatory oversight.

2. Commission Examinations of NRSROs

Pursuant to the Commission's March 2002 Order of Investigation, as well as the Commission's examination authority under the Investment Advisers Act of 1940, Commission examination staff conducted formal examinations of each of the three NRSROs. In these examinations, Commission staff reviewed documents and information provided by each NRSRO regarding its policies and procedures, as well as documents concerning its ratings of certain issuers, and interviewed various NRSRO staff. Commission staff also interviewed senior finance personnel from a number of issuers that were rated by the NRSROs.

The Commission's examination of the NRSROs revealed several concerns, including those relating to: (a) potential conflicts of interest caused by the fact that issuers pay the NRSROs for their ratings;[56] (b) exacerbation of those conflicts of interest due to

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[55] *See* Order In the Matter of the Role of Rating Agencies in the U.S. Securities Markets Directing Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934, and Designating Officers for Such Designation (March 19, 2002). File 4-454-3.

[56] In addition, the staff found evidence that indicated the NRSROs may not be in compliance with Section 17(b) of the Securities Act of 1933, with respect to disclosure of the receipt of compensation from issuers for rating their securities.

the marketing by the NRSROs of ancillary services to issuers, such as pre-rating assessments and corporate consulting, thereby heightening the NRSROs' dependence on issuer revenue; (c) the potential for the NRSROs, given their substantial power in the marketplace, to improperly pressure issuers to pay for ratings; (d) the potential for the NRSROs, given their substantial power in the marketplace, to improperly pressure issuers to purchase ancillary services; (e) the effectiveness of the NRSROs' existing policies and procedures designed to protect confidential information; and (f) the effectiveness of the Commission's examination being hampered by, among other things, the lack of recordkeeping requirements tailored to NRSRO activities, the NRSROs' assertions that the document retention and production requirements of the Investment Advisers Act of 1940 are inapplicable to the credit rating business, and their claims that the First Amendment shields the NRSROs from producing certain documents to the Commission.

3. Credit Rating Agency Hearings

The Commission's broad-based study of credit rating agencies culminated in public hearings held late last year. On November 15 and 21, 2002, the Commission conducted full-day public hearings to address a wide range of issues relating to credit rating agencies in the operation of the U.S. securities markets.[57] Panel participants represented a wide range of views, including those of the NRSROs, non-NRSRO rating agencies, broker-dealers, buy-side firms, issuers, and the academic community.[58] Commissioners and Commission staff also participated in each hearing.

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[57] *The Current Role and Function of Credit Rating Agencies in the Operation of the Securities Markets, Hearings Before the U.S. Securities and Exchange Commission* (Nov. 15 and 21, 2002). Full hearing transcripts are available on the SEC website at http://www.sec.gov/spotlight/ratingagency.htm [hereinafter "SEC Hearing Transcript"].

[58] Participants at the Commission's credit rating agency hearings on November 15 and 21, 2002, included: H. Kent Baker, Ph.D., University Professor of Finance, Kogod School of Business, American University; Deborah A. Cunningham, Senior Vice President and Senior Portfolio Manager, Federated Investors Inc.; Sean J. Egan, President, Egan-Jones Ratings Co.; Gay Huey Evans, Director, Markets and Exchanges Division, The Financial Services Authority; Frank A. Fernandez, Senior Vice President, Chief Economist and Director of Research, The Securities Industry Association; Yasuhiro Harada, Senior Executive Managing Director, Rating and Investment Information Inc.; Neal E. Sullivan, Bingham McCutchen LLP (on behalf of Rating and Investment Information Inc.); Stephen W. Joynt, President and Chief Executive Officer, Fitch; James A. Kaitz, President and Chief Executive Officer, Association for Financial Professionals; Amy B.R. Lancellota, Senior Counsel, The Investment Company Institute; Malcolm S. Macdonald, Vice President - Finance and Treasurer, Ford Motor Company; Jack Malvey, Managing Director and Chief Global Fixed-Income Strategist, Lehman Brothers Inc.; Erwin W. Martens, Managing Director, Putnam Investments, LLC; Larry G. Mayewski, Executive Vice President, Chief Rating Officer, The A.M. Best Company; Raymond W. McDaniel, President, Moody's; Leo C. O'Neill, President, S&P; Stephanie B. Petersen, Senior Vice President, Taxable Money Fund and Municipal Research, Charles Schwab & Co.; Barron H. Putnam, Ph.D., President and Financial Economist, LACE Financial Corp.; Glenn L. Reynolds, Chief Executive Officer, CreditSights Inc.; Paul Saltzman, Executive Vice President and General Counsel, The Bond Market Association; Gregory A. Root, Executive Vice President, Dominion Bond Rating Service Limited; Steven L. Schwarcz, Professor of Law, Duke University School of Law School; David L. Shedlarz, Chief Financial Officer, Pfizer Inc.; Cynthia L. Strauss, Fidelity Investments Money Management Inc., Director of Taxable Bond Research; Jerome B. Van Orman Jr., Vice President, Finance and Chief Financial Officer, North American Operations, General Motors Acceptance Corp.; and J. Ben Watkins, Director, State of Florida Division of Bond Finance.

Each hearing addressed the same topics but with a different set of participants. Broad topic areas included: (a) the current role and functioning of credit rating agencies; (b) information flow in the credit rating process; (c) concerns regarding credit rating agencies (*e.g.*, potential conflicts-of-interest or abusive practices); and (d) the regulatory treatment of credit rating agencies (including concerns regarding potential barriers to entry). Highlights of the hearing discussions, organized by broad topic area, are summarized below.

a. *Current Role and Functioning of Credit Rating Agencies.* With regard to the role and functioning of credit rating agencies, representatives from the rating agencies provided general descriptions of their businesses, such as how they determine which issues to rate, and the process for issuing and monitoring credit ratings. Rating agencies generally view their role as assessing the creditworthiness of issuers on an ongoing basis, and the likelihood that debt will be repaid in a timely manner. They emphasized, however, that they do not conduct formal audits of rated companies or search for fraud, and that the nature of their analysis is largely dependent on the quality of information provided to them.

Representatives of users of credit ratings – mutual funds and broker-dealers – explained the importance of credit ratings to their businesses. Credit ratings are used by these institutions both for informational and regulatory purposes. These firms typically have their own internal credit research departments staffed with analysts who use ratings issued by credit rating agencies as one of several valuable "inputs" to their independent credit analysis. In addition, they felt that ratings were critical to the success of the Commission's rules regulating money market funds.[59]

Issuer representatives indicated that they seek credit ratings because of the value placed on the ratings by investors, and the affect credit ratings have on their ability to access capital. In selecting which rating agencies to use, issuers seek those capable of a competent, rigorous analysis that is recognized by the marketplace. As a practical matter, these have tended to be one or more of the NRSROs.

b. *Information Flow in the Credit Rating Process.* A number of issues were raised with regard to information flow in the credit rating process. Consistent with their view that credit analysis is largely dependent on quality information, the rating agencies generally favored measures that would improve information flows from issuers to the public. Although they believed the regulatory disclosure required of most U.S. issuers generally is sufficient to enable them to issue reliable ratings, they often seek additional information from issuers to better understand their business prospects and risks (*e.g.*, undisclosed contingencies that could adversely affect the issuer's liquidity). With regard to information flow from the rating agencies to the public, the rating agencies highlighted

[59] As noted above, Rule 2a-7 under the Investment Company Act of 1940 prohibits money market funds from investing in securities that are rated below the two highest categories for short-term debt (or unrated securities of comparable quality). *See supra* note 14 and accompanying text.

their ongoing efforts to make their rating processes more transparent – by widely disseminating their ratings and the basic underlying rationale, their ratings criteria, lists of credit ratings under review, and industry commentary.

Other hearing participants raised concerns regarding the special access of subscribers to rating agency information and personnel, particularly given the exclusion from Regulation FD available for disclosures to rating agencies.[60] While the larger rating agencies generally make ratings and the basic rating rationale available simultaneously to subscribers and non-subscribers, subscribers have access to substantial additional information, such as detailed rating reports and other analyses, as well as direct access to rating agency analysts. Some expressed concern that these additional communications – particularly the informal verbal contacts between subscribers and rating agency analysts – increased the risk of improper disclosure of confidential information provided by the issuer.[61] Others believe these contacts could inappropriately signal to subscribers information about upcoming ratings changes (and their associated market impact).

Buy-side representatives generally felt there should be more public disclosure from rating agencies about the reasons for their ratings decisions. They would like more information about the assumptions underlying the rating (*e.g.*, company and industry expectations, time horizons for achieving certain financial goals, specific events or financial triggers that would prompt a ratings action), as well as more specific disclosure about the information and documents reviewed by the rating agency.

In addition, some suggested that rating agencies that issue unsolicited ratings clearly designate them as such, and that there be clear disclosure when a rating agency terminates coverage of an issuer. Finally, some believed there should be regular public disclosure of performance information by rating agencies.

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[60] 17 CFR § 243.100(b)(2)(iii). *See* Selective Disclosure and Insider Trading, Release No. 34-43154 (August 15, 2000), 65 FR 51716 (August 24, 2000). Generally, Regulation FD prohibits an issuer of securities, or persons acting on behalf of the issuer, from communicating nonpublic information to certain enumerated persons - in general, securities market professionals or others who may well use the information for trading - unless the information is publicly disclosed. When Regulation FD was adopted, the Commission exempted rating agencies – not just NRSROs – from Regulation FD, on the condition that nonpublic information is communicated to a rating agency solely for the purpose of developing a credit rating and that the rating is publicly available. The Commission believed it was appropriate to provide this exclusion from the coverage of Regulation FD because rating agencies "have a mission of public disclosure." Under this exemption, the ratings process results in a widely available publication of the rating when it is completed. As a result, the impact of nonpublic information on the creditworthiness of an issuer is publicly disseminated, without disclosing the nonpublic information itself. In addition to the specific rating agency exemption in Regulation FD, rating agencies may be able to avail themselves of the exemption for "persons who expressly agree to maintain the disclosed information in confidence."

[61] The larger credit rating agencies typically maintain confidentiality agreements with issuers they rate.

c. *Concerns Regarding Credit Rating Agencies (e.g., Potential Conflicts-of-Interest or Abusive Practices).*

i. Issuer Influence. In general, hearing participants did not believe that reliance by rating agencies on issuer fees leads to significant conflicts of interest, or otherwise calls into question the overall objectivity of credit ratings. While the issuer-fee model naturally creates the potential for conflict of interest and ratings inflation, most were of the view that this conflict is manageable and, for the most part, has been effectively addressed by the credit rating agencies. The rating agencies take the position that their reputation for issuing objective and credible ratings is of paramount importance, and that they would be loathe to jeopardize that reputation to mollify a particular issuer.[62] Furthermore, the rating agencies have implemented a number of policies and procedures designed to assure the independence and objectivity of the ratings process, such as requiring ratings decisions to be made by a ratings committee, imposing investment restrictions, and adhering to fixed fee schedules. In addition, they assert that rating analyst compensation is merit-based (*e.g.*, based on the demonstrated accuracy of their ratings), and is not dependent on the level of fees paid by issuers the analyst rates. While most hearing participants agreed that, for the most part, the rating agencies had effectively managed this potential conflict, they stressed the importance of credit rating agencies implementing stringent firewalls, independent compensation, and other related procedures.

ii. Subscriber Influence. As discussed in paragraph (b) above, several hearing participants expressed concern regarding the special, and perhaps inappropriate, access to rating information and analysts available to rating agency subscribers.

iii. Advisory Services. Greater concerns were expressed with respect to potential conflicts of interest that may arise when a rating agency offers consulting or other advisory services to issuers it rates, although most hearing participants also believed these conflicts were manageable. The three NRSROs represented that they had established extensive guidelines to manage potential conflicts in this area, including firewalls to separate the ratings services from the influence of other businesses. They also indicated that advisory services presently represent a very small portion of their total revenues. Some hearing participants expressed concern that the potential conflict could become much greater were these services to become a substantial portion of a rating agency's business, and suggestions were made that their percentage contribution to the total revenues of a credit rating agency be capped. Others worried that issuers could be unduly pressured to purchase advisory services, particularly in cases where they were solicited by the rating analyst. While this line of business currently is very small, some viewed the potential conflicts as being analogous to those faced by auditors, which recently have become subject to extensive independence rules.

[62] Fees from any single issuer typically comprise a very small percentage – less than 1% – of a rating agency's total revenue.

iv. Abusive Practices. There were reports from some hearing participants that the largest rating agencies have abused their dominant position by engaging in certain aggressive competitive practices. For example, Fitch complained that S&P and Moody's were attempting to squeeze them out of certain structured finance markets by engaging in the practice of "notching" – lowering their ratings on, or refusing to rate, securities issued by certain asset pools (*e.g.*, collateralized debt obligations), unless a substantial portion of the assets within those pools were also rated by them.[63] Fitch suggested, as a possible solution, that NRSROs be required to recognize the ratings of other NRSROs as their own for purposes of rating these asset pools.

With respect to unsolicited ratings, some questioned the appropriateness of a rating agency using what critics termed "strong-arm" tactics to induce payment for a rating an issuer did not request (*e.g.*, sending a bill for an unsolicited rating, or sending a fee schedule and "encouraging" payment).

d. *Regulatory Treatment of Credit Rating Agencies (including Concerns regarding Potential Barriers to Entry)*. Hearing participants recognized that limited competition exists today in the credit rating industry and, in general, were of the view that additional competition would have a beneficial effect on the marketplace. Some noted that, historically, successful new entrants often established themselves by first specializing in a particular industry. There was less consensus on the reasons for the concentration in the credit rating business today. Some believed natural barriers to entry exist, given the substantial investment and track record necessary to achieve marketplace acceptance of ratings. Others noted that, as a practical matter, the market may not demand more than two or three rating agencies.

As to the impact of regulation on competition, most were of the view that the regulatory use of the NRSRO concept, in and of itself, did not act as a substantial barrier to entry. In general, hearing participants were of the opinion that NRSRO status is helpful to a rating agency from a business perspective and, to that extent, has a competitive impact. But most favored the regulatory use of credit ratings issued by NRSROs as a simple, efficient benchmark of credit quality, and recognized that regulatory standards for NRSROs were necessary for this concept to have meaning (*i.e.*, to ensure that ratings used for regulatory purposes are reliable), despite the potential impact on competition.

One concern widely expressed by hearing participants, however, involved the relative lack of transparency of the existing NRSRO recognition process conducted by Commission staff. Several suggested that the Commission should specify in more detail the types of information applicants need to provide to demonstrate, and that the Commission would review in evaluating, satisfaction of the various NRSRO criteria. In

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[63] *See* Press Release, Fitch Ratings, Survey Shows Majority of Structured Finance Executives Oppose Notching as Practiced by Moody's and S&P (March 27, 2002). For example, Fitch indicated that the practice of notching has led to a decline in its market share of ratings for commercial mortgage-backed securities from 65 percent (in the first three quarters of 2001), to 27 percent (in the first quarter of 2002), although its market share recently has begun to rebound.

addition, some believed that the staff should act upon NRSRO applications in a more timely fashion. A number of hearing participants – primarily users of ratings and issuers – suggested that the Commission consider more substantive regulation of rating agencies (*e.g.*, to address potential conflicts of interest, unfair practices, and information flow), and engage in more active ongoing oversight of them (*e.g.*, monitoring compliance with the NRSRO criteria through regular Commission examinations). Others noted that the Commission might promote competition by explicitly permitting rating agencies that specialize in particular sectors to become NRSROs.

IV. DISCUSSION

With the foregoing as background, the following discussion addresses each of the areas identified for Commission study in Section 702 of the Sarbanes-Oxley Act.

A. Role of Credit Rating Agencies in the Evaluation of Issuers of Securities

1. General Procedures for Evaluating Issuers

The larger credit rating agencies engaged in traditional, fundamental credit analysis generally approach the rating process with similar procedures and organizational structures, and these are described below. Rating procedures at these firms are designed to facilitate analytical consistency and capitalize on area expertise. Organizationally, the larger rating agencies divide the rating universe into separate categories by industry (*e.g.*, energy or banking) and type of instrument (*e.g.*, corporate debt, municipal securities, structured finance). At the core of the rating process is the rating committee. Rating committees are generally formed *ad hoc* to initiate, withdraw, or change a rating. They typically are composed of a lead credit analyst, managing directors or other area supervisors, and junior analytical staff. Rating decisions are made upon a simple majority vote of the committee and are, at their most basic level, an opinion regarding the likelihood the issuer will repay its financial obligation.

Rating agencies generally designate ratings of long-term debt through some variation of an alphabetical combination of lower and upper case letters. Fitch and S&P use the same ranking designators: AAA, AA, A, and BBB are investment grade categories; BB, B, CCC, CC, C, and D are considered speculative grade rankings. Moody's long-term rating designators are: investment grade: Aaa, Aa, A, Baa, speculative grade: Ba, B, Caa, Ca, and C. Rating agencies often attach modifiers to the grades to further distinguish and rank ratings within each generic classification. S&P and Fitch generally use pluses and minuses to modify their grades, while Moody's generally uses numerical modifiers 1-3, with 1 indicating that a credit falls in the higher end of the generic rating category, 2 indicating mid-range, and 3 indicating the lower end of the ranking.

2. Rating Committee Process

Rating committees typically convene at the behest of a lead analyst or sector supervisor to, among other things: (a) rate a new issuer or instrument; (b) assess a major transaction or event that might impact a current rating; or (c) consider putting a rating on review for change. The lead analyst frames the issues and presents most of the data under consideration.[64] Opinions of all members are considered and vetted, and ultimately result in a nonpublic committee memorandum that discusses its decision, rationale, assumptions, and underlying data.[65]

Committee deliberations are preceded by regular on-going contacts with issuers and information gathering. Ratings are based on a variety of public and nonpublic information. Public information reviewed in the ratings process typically includes filings with the Commission, news reports, industry reports, bond and stock price trends, data from central banks, and proxy statements. Nonpublic information can include credit agreements, acquisition agreements, private placement memoranda, and business projections and forecasts. Nonpublic information is often provided pursuant to a confidentiality agreement between the rating agency and the issuer, or is provided premised upon the rating agency's policy to keep such information confidential. It is generally the responsibility of the lead analyst to gather this information, frame issues for committee deliberations, and act as the primary point of contact with an issuer. Annual and periodic meetings at issuer or rating agency headquarters are common. Questionnaires and detailed document and information request letters also are used to gather information from issuers. Rating agencies generally do not, however, conduct audits or due diligence reviews of issuer-provided information.

3. Rating Decisions and Publication

Rating agencies generally advise issuers in advance of an imminent rating action and allow the issuers to appeal the decision. However, the right of appeal is limited both in time and to the submission of new and important information. The time between a

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[64] The primary credit considerations used in the corporate finance area involve both non-financial and financial factors. Some of the non-financial or qualitative considerations include: (1) stability of markets, (2) diversity of markets, (3) efficiency of operation (*e.g.*, distribution system and operating margins), (4) peer group analysis, (5) competition and market positions, and (6) government regulation. Financial or quantitative considerations include: (1) cash generation or use, (2) balance sheet strength, (3) debt/capitalization ratios, (4) interest coverage ratios, (5) operating cash flow to total debt ratios, and (6) fixed charge ratios.

[65] Whether qualitative or quantitative factors comprise the majority of a rating agency's credit analysis will depend on the sector. For instance, with regard to the cable TV industry, qualitative factors may be the most important consideration. Further, because rating agencies generally want their ratings to be stable, they sometimes seek to rate through current economic cycles that are characteristic of a particular industry. However, "rating through a cycle" is not always possible. For instance, speculative-grade companies with higher levels of leverage may not be able to maintain ratings until pricing cycles recover. Liquidity constraints over short amounts of time may affect such companies more severely than other more established companies.

committee decision and publication varies from a few hours to a few days, in order to minimize the inappropriate and premature disclosure of information to the marketplace. Issuers may be allowed to review and edit press releases to ensure factual accuracy and prevent the disclosure of confidential information. Rating agencies do not, however, allow issuers to delete the primary basis of a rating action if the disclosure of confidential information is not at issue.

In addition to rating actions, rating agencies may also publish rating outlooks. An outlook is an opinion on the future direction of the rating, and may encompass a period from one to several years. Outlooks are usually categorized as being positive, negative, or stable, and are typically included in a rating action press release.[66]

Rating agencies generally surveil ratings over time by reviewing corporate filings, monitoring industry trends, and maintaining a dialogue with corporate management. Rating agencies communicate the results of this surveillance on occasion to the marketplace through the use of "watch lists." Watch lists signal to the market that a rating is under active review for a change (in any direction) and are typically in response to significant sector or issuer specific events. Typically, issuers or instruments are kept on a watch list 90–120 days, depending on the practice of a particular rating agency. As with rating actions, issuers often are informed in advance if they are to be placed on a watch list, so that they have an opportunity to provide additional information or explain existing data.

B. Importance of the Role of Credit Rating Agencies to Investors and the Functioning of the Securities Markets

Credit ratings can play a significant role in the investment decisions of investors, and the value investors place on such ratings is evident from, among other things, the impact ratings have on an issuer's ability to access capital. Set forth below is a brief description of how various market participants use credit ratings, and the importance of rating agencies to their market activities.

1. Issuers. Issuers seek credit ratings for a number of reasons, such as to improve the marketability or pricing of their financial obligations, or to satisfy investors, lenders, or counterparties who want to enhance management responsibility. Public or private credit ratings may be sought from one or more rating agencies.[67] In certain markets, such as the U.S. long-term corporate debt market, a single-rated debt issue may

[66] Outlooks are sometimes erroneously confused with "placement of a credit on review for a change." The primary difference is that an outlook is meant to focus on trends and developments expected to occur over a longer period than the 90-120 days that a credit would normally be placed on review. The probability of these developments actually occurring or trends being confirmed are significantly lower than those events prompting a formal review. Further, outlooks are not necessarily a precursor to placement of a credit on review.

[67] Even if an issuer decides against seeking a credit rating, a rating agency may nonetheless issue a rating with or without the issuer's involvement. Ratings not initiated at the request of an issuer commonly are known as "unsolicited" ratings.

be priced below an issue with similar ratings from two agencies, because the absence of a second rating is interpreted as the issuer's inability to obtain another equivalent rating. In other markets, however, such as the asset-backed securities market, a single rating may be adequate confirmation of asset quality.

2. Buy-Side Firms. Buy-side firms, such as mutual funds, pension funds, and insurance companies, are among the largest owners of debt securities, preferred stock, and commercial paper in the U.S. Retail participation in the debt markets generally takes place indirectly through these fiduciaries. Most of the large buy-side firms active in the fixed income markets are substantial users of information from credit rating agencies, even though they typically conduct their own credit analysis for risk management purposes, or to identify pricing discrepancies for their trading operations. Buy-side firms use credit ratings as one of several important inputs to their own internal credit assessments and investment analyses. For example, a buy-side analyst might review the rationale underlying a credit rating to better understand the perspectives of other respected credit analysts, or to anticipate the likelihood of future credit rating actions. Buy-side firms also may use credit ratings to comply with internal by-law restrictions or investment policies that require certain minimum credit ratings for investments, or to identify acceptable counterparties. Finally, buy-side firms use credit ratings to ensure compliance with various regulatory requirements.

3. Sell-Side Firms. Like buy-side firms, many sell-side firms (*e.g.*, broker-dealers that make recommendations and sell securities to their clients) conduct their own credit analysis for risk management and trading purposes. To a large extent, sell-side firms use credit ratings in a fashion similar to buy-side firms. One difference between buy-side and sell-side firms, however, is that many broker-dealers also maintain rating advisory groups. These groups generally assist underwriting clients in selecting appropriate credit rating agencies for their offerings, and help guide those clients through the rating process. In addition, sell-side firms often act as dealers in markets that place significant importance on credit ratings. For example, in the over-the-counter derivatives market, broker-dealers tend to use credit ratings (when available) to determine acceptable counterparties, as well as collateral levels for outstanding credit exposures. Finally, large broker-dealers themselves frequently obtain credit ratings as issuers of long- and short-term debt.

4. Regulatory Use of Ratings. Credit ratings are used for regulatory purposes around the world, primarily in the context of financial regulations. The regulatory use of credit ratings increases their importance to certain market participants. For example, ratings play an important role in the commercial paper market, where issuers find it difficult to sell paper that does not qualify for investment by money market funds under Rule 2a-7 under the Investment Company Act.[68] The regulatory use of credit ratings in

[68] The exact impact Investment Company Act of 1940 Rule 2a-7 has on the commercial paper market is unclear, however. Most money market funds voluntarily limit themselves to investing in securities rated higher than necessary to be eligible investments under Rule 2a-7, which suggests that investor requirements may also contribute to the difficulties encountered by lower rated issuers in issuing commercial paper.

the U.S. is described in detail in Section II.B. above. In addition, the regulatory use of credit ratings in foreign markets appears to be growing. A recent survey by the Bank for International Settlements, for example, summarizes the various ways financial regulatory authorities around the world use credit ratings in their regulations today.[69] That survey was undertaken in connection with the proposal of the Basel Committee on Banking Supervision to permit banks to use ratings from credit rating agencies in determining capital requirements under the new Basel Capital Accord.

5. Use of Ratings in Private Contracts. The extensive use of credit ratings in private contracts also has enhanced the importance of credit ratings to the marketplace. For example, the widespread use of "ratings triggers"[70] in financial contracts recently has received considerable attention as a result of certain high-profile bankruptcies, such as Enron and Pacific Gas and Electric Company ("PG&E").[71] In the case of Enron, the use of credit ratings as "triggers" in trading and other financial agreements gave counterparties the right to demand cash collateral, and lenders the right to demand repayment of outstanding loans, once Enron's credit rating declined to certain levels. As a result, the existence of ratings triggers contributed to Enron's financial difficulties.[72] Similarly, the impact of credit rating downgrades on PG&E's financial agreements limited its ability to borrow funds to repay its short term debt obligations.[73] In cases such as these, contractual ratings triggers can seriously escalate liquidity problems at firms faced with a deteriorating financial outlook. As noted in Section V below, because of the significant potential negative impact of contractual ratings triggers on issuers, the Commission intends to explore whether issuers should be required to provide more extensive public disclosure regarding such triggers.[74] In addition, credit rating agencies and others have been conducting intensive studies to better understand the nature and extent of the use of credit ratings in financial contracts, and their potential impact on a company's liquidity and creditworthiness. [75]

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69 *See* Credit Ratings and Complementary Sources of Credit Quality Information, Basel Committee on Banking Supervision Working Papers (August 2000) [hereinafter "Basel Study"], at 42-43.

70 "Ratings triggers" are described in subsection C.1. below.

71 *See* Special Comment, "The Unintended Consequences of Ratings Triggers," Moody's Global Credit Research (December 2001).

72 *Id*. at 6.

73 *Id*. at 8.

74 *See* Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date, Release No. 33-8106 (June 17, 2002), 67 FR 42914 (June 25, 2002).

75 *See* Special Comment, "Moody's Analysis of US Corporate Rating Triggers Heightens Need for Increased Disclosure," Moody's Global Credit Research (July 2002) [hereinafter "Moody's Special Comment"]. *See also,* Preliminary Report of the GIC With Credit Rating Downgrade Provisions Working Group of the American Academy of Actuaries to the Innovative Products Working Group of the Life and Health Actuarial Task Force of the NAIC (October 1999) (discussing the liquidity demands on insurance

C. Impediments to the Accurate Appraisal of Issuers by Credit Rating Agencies

One of the most fundamental impediments to the accurate appraisal of issuers by credit rating agencies is the inability of rating agencies to access a continuous flow of accurate and reliable information from issuers. Some have questioned whether the level of public disclosure by issuers is adequate. As discussed below, the Commission recently has taken steps to improve the extent and quality of information disclosed by issuers, with the goal of assuring that the marketplace (including rating agencies) has better information with which to evaluate the risks of those securities. In addition, some have expressed concern regarding the recent performance of credit rating agencies, particularly in the case of Enron, and questioned whether the rating agencies have been using the appropriate level of diligence in conducting their analysis and fulfilling their important role in the marketplace.

1. Level of Public Disclosure by Issuers

In the course of our study, concerns were expressed about the level of public disclosure by issuers. At the Commission's credit rating agency hearings, several specific areas for improved issuer disclosure were mentioned, including the need for additional detail regarding an issuer's short-term credit facilities and, particularly in light of the Enron experience, better disclosure of the existence and nature of "ratings triggers" in contracts material to an issuer.

In essence, "ratings triggers" are contractual provisions that terminate credit availability or accelerate credit obligations in the event of specified rating actions, with the result that a rating downgrade could lead to an escalating liquidity crisis for issuers subject to ratings triggers.[76] Given the potentially catastrophic impact ratings triggers could have on an issuer, disclosure of their existence both to rating agencies and the public would appear critical. In the aftermath of the Enron bankruptcy, the rating agencies appear to have become more diligent in seeking information regarding ratings triggers.[77] Nevertheless, as noted in Section V below, the Commission is exploring whether additional issuer disclosures should be required, including disclosures relating to the existence and impact of ratings triggers.

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companies from guaranteed investment contracts (GICs) that allow contract holders to surrender the GIC for its book value in the event the insurance company's credit ratings decline below certain levels).

[76] *See* Moody's Special Comment, *supra* note 75.

[77] Shortly after the Enron bankruptcy, several of the larger credit rating agencies surveyed a number of U.S. and European companies to determine their exposure to ratings triggers. According to the published surveys, the rating agencies indicated that few companies appeared to be exposed to a high degree of risk on account of ratings triggers, other than those previously known to them. In addition, some companies and lenders appear to have acknowledged that the use of ratings triggers can backfire and precipitate a liquidity crisis and, accordingly, are beginning to remove ratings triggers from their agreements. *See, e.g.,* Rating Action: Moody's Confirms El Paso Corp.'s Debt Ratings (Baa2 SR. UNS.) in Response to Debt Reduction Plan That Includes Elimination of Rating Triggers (December 12, 2001).

More generally, the Commission has taken a number of steps in recent months to improve the extent and quality of issuer disclosure. The Commission recently adopted rules significantly shortening the time period between the end of an issuer's quarter or fiscal year and the due date of its quarterly report on Form 10-Q or annual report on Form 10-K.[78] In January 2003, the Commission adopted rules regarding the disclosure of non-GAAP financial information.[79] These rules also require issuers to furnish their earnings releases on a current report on Form 8-K. In addition, the Commission adopted revisions to its rules governing Management's Discussion and Analysis to require disclosure of off-balance sheet arrangements, contractual obligations and contingent liabilities and commitments.[80] The Commission recently proposed rules relating to enhanced disclosure of material events on current report on Form 8-K, which would also require a significant acceleration of the filing deadline, and enhanced disclosure regarding critical accounting policies.[81] These rule proposals are pending and the Commission staff is currently reviewing comments received in order to determine what recommendations to make to the Commission. The impact of all of these initiatives, among other things, should be to enhance the ability both of rating agencies and investors to evaluate the credit quality of issuers. In addition, as noted in Section V below, the Commission is exploring whether there should be additional improvements to the extent and quality of disclosure by issuers, including disclosures relating to conditional elements of important financial contracts, ratings triggers, short-term credit facilities, special purpose entities, and material future liabilities.

2. Diligence and Qualifications of Credit Rating Agency Analysts

In the aftermath of the Enron situation and other recent corporate failures, some have criticized the performance of the credit rating agencies, and questioned whether they are conducting sufficiently thorough analyses of issuers, particularly given their special position in the marketplace. Concerns also have been raised regarding the training and qualifications of credit rating agency analysts.

In particular, the Staff Report, issued in connection with the investigation by the Senate Committee on Governmental Affairs of the Enron situation, found that, while the credit rating agencies did not completely ignore the problems at Enron, "their monitoring and review of [Enron's] finances fell far below the careful efforts one would have

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[78] *See* Acceleration of Periodic Report Filing Dates and Disclosure Concerning Website Access to Reports, Release No. 33-8128 (Sept. 5, 2002), 67 FR 58479 (Sept. 16, 2002).

[79] *See* Conditions for Use of Non-GAAP Financial Information, Release No. 33-8176 (Jan. 22, 2003).

[80] *See* Disclosure in Management's Discussion and Analysis about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations (Release No. forthcoming).

[81] *See supra* note 74. *See also* Disclosure in Management's Discussion and Analysis about the Application of Critical Accounting Policies, Release No. 33-8098 (May 10, 2002), 67 FR 35620 (May 20, 2002).

expected from organizations whose ratings hold so much importance."[82] According to the Staff Report, in some cases the rating agencies appeared simply to take the word of Enron officials when issues were raised, and failed to probe more deeply. In addition, the credit rating agency analysts seemed to have been less than thorough in their review of Enron's public filings, even though these filings are a primary source of information for the ratings decision. Among other things, the rating analysts appeared to pay insufficient attention to the detail in Enron's financial statements, failed to probe opaque disclosures, did not review Enron's proxy statements, and failed to take into account the overall aggressiveness of Enron's accounting practices. In essence, the Staff Report found that the rating agencies failed to use the necessary rigor to ensure their analysis of a complex company, such as Enron, was sound.[83] Accordingly, as discussed in Section III.A.2. above, the Staff Report recommended the Commission impose standards for credit rating agencies in deriving their ratings.[84]

The rating agencies tend to have a more limited view of their role in verifying information reviewed in the credit rating process. In general, the rating agencies state that they rely on issuers and other sources to provide them with accurate and complete information.[85] They typically do not audit the accuracy or integrity of issuer information. Though rating agencies may at times be able to use their influence in the marketplace to compel issuers to provide additional information, they have no legal power to subpoena issuer information. In cases where a rating agency concludes that important information is unavailable, or an issuer is less than forthcoming with them, the rating agency may, depending on the significance of the information involved, issue a lower rating, refuse to issue a rating, or even withdraw an existing rating. In general, the rating agencies indicate that reputational concerns are sufficient to ensure that they exercise appropriate levels of diligence in the ratings process.

Nevertheless, as noted in Section V below, the Commission intends to explore whether NRSROs should incorporate general standards of diligence in performing their ratings analysis, and with respect to the training and qualifications of credit rating analysts.

D. Measures to Improve the Dissemination of Information by Credit Rating Agencies

The nature and extent of information made available to the public and/or subscribers varies from one credit rating agency to another. Credit rating agencies may provide comprehensive, lengthy research reports detailing the criteria and support for

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82 Staff Report, *supra* note 5, at 115.

83 *See id.* at 115-125.

84 *Id.* at 127.

85 Primary sources of information cited by the rating agencies generally included issuers, auditors, investment bankers, and public and private databases.

their ratings, or they may provide less intensive summary information that can be quickly and easily reviewed, or both. The rating rationale provided by credit rating agencies may be primarily qualitative, or primarily quantitative, or a combination of the two. Some credit rating agencies – typically those less dependent on subscriber revenues – make their ratings and rating rationale publicly available, at no charge, on their internet web sites and through press releases. (Subscribers typically are provided with more detailed information.) Other rating agencies limit all access to their ratings and research to subscribers. The frequency with which a rating agency issues ratings also varies. Some provide ratings on a periodic basis – the ratings are intended to reflect creditworthiness only for a specified time period, after which a new rating must be issued. Others issue ratings of indefinite duration, which are monitored on an ongoing basis and confirmed, upgraded, or downgraded, if and when necessary.

The Commission studied several issues relating to the dissemination of information by credit rating agencies, and possible improvements that might be considered. The most significant of these are summarized below.

1. Transparency of Ratings Process. At the Commission's credit rating agency hearings, representatives of users of securities ratings – particularly buy-side firms – stressed the importance of transparency in the ratings process. In their view, the marketplace needs to more fully understand the reasoning behind a ratings decision, and the types of information relied upon by the rating agencies in their analysis. Better information about rating decisions, they assert, would reduce the uncertainty, and accompanying market volatility, that frequently surrounds a ratings change.[86] Among other things, users would like more information about the rating analyst's key assumptions or expectations regarding the issuer's financial performance and industry trends, as well as specific events or financial triggers that might prompt a reconsideration of the rating. They would also like a list of the key documents reviewed as part of the ratings process.[87]

A related concern arises as a result of the recent implementation by the Commission of Regulation FD which, in very broad terms, prohibits selective disclosure of nonpublic issuer information, but provides a conditional exception for rating agencies.[88] Rating agencies commonly use nonpublic information in their analysis, such

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[86] *See* SEC Hearing Transcript, *supra* note 57 (November 15, 2002) (testimony of Cynthia L. Strauss, Director of Taxable Bond Research, Fidelity Investments Money Management Inc. [hereinafter "Strauss Testimony"]) ("[O]ne of the first things we wonder is what is it that they [the credit rating agencies] know, and [to the extent what they know is unclear] I think that adds unnecessary volatility and uncertainty to the marketplace.").

[87] *See* SEC Hearing Transcript, *supra* note 57 (November 15, 2002) (testimony of Deborah A. Cunningham, Senior Vice President and Senior Portfolio Manager [hereinafter "Cunningham Testimony"]) ("What we are paying for is the information that is key in understanding why their ratings are as they are.") and (Strauss Testimony) ("What makes a rating good is how well the agency analyzes the company, makes an assessment, and clearly articulates that to the marketplace, so the marketplace can make its best assessment of that.").

as budgets and forecasts, financial statements on a stand-alone basis, and internal capital allocations and contingent risks. While some observers have commented that a rating agency's access to nonpublic information improves the rating process[89] and results in a more informed and complete credit rating,[90] this access, in the context of Regulation FD, has caused concern to others.[91] Specifically, concerns have been expressed that the rating agency exemption in Regulation FD may increase volatility and decrease transparency in the market.[92] When nonpublic information is used to develop a credit rating, rating agencies attempt to convey the consequences of such information in their published rating decision, without disclosing the nonpublic information itself or even the extent nonpublic information factored into the ratings decision. Some are of the view that, to the extent market participants must speculate as to whether nonpublic information was used in the rating process and, if so, the relative importance placed upon it, market uncertainty and volatility result.

Rating agency representatives generally agreed that users should understand the reasoning behind a rating before relying on it, and described the information presently made available in this regard.[93] They also expressed a willingness to work with users to offer additional information concerning their ratings analysis and decisions.[94]

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88 *See supra* note 60. In addition to the specific rating agency exemption in Regulation FD, rating agencies may be able to avail themselves of the exemption for "persons who expressly agree to maintain the disclosed information in confidence."

89 *See* SEC Hearing Transcript, *supra* note 57 (November 15, 2002) (testimony of Malcolm S. Macdonald, Vice President – Finance and Treasurer, Ford Motor Company [hereinafter "Macdonald Testimony"]) ("[I]f we were required to observe FD with the [rating agencies], the quality of the rating for the investors would undoubtedly go down, because there is no way that we would release confidential product plans for future years and data of that type, which could be used by our competitors. So applying the exemption from FD, I think, improves the rating process.").

90 *See, e.g.*, the Elsner Letter, *supra* note 40 ("Having access to the issuer and confidential information at the time of issuance and on going, is one of the strengths of an NRSRO securities rating . . . A rating agency that has access to key management or that has full access to critical underlying information essential for issuing a rating, has the ability to produce an informed rating. Only such informed ratings should be classified as 'complete' ratings to qualify for regulatory purposes.").

91 *See* SEC Hearing Transcript, *supra* note 57 (November 15, 2002) (Strauss Testimony) ("[T]he fact that the rating agencies have access to information that investors cannot have creates great concern for us.").

92 *See* SEC Hearing Transcript, *supra* note 57 (November 15, 2002) (Strauss Testimony) ("We don't have [nonpublic information,] and then we're reliant, we the marketplace, on the rating agencies doing the right thing with it. I just think it creates an uncomfortable imbalance which can also add volatility.").

93 *See generally* SEC Hearing Transcript, *supra* note 57 (November 15, 2002) (testimony of Leo C. O'Neill, President, S&P [hereinafter "O'Neill Testimony"]), and (November 21, 2002) (testimony of Raymond W. McDaniel, President, Moody's [hereinafter "McDaniel Testimony"]).

94 *See generally* SEC Hearing Transcript, *supra* note 57 (November 15, 2002) (O'Neill Testimony), regarding S&P's willingness to "go to work" on improving the transparency of its rating process.

Accordingly, as noted in Section V below, the Commission is exploring whether NRSROs should disclose more information about the key bases of, and assumptions underlying, the ratings decision.

2. Preferential Subscriber Access to Information. Some have expressed concern regarding the special access of subscribers to rating agency information and personnel. In the course of its study, the staff, among other things, examined: (a) whether information concerning a rating action is made available to subscribers prior to the rating being issued; and (b) the extent to which information concerning a rating is made available to subscribers that is not available, or not available as readily or as soon, to the public. As discussed above, those rating agencies that make ratings publicly available (including the largest rating agencies) represent that the ratings themselves are available to the public and subscribers at the same time.[95] But additional, more extensive information is provided to subscribers and, as a practical matter, many subscribers have direct access to rating agency analysts for elaborative conversations.

Questions have been raised as to whether this preferential subscriber access to important information about issuers and credit ratings creates an unfair information asymmetry in the marketplace.[96] For example, analysts at credit rating agencies routinely take calls from subscribers, and the existence of these informal contacts raises the possibility of disclosure (intentional or inadvertent) of information concerning a rating prior to its issuance, or regarding the timing or nature of a forthcoming rating change. Selective disclosure of information regarding upcoming rating changes is particularly troublesome, given the substantial market impact rating changes may have. In addition, these contacts would appear to increase the risk of confidential issuer information being disclosed.

The rating agencies note that they have policies and procedures to prevent these problems. Typically, rating agencies have extensive internal rules that prohibit analysts from communicating information regarding rating actions until the rating is publicly

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95 *See* SEC Hearing Transcript, *supra* note 57 (November 21, 2002) (testimony of Stephen W. Joynt, President and Chief Executive Officer, Fitch [hereinafter "Joynt Testimony"]) ("Our ratings are public . . . Any press releases we make and public announcements that we make are designed to provide sufficient information to substantiate any rating we do, or any rating change we make.") and (McDaniel Testimony) ("Our press releases, which contain any rating changes and the rationale for rating changes . . . are made available publicly on our website.").

96 *See* SEC Hearing Transcript, *supra* note 57 (November 15, 2002) (Macdonald Testimony) ("[W]e do find that we receive reports that personnel from the rating agencies have made comments to analysts, investors, and others that they will not make publicly and they will not make to us, and I believe and I am concerned that that can lead to serious distortions in the markets."). Mr. Macdonald expressed additional concern that an individual analyst's views might not necessarily reflect those of the rating agency's rating committee – which controls the ratings decision – and that the potential exists for misleading subscribers who communicate with the analyst.

released.[97] In addition, analysts specifically are prohibited from discussing confidential issuer information with anyone outside the appropriate departments at the rating agency.

Nevertheless, as noted in Section V below, the Commission is exploring whether NRSROs should prohibit (or severely restrict) direct contacts between rating analysts and users of ratings, including subscribers.

3. Public Availability of Ratings. Many are of the view that the ratings of an NRSRO should be publicly available, at no charge, to assure wide availability of the ratings and the opportunity for the marketplace to judge their credibility and reliability. As noted in Section V below, is exploring whether NRSROs should publicly disseminate their ratings on a widespread basis.

E. Barriers to Entry into the Business of Acting as a Credit Rating Agency – Measures Needed to Remove Such Barriers

For many years, market participants have voiced concerns about the concentration of credit rating agencies in the U.S. securities markets, and whether inordinate barriers to entry exist. There also has been substantial debate regarding the extent to which any natural barriers to entry are augmented by the regulatory use of the NRSRO concept, and the process of Commission recognition of NRSROs.

Technically, the barriers to entry into the business of acting as a credit rating agency would appear to be quite small, given that through the internet, for example, one can easily publish credit opinions to a worldwide audience at minimal cost. Nevertheless, most agree that the barriers to building a successful rating agency that rates a large number of issues, and is widely relied upon by market participants, are substantially greater. Opinions differ regarding the critical elements for success in the credit rating business (*e.g.*, staff, experience, capital), and this leads to differing opinions as to the precise nature and extent of the natural barriers to successful entry.

Nevertheless, in general terms, there is a widespread view that one of the most significant natural barriers into the credit rating business is the current dominance of a few highly-regarded, well-capitalized rating agencies that pioneered the industry many decades ago. The business of issuing credit ratings on securities originated in the early 1900s and, until the mid-1970s, only a handful of firms (primarily the three current NRSROs) issued credit ratings on securities. Since the mid-1970's, however, there has been a steady increase in the number of credit rating agencies operating in the U.S. and

[97] With regard to issuers, analysts are often allowed to inform the issuer of concerns during the course of the rating process, but with the caveat that the rating has not yet been finalized until it is settled by a rating committee. Further, issuers are often provided with an opportunity to review a rating shortly before it is released to ensure that the information contained in the draft report and/or press release is factually correct and devoid of any confidential information used in developing the rating.

internationally, so that today it is estimated that there are more than 100 active credit rating agencies worldwide.[98]

The recent growth in the number of firms operating as credit rating agencies suggests a growing appetite among market participants for advice about credit quality, and that new entrants are able to develop a following for their credit judgments. At the same time, few would dispute that new entrants generally have been unable to evolve into a substantial presence in the ratings industry. Many believe this is due primarily to the longstanding dominance of the credit rating business by a few firms – essentially the NRSROs – as well as the fact that the marketplace may not demand ratings from more than two or three rating agencies.

As to the regulatory impact on rating agency competition, a wide range of observers has criticized the regulatory use of the NRSRO concept – particularly the "national recognition" requirement – as creating a substantial barrier to entry. In essence, these critics contend that important users of securities ratings have a regulatory incentive to obtain ratings issued by NRSROs, and that without NRSRO status new entrants encounter great difficulties achieving the "national recognition" necessary to acquire the NRSRO designation. In other words, new entrants are faced with something akin to a "chicken and egg" problem in achieving NRSRO status, which they view as necessary or, at a minimum, very important for becoming a substantial presence in the credit rating industry.

For example, the U.S. Department of Justice ("DOJ"), commenting on the Commission's 1997 rule proposal, opposed the use of the "national recognition" requirement because, in its view, that criterion likely creates a "nearly insurmountable barrier to new entry into the market for NRSRO services."[99] DOJ believed that, while the historical dominance of Moody's and S&P had eroded in recent years for certain types of securities, the overall level of market power they retained continued to be a competitive concern. To ameliorate entry barriers, DOJ suggested the Commission consider giving "provisional" NRSRO status (for the first 12 to 18 months of existence) to newly-formed credit rating affiliates of established, well-capitalized firms that have reputations for quality financial analysis in the investment community (*e.g.*, investment banks, commercial banks, insurance companies, consulting firms, or accounting firms). DOJ also recommended the Commission consider "provisional" NRSRO status for foreign rating agencies, and indicated they might initially specialize in rating U.S. companies with substantial operations abroad.

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[98] *See* Basel Study, *supra* note 69, at 14 ("[I]n September 1999, it was believed that there might be some 130 [rating] agencies world-wide, although industry sources indicated this number was closer to 150."). *See also* SEC Hearing Transcript, *supra* note 57 (November 15, 2002) (testimony of Gay Huey Evans, Director, Markets and Exchanges Division, The Financial Services Authority) ("There are [approximately] 150 [rating] agencies in total around the world and they vary in size and scope.").

[99] *See* Comments of the United States Department of Justice in the Matter of: File No. S7-33-97 Proposed Amendments to Rule 15c3-1 under the Securities Exchange Act of 1934 (March 6, 1998).

In the course of the Commission's study, NRSRO representatives generally took the position that, while NRSRO status might have some marginal impact on their business, its effect was not substantial. Representatives from certain non-NRSRO rating agencies, on the other hand, were of the view that lack of NRSRO status substantially hindered their businesses' rate of growth.[100] In their view, NRSRO status is of great significance, not only because the concept permeates financial regulation, but also because the marketplace views the NRSRO designation as the equivalent of the "Good Housekeeping Seal Of Approval."[101]

Users of credit ratings and others point out, however, that there must be substantive threshold standards for achieving NRSRO status for that term to have meaning.[102] In essence, the NRSRO designation is meant to reflect the fact that the marketplace views a rating agency's ratings as credible and reliable. Without such an assurance as to the quality of the ratings issued by a rating agency, it would be foolhardy to rely upon ratings as a proxy for credit quality in regulation. Furthermore, any regulatory barriers to entry have not proved to be insurmountable. Since the mid-1970s, several rating agencies have been able to enter the credit rating business and achieve the requisite level of market recognition to be designated NRSROs.[103] And there are several additional applications for NRSRO designation currently under review by Commission staff.

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100 *See, e.g.*, SEC Hearing Transcript, *supra* note 57 (November 21, 2002) (testimony of Barron H. Putnam, Ph.D., President and Financial Economist, LACE Financial Corp.) ("When Thomson BankWatch received NRSRO status . . . our company just stopped growing, and we really haven't grown much since that time."). However, *see also* SEC Hearing Transcript, *supra* note 57 (November 15, 2002) (testimony of Sean J. Egan, President, Egan-Jones Ratings Co.) (Mr. Egan, responding to a question on whether it is difficult to expand his firm without being recognized as an NRSRO, stated, "[I]t's possible to establish yourself in the market, to grow [your] firm, to get the critical mass, to have a sustainable operation.").

101 *See, e.g.*, SEC Hearing Transcript, *supra* note 57 (November 21, 2002) (testimony of Larry G. Mayewski, Executive Vice President and Chief Ratings Officer, Ratings Division, The A.M. Best Company) ("Clearly, the lack of an NRSRO designation has had some impact . . . [O]verall, issuers look at [NRSRO] designation as a Good Housekeeping Seal of Approval.").

102 *See, e.g.*, SEC Hearing Transcript, *supra* note 57 (November 15, 2002) (testimony of Frank A. Fernandez, Senior Vice President, Chief Economist and Director of Research, The Securities Industry Association [hereinafter "Fernandez Testimony"]) ("I think there are some very high barriers to entry with respect to the NRSRO designation. Some of them I believe are natural, some I believe are necessary") and (testimony of Gregory A. Root, Executive Vice President, Dominion Bond Rating Service Limited) ("I think the barriers to entry need to be high as long as there is going to be an NRSRO designation and ratings are going to play the role they do. They need to be high. Not insurmountable, but high.").

103 Duff & Phelps, Inc. began issuing credit ratings in 1974 and became an NRSRO in 1982. McCarthy Crisanti & Maffei began issuing credit ratings in 1975 and became an NRSRO by 1983. IBCA Limited and IBCA Inc. began issuing credit ratings in 1978 and 1985, respectively, and were designated together as an NRSRO in 1990. Thomson BankWatch, Inc. entered the credit rating business in 1974 and became an NRSRO in 1991. As discussed in Section II, however, each of these NRSROs subsequently was acquired by or merged into another NRSRO, with the result that today there remain only three NRSROs.

Nevertheless, in the course of the Commission's examination, there appeared to be substantial support – even from the existing NRSROs[104] – for efforts to improve competition in the credit rating industry. Some have suggested that one clear way to remove any regulatory barriers to competition is to eliminate the use of the NRSRO concept in regulation. One view, for example, is that credit spreads could be a viable substitute for credit ratings in financial regulation.[105] But others believe that the volatility of credit spreads, their backward-looking nature, and the fact that their use would be limited to liquid securities, make them an inferior alternative to credit ratings.[106] As noted in Section V below, the Commission is exploring whether there are viable alternatives to the NRSRO concept in Commission rules and regulations.

Many believe that rating agencies that focus on a specific sector of the debt market should be able to achieve NRSRO recognition.[107] As previously noted, rating agencies often enter the business by focusing on a particular segment of the debt markets. Allowing them to demonstrate national recognition of their sectoral expertise in order to become an NRSRO, therefore, could stimulate competition in the credit rating industry. Accordingly, as noted in Section V below, the Commission is exploring whether it should expressly permit NRSROs that cover a limited sector of the debt market to achieve NRSRO designation.[108] The Commission also is exploring the appropriateness of

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[104] *See, e.g.,* SEC Hearing Transcript, *supra* note 57 (November 21, 2002) (testimony of Stephanie B. Petersen, Senior Vice President, Taxable Money Fund and Municipal Research, Charles Schwab & Co., Inc.) ("[I]ncreased competition is an area to be focused on.") and (Joynt Testimony) ("[W]e are pro competition, and I do see a role for other rating agencies.") *See also* Written Statement of The Bond Market Association, SEC Hearing on Credit Rating Agencies (November 21, 2002) ("[W]e believe that the Commission should undertake the [NRSRO] designation process with a view to promoting competition by designating additional organizations, consistent with prudent application of the regulatory standards.").

[105] *See, e.g,,* Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 Wash.U.L.Q. 619 (1999). Professor Partnoy suggests that money market mutual funds, for example, be permitted to purchase only those bonds with a credit spread of 75 basis points or less, and be required to sell bonds whose credit spread increased above 75 basis points for some period of time. *Id.* at 706.

[106] *See, e.g.,* SEC Hearing Transcript, *supra* note 57 (November 15, 2002) (Fernandez Testimony) ("If the implication here is that for some reason spreads might be a substitute for ratings, I think that would be a disservice to everyone. Spreads are the reflection of the last trade in the marketplace, and that market may be wrong on any given day about the long-term fundamental value, the probability of default or ultimate recovery value of any security.") and (November 21, 2002) (testimony of Paul Saltzman, Executive Vice President and General Counsel, The Bond Market Association) ("[C]redit spreads basically are much more likely to give you false negatives.") and (testimony of Steven L. Schwarcz, Professor of Law, Duke University School of Law) ("Rating agencies are, and are intended to be, more conservatively stable [than credit spreads].").

[107] *See, e.g.*, Written Statement of Rating and Investment Information, Inc., Submitted to the U.S. Securities and Exchange Commission In Connection with the November 15 and 21, 2002 Hearings on Credit Rating Agencies (File No. 4-467) (November 14, 2002) (recommending "that the Commission permit limited purpose recognition of credit rating agencies for those agencies that have demonstrated an expertise in a discrete area of rating services.").

[108] Two of the seven firms previously recognized as NRSROs were recognized on a limited purpose basis. In a letter dated November 27, 1990, to Mr. Robin Monro-Davies, President of IBCA Limited, the

recognizing as an NRSRO a rating agency that confines its activity to a limited geographic area.

In addition, the Commission's process of recognizing NRSROs has come under criticism for being opaque and lengthy. If this process were to be clarified and streamlined, perhaps rating agencies could achieve NRSRO status more readily, thereby promoting competition in the credit rating industry. Some rating agencies that have been reviewed by Commission staff for purposes of achieving NRSRO status complain that, while the general criteria reviewed by the staff and referenced in applicable no-action letters are well-known, it is unclear how Commission staff conducts its assessment, and exactly what is needed to demonstrate satisfaction of the general criteria. For example, there appears to be confusion as to the types of evidence of national recognition the staff finds persuasive, and the minimum levels of staffing and financial resources that are required. In addition, some NRSRO applicants have expressed concern over the length of time it takes Commission staff to evaluate them and reach a conclusion on their applications. Accordingly, as noted in Section V below, the Commission is exploring possible clarifications of the NRSRO criteria, as well as instituting timing goals for the evaluation of NRSRO applications.

F. Conflicts of Interest in the Operation of Credit Rating Agencies – Measures to Address Such Conflicts

Potential conflicts of interest have existed in the credit rating business for many years and, as mentioned in Section III.B.2. above, the Commission has reviewed the impact of certain of these potential conflicts in the past.[109] Many are of the view, however, that the potential conflicts of interest faced by credit rating agencies have increased in recent years, particularly given the expansion of large credit rating agencies into ancillary advisory and other businesses, and the continued rise in importance of rating agencies in the U.S. securities markets. Two of the most significant potential conflicts of interest, which were a focus of the Commission's study, are discussed below.

Commission's Division of Market Regulation stated that it would not recommend enforcement action to the Commission against broker-dealers that considered IBCA Limited and its subsidiary, IBCA Inc., together, as an NRSRO for purposes of the Net Capital Rule, in the case of debt issued by banks, bank holding companies, United Kingdom building societies, broker-dealers, and broker-dealers' parent companies, as well as bank-supported debt. Similarly, by letter dated August 6, 1991, the Division of Market Regulation informed Mr. Gregory A. Root, then President of Thomson BankWatch, Inc. ("BankWatch"), that it would not recommend enforcement action against broker-dealers that considered BankWatch as an NRSRO for purposes of the Net Capital Rule, in the case of debt issued by banks, bank holding companies, non-bank banks, thrifts, broker-dealers, and broker-dealers' parent companies. On January 25, 1999, however, the Division of Market Regulation granted the request of BankWatch to be considered by broker-dealers as an NRSRO for its ratings of all debt securities. *See* Letter from Michael A. Macchiaroli, Associate Director, Division of Market Regulation, SEC, to Lee Pickard, Esq., Pickard and Djinis LLP (January 25, 1999).

[109] In both the 1994 Concept Release and the 1997 Proposing Release, for example, the Commission solicited comment on the practice of NRSROs charging issuers for ratings, and basing their fees on the size of the transaction. Among other things, concerns had been expressed that a rating agency might be tempted to give a more favorable rating to a large issue because of the large fee, and to encourage the issuer to submit future large issues to the rating agency. *See supra* note 38.

1. Issuers Paying for Ratings. Concerns have been expressed for a number of years about the potential conflict of interest that arises from the fact that the largest credit rating agencies rely on issuer fees for the vast majority of their revenues.[110] Historically, rating agencies were financed solely by subscription fees paid by investors and other users of credit ratings. By the mid-1970s, however, the largest rating agencies began charging issuers for ratings, due to difficulties in limiting access to ratings information to subscribers, as well as to the demand for more comprehensive and resource-intensive analysis of issuers. In general, the fees that rating agencies charge issuers are based on the size of the issuance and the nature of the instrument being rated. They typically include both a fee for the initial rating and an annual maintenance fee. The fees are not regulated and vary only slightly among the larger rating agencies. In some cases, the rating agencies will discount the fees for frequent issuers or negotiate flat rate fees.

The practice of issuers paying for their own ratings creates the potential for a conflict of interest.[111] Arguably, the dependence of rating agencies on revenues from the companies they rate could induce them to rate issuers more liberally, and temper their diligence in probing for negative information. This potential conflict could be exacerbated by the rating agencies' practice of charging fees based on the size of the issuance, as large issuers could be given inordinate influence with the rating agencies.

The large rating agencies and a number of other market participants agree that the issuer-fee model creates the potential for a conflict of interest, but believe that the rating agencies historically have demonstrated an ability to effectively manage that potential conflict.[112] As an initial matter, the rating agencies that rely on issuer fees downplay the significance of this potential conflict by pointing out that fees received from individual issuers are a very small percentage of their total revenues,[113] so that no single issuer has material economic influence with a rating agency. Furthermore, the rating agencies

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[110] *See, e.g.*, SEC Hearing Transcript, *supra* note 57 (November 21, 2002) (McDaniel Testimony) ("About 90 percent [of Moody's research service revenues] comes from issuers who pay fees for ratings, and about 10 percent comes from [Moody's] research and data services.") and (Joynt Testimony) ("90 percent [of Fitch's revenues] come from issuer fees, and around 10 percent come from subscription services.").

[111] A related potential conflict could arise in the context of underwriters attempting to influence the credit rating process. A large percentage of bond offerings are underwritten by a few large firms, and the potential exists for rating agencies to rate a particular underwriter's clients more favorably in return for future business.

[112] Notably, a recent Senate Committee staff report concluded that Moody's November 8, 2001 decision not to downgrade Enron's credit rating below investment grade was not based on improper influence or pressure, but on new information presented by financial institutions and others that in Moody's view changed Enron's circumstances. *See supra* note 53.

[113] For example, S&P stated that no single issuer or issuer group represents more than approximately 2% of the total annual revenue of its ratings business.

assert that their reputation for issuing credible and reliable ratings is critical to their business, and that they would be loathe to jeopardize that reputation by allowing issuers to improperly influence their ratings, or by otherwise failing to be diligent and objective in their rating assessments. Finally, the rating agencies note their extensive policies and procedures regarding analyst compensation are designed to prevent potential interference with the objectivity of the analyst's assessment of an issuer.[114]

Nevertheless, as noted in Section V below, the Commission is exploring whether NRSROs should implement procedures to manage potential conflicts of interest that arise when issuers paying for ratings.

2. Development of Ancillary Businesses. In recent years, the large rating agencies have begun developing ancillary businesses to complement their core ratings business. These businesses include ratings assessment services where, for an additional fee, issuers present hypothetical scenarios to the rating agencies to determine how their ratings would be affected by a proposed corporate action (*e.g.*, a merger, asset sale, or stock repurchase).[115] They also include risk management and consulting services.[116]

The development of these ancillary businesses creates another potential conflict of interest for rating agencies. Concerns have been expressed that credit rating decisions might be impacted by whether or not an issuer purchases additional services offered by the credit rating agency. In fact, some have argued that this potential conflict is analogous to that of accounting firms offering consulting services, or research analysts

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[114] In general, the large rating agencies represented that rating analysts do not solicit new business and have no direct financial interest in the outcome of their ratings. In addition, they assert that the compensation of their rating analysts is merit-based (*i.e.*, based on the demonstrated reliability of their ratings), and is not directly dependent on the fees paid by particular issuers.

[115] Each of the NRSROs currently offers rating assessment services. S&P has offered its "Ratings Evaluation Service" since 1997; Moody's formalized its comparable "Rating Assessment Service" in 2000; and Fitch began offering its "Ratings Assessment Service" in 2002. Representatives from the NRSROs indicated that revenues from their rating assessment services were nominal compared with ratings-related revenues. *See, e.g.*, SEC Hearing Transcript, *supra* note 57 (November 21, 2002) (McDaniel Testimony) ("The rating assessment service that we run is . . . about 1 percent of our revenues in the last year") and (Joynt Testimony) ("We have a very limited rating assessment service. We only actually introduced this service within the last nine months."). There are indications, however, that revenues from rating assessment services are becoming more substantial. *See, e.g.*, McGraw-Hill Companies Inc. 2001 Form 10-K Annual Report ("[S&P's] revenue from rating evaluation services . . . increased substantially during 2000.").

[116] For example, Fitch operates "Fitch Risk Management," Moody's operates "Moody's Risk Management Services," and S&P operates "Risk Solutions." Each of these groups provide products and services intended to help financial institutions and other companies manage credit and operational risk. Products and services offered include public and private firm credit scoring models, internal ratings systems services, and empirical data on default incidence, loss severity, default correlations, and rating transitions.

seeking investment banking business.[117] In addition, some believe that, whether or not the purchase of ancillary services actually impacts the credit rating decision, issuers may be pressured into using them out of fear that their failure to do so could adversely impact their credit rating (or, conversely, with the expectation that purchasing these services could help their credit rating). Furthermore, in the case of ratings assessment services, there are concerns that, to the extent a rating agency has already "promised" a certain rating to an issuer's hypothetical scenario, pressure to match the actual rating to the promised rating is likely to be forceful, even if the ultimate analysis otherwise might not have supported the rating.

The rating agencies that offer ancillary services point out that they have established extensive policies and procedures to manage potential conflicts in this area, including substantial firewalls that separate the ratings business from the influence of ancillary businesses. Rating analysts generally do not participate in the marketing of ancillary services;[118] separate staffs typically are maintained to perform this function. Furthermore, the compensation of rating analysts is not directly dependent on the performance of the ancillary businesses. In the case of ratings assessment services, the rating agencies assert that there is no guarantee associated with that service, and that the ultimate credit rating is not driven by the assessment. Finally, the rating agencies note that, at present, ancillary services are an insignificant aspect of their businesses, generating a very small percentage of total revenues, so that the potential conflicts of interest are immaterial.

Nevertheless, as noted in Section V below, the Commission is exploring whether NRSROs should implement procedures to manage potential conflicts of interest that arise when credit rating agencies develop ancillary businesses.[119]

V. CONCLUSION

As a result of the study of credit rating agencies described in this Report, the Commission has identified a wide range of issues that deserve further examination. Accordingly, the Commission plans to publish a concept release within 60 days of this Report to address concerns related to credit rating agencies and expects to issue proposed rules, after reviewing and evaluating the comments received on the concept release,

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[117] *See, e.g.*, Letter from Sean J. Egan and W. Bruce Jones, Egan-Jones Ratings Company, to Jonathan G. Katz, Secretary, SEC (November 10, 2002) ("Separate ratings from consulting – just as accountants were compromised by their consulting assignments, ratings firms have similar issues.").

[118] In the case of rating assessment services, however, the rating analysts actually will perform the ancillary assessments. In addition, at the Commission's hearings, one buy-side participant indicated that she was aware of at least one instance in which analysts from a rating agency were involved in marketing advisory services to her firm. *See* SEC Hearing Transcript, *supra* note 57 (November 15, 2002) (Strauss Testimony).

[119] Research analysts at investment banking firms recently have become subject to rules imposing restrictions on their activities and compensation.

within a reasonable period of time after the close of the comment period.[120] The Commission hopes to elicit extensive comments on these issues, from market participants, other regulators, and the public at large.

A. Information Flow

1. The Commission will explore whether NRSROs should disclose more information about the key bases of, and assumptions underlying, the ratings decision.

2. The Commission will explore whether NRSROs should publicly disseminate their ratings on a widespread basis.

3. The Commission will explore whether NRSROs that issue unsolicited ratings should clearly indicate that fact on any such rating.

4. The Commission will explore whether there should be improvements to the extent and quality of disclosure by issuers, including disclosures relating to the existence and impact of ratings triggers, conditional elements of important financial contracts, short-term credit facilities, special purpose entities, and material future liabilities.

B. Potential Conflicts of Interest

1. The Commission will explore whether NRSROs should implement procedures to manage potential conflicts of interest that arise when issuers pay for ratings.

2. The Commission will explore whether NRSROs should prohibit (or severely restrict) direct contacts between rating analysts and subscribers.

3. The Commission will explore whether NRSROs should implement procedures to manage potential conflicts of interest that arise when rating agencies develop ancillary fee-based businesses.

C. Alleged Anticompetitive or Unfair Practices

1. The Commission will explore the extent to which allegations of anticompetitive or unfair practices by large credit rating agencies have merit and, if so, possible Commission action to address them.

[120] The Commission is mindful that some of the concepts discussed in this report may raise questions about the limits of the Commission's authority. We will, of course, consider those issues carefully.

D. Reducing Potential Regulatory Barriers to Entry

1. The Commission will explore possible clarifications of the current NRSRO recognition criteria.

2. The Commission will explore instituting timing goals for the evaluation of NRSRO applications.

3. The Commission will explore whether it should expressly permit NRSROs that cover a limited sector of the debt market to achieve NRSRO recognition.

4. The Commission will explore whether it should permit a rating agency that confines its activity to a limited geographic area to achieve NRSRO recognition.

5. The Commission will explore whether there are viable alternatives to the NRSRO concept in Commission rules and regulations.

E. Ongoing Oversight

1. The Commission will explore whether more direct, ongoing oversight of NRSROs is warranted (*e.g.*, recordkeeping requirements and regular examinations) and, if so, will explore appropriate means for doing so.

2. If such additional oversight is warranted, the Commission will explore whether it is advisable to ask Congress for specific legislative oversight authority.

3. The Commission will explore whether NRSROs should incorporate general standards of diligence in performing their ratings analysis, and with respect to the training and qualifications of credit rating analysts.