AUTHENTICATED
U.S. GOVERNMENT
INFORMATION
GPO

LEGISLATIVE SOLUTIONS FOR THE RATING AGENCY DUOPOLY

HEARING

BEFORE THE

SUBCOMMITTEE ON
CAPITAL MARKETS, INSURANCE AND
GOVERNMENT SPONSORED ENTERPRISES

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED NINTH CONGRESS

FIRST SESSION

JUNE 29, 2005

Printed for the use of the Committee on Financial Services

Serial No. 109–42

U.S. GOVERNMENT PRINTING OFFICE

26–274 PDF WASHINGTON : 2006

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2250 Mail: Stop SSOP, Washington, DC 20402–0001

HOUSE COMMITTEE ON FINANCIAL SERVICES

MICHAEL G. OXLEY, Ohio, *Chairman*

JAMES A. LEACH, Iowa
RICHARD H. BAKER, Louisiana
DEBORAH PRYCE, Ohio
SPENCER BACHUS, Alabama
MICHAEL N. CASTLE, Delaware
PETER T. KING, New York
EDWARD R. ROYCE, California
FRANK D. LUCAS, Oklahoma
ROBERT W. NEY, Ohio
SUE W. KELLY, New York, *Vice Chair*
RON PAUL, Texas
PAUL E. GILLMOR, Ohio
JIM RYUN, Kansas
STEVEN C. LATOURETTE, Ohio
DONALD A. MANZULLO, Illinois
WALTER B. JONES, JR., North Carolina
JUDY BIGGERT, Illinois
CHRISTOPHER SHAYS, Connecticut
VITO FOSSELLA, New York
GARY G. MILLER, California
PATRICK J. TIBERI, Ohio
MARK R. KENNEDY, Minnesota
TOM FEENEY, Florida
JEB HENSARLING, Texas
SCOTT GARRETT, New Jersey
GINNY BROWN-WAITE, Florida
J. GRESHAM BARRETT, South Carolina
KATHERINE HARRIS, Florida
RICK RENZI, Arizona
JIM GERLACH, Pennsylvania
STEVAN PEARCE, New Mexico
RANDY NEUGEBAUER, Texas
TOM PRICE, Georgia
MICHAEL G. FITZPATRICK, Pennsylvania
GEOFF DAVIS, Kentucky
PATRICK T. MCHENRY, North Carolina

BARNEY FRANK, Massachusetts
PAUL E. KANJORSKI, Pennsylvania
MAXINE WATERS, California
CAROLYN B. MALONEY, New York
LUIS V. GUTIERREZ, Illinois
NYDIA M. VELÁZQUEZ, New York
MELVIN L. WATT, North Carolina
GARY L. ACKERMAN, New York
DARLENE HOOLEY, Oregon
JULIA CARSON, Indiana
BRAD SHERMAN, California
GREGORY W. MEEKS, New York
BARBARA LEE, California
DENNIS MOORE, Kansas
MICHAEL E. CAPUANO, Massachusetts
HAROLD E. FORD, JR., Tennessee
RUBÉN HINOJOSA, Texas
JOSEPH CROWLEY, New York
WM. LACY CLAY, Missouri
STEVE ISRAEL, New York
CAROLYN MCCARTHY, New York
JOE BACA, California
JIM MATHESON, Utah
STEPHEN F. LYNCH, Massachusetts
BRAD MILLER, North Carolina
DAVID SCOTT, Georgia
ARTUR DAVIS, Alabama
AL GREEN, Texas
EMANUEL CLEAVER, Missouri
MELISSA L. BEAN, Illinois
DEBBIE WASSERMAN SCHULTZ, Florida
GWEN MOORE, Wisconsin,

BERNARD SANDERS, Vermont

Robert U. Foster, III, *Staff Director*

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES

RICHARD H. BAKER, Louisiana, *Chairman*

JIM RYUN, Kansas, *Vice Chair*
CHRISTOPHER SHAYS, Connecticut
PAUL E. GILLMOR, Ohio
SPENCER BACHUS, Alabama
MICHAEL N. CASTLE, Delaware
PETER T. KING, New York
FRANK D. LUCAS, Oklahoma
DONALD A. MANZULLO, Illinois
EDWARD R. ROYCE, California
SUE W. KELLY, New York
ROBERT W. NEY, Ohio
VITO FOSSELLA, New York,
JUDY BIGGERT, Illinois
GARY G. MILLER, California
MARK R. KENNEDY, Minnesota
PATRICK J. TIBERI, Ohio
J. GRESHAM BARRETT, South Carolina
GINNY BROWN-WAITE, Florida
TOM FEENEY, Florida
JIM GERLACH, Pennsylvania
KATHERINE HARRIS, Florida
JEB HENSARLING, Texas
RICK RENZI, Arizona
GEOFF DAVIS, Kentucky
MICHAEL G. FITZPATRICK, Pennsylvania
MICHAEL G. OXLEY, Ohio

PAUL E. KANJORSKI, Pennsylvania
GARY L. ACKERMAN, New York
DARLENE HOOLEY, Oregon
BRAD SHERMAN, California
GREGORY W. MEEKS, New York
DENNIS MOORE, Kansas
MICHAEL E. CAPUANO, Massachusetts
HAROLD E. FORD, JR., Tennessee
RUBÉN HINOJOSA, Texas
JOSEPH CROWLEY, New York
STEVE ISRAEL, New York
WM. LACY CLAY, Missouri
CAROLYN MCCARTHY, New York
JOE BACA, California
JIM MATHESON, Utah
STEPHEN F. LYNCH, Massachusetts
BRAD MILLER, North Carolina
DAVID SCOTT, Georgia
NYDIA M. VELÁZQUEZ, New York
MELVIN L. WATT, North Carolina
ARTUR DAVIS, Alabama
MELISSA L. BEAN, Illinois
DEBBIE WASSERMAN SCHULTZ, Florida
BARNEY FRANK, Massachusetts

CONTENTS

	Page
Hearing held on:	
June 29, 2005	1
Appendix:	
June 29, 2005	41

WITNESSES

WEDNESDAY, JUNE 29, 2005

Bolger, Rita M., Managing Director and Associate General Counsel, Standard and Poor's	15
Egan, Sean, Managing Director, Egan-Jones Ratings Co.	11
Kaitz, James A., President and CEO, Association for Financial Professionals	17
Partnoy, Frank, Professor of Law, University of San Diego School of Law	7
Pollock, Alex J., Resident Fellow, American Enterprise Institute	13
Stroker, Nancy, Group Managing Director, Fitch Ratings	9

APPENDIX

Prepared statements:	
Oxley, Hon. Michael G.	42
Hinojosa, Hon. Ruben	44
Kanjorski, Hon. Paul E.	45
Bolger, Rita M.	47
Egan, Sean	64
Kaitz, James A.	72
Partnoy, Frank	83
Pollock, Alex J.	99
Stroker, Nancy	102

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

Baker, Hon. Richard. H.:	
Letter from Investment Company Institute, June 29, 2005	126
Kanjorski, Hon. Paul E.:	
Letter from Securities and Exchange Commission, June 6, 2005	127
The Bond Market Association, prepared statement	131

LEGISLATIVE SOLUTIONS FOR THE RATING AGENCY DUOPOLY

Wednesday, June 29, 2005

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE
AND GOVERNMENT SPONSORED ENTERPRISES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to call, at 10:05 a.m., in Room 2128, Rayburn House Office Building, Hon. Richard H. Baker [chairman of the subcommittee] Presiding.

Present: Representatives Baker, Shays, Kelly, Biggert, Kennedy, Tiberi, Brown-Waite, Feeney, Gerlach, Hensarling, Fitzpatrick, Kanjorski, Sherman, Hinojosa, Clay, Scott, and Wasserman Schultz.

[10:05 a.m.]

Chairman BAKER. I would like to call this meeting of the Capital Markets Subcommittee to order. I am advised that Mr. Kanjorski, the ranking member, is en route, and we are going to proceed and reserve the right for Mr. Kanjorski to give his opening statement should he not arrive at the conclusion of my own statement.

Today, the subcommittee meets to discuss, for a change of pace—we are not on GSEs today; we are going to be talking about GSDs. And what is that, you ask? It is a Government Sponsored Duopoly. Now I read over several witness's testimony this morning and found myself almost immediately being corrected.

I read the words ″dual monopoly.″ Then I read ″partner monopoly.″ Then I read ″oligopoly.″ I am not sure what kind of opoly we have got this morning, but it will be the subject of the committee's discussions and determinations over the coming couple of hours.

Since the early 20th century, credit rating agencies have been issuing ratings on the likelihood of issuers' default on debt payments. As a result of the difficult corporate period we have come through and the fact that dominant rating agencies were not accurately predicting Enron and WorldCom's financial condition, reforming the rating agency industry practice has been the subject of discussion over the last several years.

The Subcommittee on Capital Markets has held a series of hearings on credit rating agencies. And most recently in April, Ms. Nazareth, director of the Division of Market Regulation, testified that to conduct oversight of the industry, the SEC needed more direct and explicit congressional authority to do so.

The SEC also announced last March a proposal to define nationally-recognized statistical rating organizations as firms generally accepted in the marketplace.

Some critics have once again criticized the SEC for what they believe to be an anticompetitive definition. In 1997, a rule proposed to define the NRSROs; the SEC claimed that the most important factor was the firm be nationally recognized.

That decision was not implemented in part because of a Department of Justice objection that the requirement, be nationally recognized, was an insurmountable barrier to entry of new market participants. Unfortunately, not much has changed since that proposal has failed.

Today there are over 130 agencies, rating agencies. However, instead of allowing public companies' investors to decide which one of those 130 to utilize, the SEC makes that determination. Now, after three decades of uncertainty, Mr. Fitzpatrick has introduced H.R. 2990, which would return this decision to the markets and the choice by consumers.

Beyond the difference in retaining the SECs staff's designation process, the SEC staff's outline contained provisions similar to those in the Fitzpatrick bill. It suggests mandating reporting and recordkeeping requirements for registered firms, as well as giving inspection, examination, and enforcement authority to the SEC.

In short, H.R. 2990 incorporates most of the SEC staff outline without the anticompetitive system that the designation process was to establish. I believe that competition is the essential component of a healthy capital market.

Currently, there just isn't competition in the rating industry. The SEC has chosen with specificity which agencies not only are acceptable, but which shall perform this singular duty.

NRSROs are what they are because of a grant of privilege, not because they have earned it by competitive market choice. Competition has always proved to the benefit of investors and shareholders and consumers. Whether it is mutual funds, brokerage costs, insurance premiums, or whatever sector of the financial marketplace.

Without competition in the ratings business, operating companies are frankly held hostage with S&P and Moody's controlling approximately 80 percent of the market. The question is, do they control 80 percent of the market because they are really that good or because the SEC and the SEC staff has merely given them that opportunity?

Compounding the problem is a lack of transparency regarding the ratings process and the operation of the firms. Additionally, the companies held hostage by their ratings avoid speaking out for fear of the consequences of the rating evaluation system.

It is my hope that free enterprise, competitive principles will direct the committee's decision in this arena. We should not seek to preserve a privilege. We should, however, fight to guarantee opportunity. Then the market will make the determination as to the winners and the losers. This is not and never has been the role of the Federal Government.

Mr. Kanjorski.

Mr. KANJORSKI. Mr. Chairman, we return this morning once again to explore the issue of regulating credit rating agencies. As I have noted during our past hearings, entities like Standard & Poor's, Moody's, and Fitch have long published their views on the credit worthiness of the issuers of debt securities, and the significance of these opinions has greatly expanded in recent years.

Although rating agencies received some scrutiny after the recent surge of corporate scandals, we have not yet mandated any substantive changes in their practices. We have, however, since our last hearing, begun to consider potential legislative reforms in this area.

A bill, H.R. 2990, has been introduced by my colleague from Pennsylvania. In addition, at my request, the experts of the Securities and Exchange Commission have put together a conceptual legislative outline for our consideration.

While I agree with you, Mr. Chairman, that something needs to be done in this area of the securities marketplace to improve transparency and oversight, H.R. 2990, as introduced, is not the solution to this problem. It would eliminate the current nationally-recognized statistical rating organization framework that we have had in place for three decades.

Instead of casting this accepted framework aside, we should build on the work of the Commission in these matters. H.R. 2990 is also, as one witness will note in her testimony today, ″inconsistent with the overwhelming majority″ of the commentators in the most recent Commission concept release.

As I understand, less than 10 percent of the respondents to this concept release supported the elimination of the NRSRO framework. Additionally, we now have a classic quantity versus quality debate. H.R. 2990 focuses on increasing the quantity of raters. To protect investors, we should focus on the quality of ratings as the Commission's conceptual legislative outline seeks to do.

In my view, the problems encountered by investors before Enron's downfall, WorldCom's bankruptcy, and New York City's debt crisis, among others, were related to the quality of ratings, not the quantity of raters.

Nevertheless, Mr. Chairman, I understand the desire to increase competition in this field, and I am willing to explore these matters further. Additionally, in a statement prepared for today's hearing, the Bond Market Association notes that the bill ″could ultimately dilute the important role credit rating agencies play in capital markets.″

Mr. Chairman, I ask unanimous consent to insert this statement into the record.

Chairman BAKER. Without objection.

Mr. KANJORSKI. Beyond quality issues, I am also concerned that H.R. 2990, could cause serious disruptions in the marketplace if enacted into law. Eliminating the recognition process and replacing it with a registration process could cause unintended consequences.

The NRSRO concept, after all, has become embedded in many areas of the law. The term is used in about 8 Federal statutes, 47 Federal rules, and more than 100 State laws. It is also used in laws related to communications, education, transportation, in addition to banking and security statutes.

Moreover, changing the phrase could cause uncertainty and potential turmoil for any mutual fund that relies on a strategy of purchasing only those debt securities of investment grade as determined by an NRSRO.

We must further be very sensitive to the First Amendment issues posed in these debates. The courts have previously ruled on matters such as the permissibility of registration requirements for publishers, which the NRSROs contend that they are. The courts have also ruled that we must be very precise in crafting statutes that impede upon the First Amendment.

H.R. 2990 is vague, in its present construction, and needs work to withstand judicial scrutiny. Ultimately, we need to move deliberately in these matters. From my perspective, we need to focus on the prior work of the Securities and Exchange Commission. We should also put a great deal of weight on their conceptual legislative outline as a roadmap for our work in the months ahead.

The outline seeks to establish an effective supervisory system to ensure that credit rating agencies operate in a transparent manner with adequate policies and procedures. To help us in these efforts, last week I called upon all interested parties to examine the roadmap of proposed reforms developed by the Commission's experts at my request, and I request unanimous consent to insert this document into the record.

Chairman BAKER. Without objection.

Mr. KANJORSKI. Today I again call upon all parties to review this legislative outline and offer comments on it before the end of August. In the meantime, I hope that the Commission and the rating agencies will expedite their deliberations over a voluntary agreement to improve transparency in the coming months. The success of these negotiations and the effectiveness in enforcing any final voluntary accord will help to determine the need for a compulsory bill and the speed of legislative action.

In conclusion, Mr. Chairman, this issue is one on which we should focus in the 109th Congress. I commend you for your leadership in these matters and hope that we can work together to identify an appropriate consensus in the months ahead. Thank you, Mr. Chairman.

Chairman BAKER. I thank the gentleman.

Mr. Shays, did you have a statement?

Mr. SHAYS. No.

Chairman BAKER. Mrs. Biggert.

Mrs. BIGGERT. No.

Mr. FITZGERALD. Thank you, Mr. Chairman. And I appreciate the comments of my colleague from Pennsylvania and his recognition that there is some requirement for reform. And I look forward to working with my colleague from Pennsylvania in that.

As the chairman was, in his opening comments, identifying all of the different opolies that are referenced in your opening statements, whether it be monopoly or oligopoly or duopoly, clearly one of them applies. Probably duopoly is the best description, but what it means is that there is lack of competition. And lack of competition is not good for the individual investor or the consumer.

As a Bucks County Commissioner, I remember the financial hardships that the people of the 8th Congressional District of

Pennsylvania faced when Enron and WorldCom went bankruptcy. And it is, for many of us, extremely disturbing that the two largest nationally recognized statistical rating organizations, Moody's and S&P, rated Enron and WorldCom at investment grade just prior to their filing of bankruptcies.

Essentially, Moody's and S&P told the market that Enron and WorldCom were safe investments. Credit rating agencies claim that they are not in the business of detecting fraud, but they are most certainly in the business of impacting the bottom line of companies and also municipalities, school districts.

The better the credit rating, the lower the interest rate the borrower must pay to expand its operations, construct a road, or build a school. The credit ratings industry is dominated by Moody's and S&P. Together, as you heard, they have over 80 percent of the market share.

In three previous hearings, this subcommittee has received testimony that the lack of competition in the credit rating industry has lowered the quality of ratings, has inflated prices, stifled innovation, and allowed conflicts of interest to go unchecked. This duopoly cannot continue to be preserved by an artificial barrier to entry and anticompetitive industry practices.

Last week I introduced the Credit Rating Agency Relief Act, H.R. 2990, that would inject greater competition, transparency, and accountability in the credit rating agency industry through market-based reform. My legislation would eliminate the SEC staff's anticompetitive designation process and prohibit anticompetitive industry practices by mandating reporting and record keeping requirements for registered firms as well as giving inspection, examination, and enforcement authority to the SEC.

By eliminating the SECs staff's opaque designation process, the bill incorporates most of the SEC staff's outline of a regulatory framework. A minority of commentators have claimed that any registration of this industry amounts to a violation of First Amendment privileges. My bill does not infringe upon those privileges.

H.R. 2990 neither bans nor restrict their First Amendment rights in any manner. The Government has an undeniable interest in registering rating agencies giving the credit rating industry's substantial impact and effects on the market. My legislation regulates the credit ratings industry through disclosure. This is the least restrictive means of any regulation.

Currently, all five SEC-approved agencies already voluntarily register under the Investment Advisors Act of 1940, and many of the complaints seem hypocritical. By encouraging competition in the industry, prices and anticompetitive practices will be reduced. Credit ratings quality will improve, and firms will innovate.

H.R. 2990 addresses the basic problems of the credit ratings industry and protects our robust marketplace and, thus, more importantly, the individual investors.

I look forward to discussing my proposal with the distinguished panel here today as a solution in the credit rating industry.

Chairman Baker, I thank you for your leadership on this issue, this vital issue, and I yield back the balance of my time.

Chairman BAKER. I thank the gentleman. Mr. Hinojosa.

Mr. HINOJOSA. Chairman Baker and Ranking Member Kanjorski, I want to express my sincere appreciation for you holding this fourth in a series of hearings on credit rating agencies.

Chairman Baker, I want to thank you for doggedly pursuing the reform of the definition and oversight of the agencies. This hearing is of particular interest to me as a Member of the Texas delegation. The Enron bankruptcy and the harm it caused to its employees, the small businesses, the community, and the overall perception of public trust in corporations and the national recognized statistical rating agencies was enormous.

So this hearing is timely and needed, despite the number of years that have passed since the Enron bankruptcy.

Ranking Member Kanjorski, I commend you for working with the Securities and Exchange Commission to arrive at legislative language. Hopefully, it will not only increase competition among the credit rating agencies and make the system more transparent, but also ensure that the legislation does not violate the nationally recognized statistical rating organizations' First Amendment rights to free speech.

I also believe that your actions have encouraged the Securities and Exchange Commission to begin working with these nationally-recognized statistical rating organizations on a voluntary framework to establish an SEC oversight regime. In essence, this could result in something resembling a best practices for the NRSROs.

Additionally, the SEC has proposed a rule that would codify the definition of an NRSRO. Some of our Members of Congress and the SEC have suggested that legislation might be needed to give the SEC the oversight authority to increase its regulations of the NRSROs.

I understand that my colleague across the aisle, Congressman Fitzpatrick, has introduced legislation to address the current oversight of the NRSROs, and this panel of witnesses is heavily weighted with those in support of that legislation, with the exception of Standard and Poor's.

Mr. Chairman, I would like to hear from a more balanced panel in the future. Chairman Baker and Ranking Member Kanjorski, I believe that Congress should give the SEC, the NRSROs additional time to work on a voluntary framework and to develop and introduce any legislation needed to oversee the NRSROs and provide the SEC whatever statutory authority it needs to regulate them.

Having said that, Mr. Chairman, I yield back the remainder of my time.

[The prepared statement of Hon. Ruben Hinojosa can be found on page 44 in the appendix.]

Chairman BAKER. Thank the gentleman. Ms. Brown-Waite, did you have a statement?

Ms. GINNY BROWN-WAITE. No, I do not have an opening statement. I just look forward to hearing the witnesses that we have today.

Chairman BAKER. I thank the gentlelady. Mr. Hensarling?

Mr. HENSARLING. No.

Chairman BAKER. Mrs. Kelly.

Mrs. KELLY. Yes, I do, Mr. Chairman.

Chairman BAKER. Please proceed.

Mrs. KELLY. First I want to thank you, Chairman Baker and Mr. Fitzpatrick, to your commitment to ensuring openness and competition within the debt rating industry. I want to thank all of the witnesses for being here today.

I share the committee's view that it is important that debt rating firms provide the best possible analysis at the lowest possible price. I believe that encouraging more firms to enter this industry is critical, and I am glad the SEC is working within the industry.

The nationally recognized statistical rating organizations and the SEC have entered into a process for ensuring that high standards and open competition are met within the industry without disrupting the bond markets or imposing unneeded regulation.

These talks are continuing, and I hope that Chairman Cox, when confirmed, will be able to complete this process and present the committee with a finished product. I have serious concerns however, that any abrupt change to the ratings market could adversely impact the bond markets, confuse investors, and increase the size and scope of Government regulation.

As the BMA noted, as currently—and I am quoting, ″as currently drafted, H.R. 2990 could ultimately dilute the important role credit rating agencies play in the capital markets.″ Debt ratings are, as the courts have observed, journalistic products protected by the First Amendment. Mandatory regulation regimes on financial speech, however well intentioned, harm the very freedom to make qualitative judgments that make the debt rating process valuable.

The ability to speak freely and honestly about a debt product without Government sanction needs to be protected by this committee. And I will closely examine all proposals for regulation of debt ratings agencies with that in mind. Thank you very much, Mr. Chairman.

Chairman BAKER. I thank the gentlelady. Any member, other member have an opening statement? If not, at this time, I would proceed to our panel of witnesses, and I would like to state the general rules by which the committee functions, that all of your official statements will be made part of the committee's record.

We would request that, to the best of your ability, that you proceed with a 5-minute clock in mind to enable members to have the opportunity to ask questions in the course of the hearing this morning.

And we will proceed from left to right, first with Mr. Frank Partnoy, professor of law, University of San Diego School of Law. Please proceed at your leisure, sir.

STATEMENT OF FRANK PARTNOY, PROFESSOR OF LAW, UNIVERSITY OF SAN DIEGO SCHOOL OF LAW

Mr. PARTNOY. Thank you, Chairman Baker and Ranking Member Kanjorski and members of the committee. I am a law professor at the University of San Diego, where I have spent much of the past 8 years studying the credit rating industry and credit ratings.

I, before teaching, worked on the derivatives desks at Morgan Stanley and CS First Boston, where my group structured debt instruments that received ratings from S&P and Moody's. First, let me say that I agree with Chairman Baker and Chairman Oxley that this legislation marks an excellent starting point for debate.

I commend Congressman Fitzpatrick for introducing this legislation.

I also agree with much of what Ranking Member Kanjorski has said here today, and in the recent past; there should be bipartisan support for credit rating reform. The primary split in opinion is between those with a vested interest in preserving the status quo, namely S&P and Moody's, and virtually everyone else. So with respect, I actually think this panel is quite balanced.

I want to discuss very briefly some background I hope will be useful to this committee. I have found in my research that credit rating agencies pose a troubling paradox. On one hand, credit ratings are enormously valuable and important. A downgrade can kill a company and issuers pay big money for ratings. Moody's alone had gross profits of more than a billion dollars last year. And its shares are worth almost as much as General Motors and Ford.

On the other hand, there is overwhelming evidence that ratings are of scant informational value, particularly since the mid 1970s, the informational value of ratings has plummeted. You do not need to read academic studies to know this; just recall Orange County, Enron, WorldCom and most recently, General Motors and Ford.

The Agency's response that ratings are correlated with actual default is misplaced because ratings can both correlated with defaults and have no informational value. All of you and I could publish ratings that were correlated with default experience simply by reading the newspaper.

In my writings I have argued that this paradox, high market value, low informational value, is best explained by regulation. As Chairman Baker has stated, namely the rules that depend on ratings by nationally recognized statistical ratings organizations. It started in 1975, and during the next 3 decades, numerous regulators, especially the Commission, established rules that depended on NRSRO ratings. Put simply, NRSRO ratings now are important because the rules say they are.

NRSRO ratings are valuable as keys to unlock the benefits or avoid the costs of various regulatory schemes. Yet for more than 30 years, no one has bothered to say conclusively what the term NRSRO means. Not even George Orwell could have imagined such a state.

Given that the Commission has designated just five NRSROs for regulatory purposes, it is not surprising that the industry is so concentrated. If regulators required that the Washington Wizards play just five basketball players, and one of the approved players was me, even I would get a lot of playing time. And if I played, you can be sure the others would score most of the points, even if they weren't very good.

The Commission's proposals would not correct these fundamental flaws. Defining NRSRO is too little too late, and the commission is not an office of central planning; nor should it be. It generally does not designate which companies can issue securities to the public, and it certainly does not do so based on ambiguous standards such as whether ratings are ″generally accepted.″

Instead, the Commission requires companies to disclose material facts and then permits market participants to make decisions based on those facts. That is the role the Commission should play

with respect to NRSROs. Congressman Fitzpatrick's bill is a major step in the direction of resolving the paradox I just described.

It permits the 130-plus non-NRSRO agencies to compete with current NRSROs. Perhaps most importantly, it encourages new rating agencies, which could use market-based measures in assessing companies. In my academic work, I have stressed that market-based measures are the best alternatives to current NRSRO ratings.

We have already heard, and some will argue, that opening the market to competition will be disruptive and/or lead to rate shopping. But based on my experience and available evidence, I think the opposite is true.

When markets such as credit ratings are opened to competition, they become more stable, indeed, because current ratings by S&P and Moody's distort the markets; they create incentives for dysfunctional regulatory arbitrized transactions, which this legislation would reduce.

My further understanding is that NRSROs would be subject to liability for Federal securities fraud and/or State law causes of actions just like other gatekeeper firms. S&P and Moody's claim their ratings are merely opinions and there is the free speech argument that has already been mentioned today, which is a clever one; it has been accepted by some courts.

But credit ratings are not really just opinions any more than fairness opinions of investment banks, audit opinions of accounting firms, legal opinions of attorneys, buy-sell ratings of security analysts, or even the certification of financial statements by CEOs and CFOs are mere opinions.

So, in sum, I commend Congressman Fitzpatrick for introducing this legislation. I believe that this panel does represent all of the interests except perhaps one interest that is not here today, the millions of individual investors whose mutual funds and pension funds are in fixed-income investments and whose faith in S&P and Moody's has been shattered by events of recent years.

Those people have much more to gain from this legislation than S&P and Moody's have to lose. I thank you, and they will thank you.

[The prepared statement of Frank Partnoy can be found on page 83 in the appendix.]

Chairman BAKER. I thank the gentleman for his statement.

Our next witness is Ms. Nancy Stroker, group managing director, Fitch Ratings. Welcome.

STATEMENT OF NANCY STROKER, GROUP MANAGING DIRECTOR, FITCH RATINGS

Ms. STROKER. Good morning, Chairman Baker, Ranking Member Kanjorski, and members of the committee. My name is Nancy Stroker, and I am a group managing director at Fitch Ratings, responsible for overseeing the North American corporate financial institutions and public finance ratings.

I would like to thank you for offering Fitch the opportunity to testify today and to share with you our views on the recently proposed Credit Rating Agency Duopoly Act and SEC staff outline on

oversight of credit rating agencies that was delivered earlier this month.

We commend Representative Fitzpatrick and the committee for recognizing the importance of fostering competition in the ratings industry. We hope you will find our views constructive.

Fitch firmly believes in the power of competition, and we fully support the objectives of the Fitzpatrick bill, providing greater competition and transparency in the credit rating industry.

While we have concerns about whether the Act as currently proposed will provide either greater competition or transparency, we believe that the Act and the debate surrounding it will serve as a constructive first step in fostering competition in the credit rating industry, a point made by both Representatives Oxley and Baker at the introduction of the bill.

In terms of addressing the issues before this committee, we would like to make the following three points. First, any recognition or registration system should be a transparent process based on objective standards related to the demonstrated reliability of ratings that are uniformly applied.

Second, any oversight regime should be designed to avoid unnecessary burdens and interference in the decision-making process of rating agencies. As the SEC staff has noted, any legislation in this area must make clear that the decision-making process of rating agencies and the content of the ratings assigned should be beyond the scope of regulation.

And finally, we will state the obvious, but investors will benefit from increased competition. I would like to take this opportunity to elaborate on these three key points. Regardless of whether or not the NRSRO system remains intact or a system of registration is adopted, there needs to be clear and objective standards to assess the reliability of an agency's ratings.

Indicators of reliability, including a proven track record, should be the key because the public interest will not be served if the ratings of potentially dozens of agencies without such a proven record are used in safety and soundness regulations.

In terms of oversight, given the importance of unbiased credit ratings in the financial markets, we believe oversight and enforcement authority in matters such as conflict of interest and integrity are vitally important. Furthermore, we believe that the examination and oversight of rating agencies should be principally focused on objective measures of the ongoing reliability of a rating organization's rating, such as default and transition studies.

Within this framework, any regulatory or legislative approach should provide a narrowly tailored oversight scheme specifically developed for rating agencies. We do not believe that the existing regulatory schemes under the Exchange Act or under the Investment Advisers Act are a plausible fit, as agencies are very unique.

And finally, in terms of the increased competition and how investors will benefit, while the NRSRO system is often cited as a barrier to entry for new rating organizations, we believe that the debate over the NRSRO system ignores the single most important barrier to entry in the ratings market, and that is the S&P and Moody's monopolies.

In Fitch's own experience, simply being recognized as an NRSRO or being registered will not ensure an organization's ability to compete. An organization would need to devote significant resources in demonstrating a record of reliability in winning the support of investors.

We are proud of our growth over the past 15 years. We now rate over 60 percent of the bonds issued world-wide, but we account for only 15 percent of world-wide revenue. Fitch believes that our emergence as a global full service rating agency has created meaningful competition in the ratings market for the first time in years.

Fitch's challenge to the Moody's and S&P monopoly has enhanced innovation, forced transparency in the rating process, and improved service to investors, and created much needed price competition.

If Congress wishes to address barriers to entry in the ratings market and ensure competition, legislation should be adopted that eliminates the barriers and outright prohibits anticompetitive conduct, such as coercion, tying, and discriminating against ratings by other rating agencies for the purpose of preserving market share.

Fitch believes that this is an area where focused legislation might help to protect rating agency competition. Fitch believes that any rating agency found to be using anticompetitive practices or unfair business practices should be subject to a full range of appropriate sanctions.

In conclusion, we reassert our belief in competition, the importance of focusing on objective standards that demonstrate reliability of ratings, and the need for any legislation to be specifically tailored to the uniqueness of the rating industry. We also do not believe that increased regulation typically fosters competition, and the vague standards for registration will do little to advance a more transparent process for the Commission.

Thank you for your consideration of our views. We would be happy to answer any questions.

[The prepared statement of Nancy Stroker can be found on page 102 in the appendix.]

Chairman BAKER.I thank the gentlelady.

Our next witness is Mr. Sean Egan, managing director of Egan-Jones Ratings Company. Welcome.

STATEMENT OF SEAN EGAN, MANAGING DIRECTOR, EGAN-JONES RATINGS CO.

Mr. EGAN. Thank you. We at Egan-Jones strongly support the proposed legislation for reforming the rating industry since it does not impair the freedom of speech defense afforded rating firms, and it addresses the two major problems that have long plagued the industry.

Number one, the dearth of competition and, two, the failure of the current rating firms to provide timely, accurate ratings for protecting investors.

Perhaps the most appealing aspect of the proposed legislation is that it removes the SEC from the role of recognizing rating firms, i.e., NRSRO firms, a role in which it has failed miserably. The SEC's primary mandate is protecting investors.

From the SEC's Web site ″Who we are″, the primary mission of the SEC is to protect investors.

Within the past 3 years, we have experienced two of the largest credit failures in U.S. History, Enron and WorldCom, failures that resulted in the loss of hundreds of billions of dollars, tens of thousands of jobs, and the pensions of thousands.

After these colossal failures, one would expect that the agency charged with recognizing rating firms would have shown some initiative for addressing the problems so that they would not occur again. Unfortunately, this has not been the case.

Instead, the SEC is continuing its study of the industry, a study which began in the early 1990s, 15 years ago, and is continuing today. While the first NRSRO firm was recognized in 1970, it is only 90 days ago that the SEC finally devised a definition of NRSRO.

It seems obvious that a definition should have existed before the first NRSRO was designated. Furthermore the SEC's proposal for NRSRO requires that rating firms provide their ratings free to the public, which effectively means that the rating firms have to seek compensation form the Enrons and WorldComs of the world, which, in many people's view, is a system rife with conflict.

Yes, the SEC has recognized two new NRSROs during the past 18 months. However, neither firm warned investors about the recent major failures, nor did they provide any significant competition to the two partner monopoly firms, S&P and Moody's.

The SEC has indicated that it consults with major rating firms before proposing any changes to the regulation of the industry. Perhaps they should have consulted also with investors who have been and continue to be hurt by the flawed industry structure.

Conspicuously absent from the SEC's proposed definition of NRSRO rating firms are the following requirements. One is severing ties between the personnel of the issuers and the dealers. The ex-chairman of Moody's should not have served as director of WorldCom, nor should the rating firm's personnel be tied to broker-dealers or the broker-dealer industry association, such as the NASD.

Two, discourage insider training. The proposal addresses the misuse of nonpublic information given to rating firms, but does not address misuse of information generated by the rating firms themselves, such as Moody's informing Citigroup of its intention to downgrade Enron below investment grade before the fact. By the way, no investigation was made of Citigroup's trading in advance of that downgrade.

Three, take timely action. It has been over 3 years since the failure of Enron and yet the SEC has still not made any significant changes in the rating industry.

Regarding Egan-Jones' ratings, Kafkaesque is probably the best description of our experience with the SEC. We have regularly issued timely, accurate ratings and provided warning for the Enron, Genuity, Global Crossing and WorldCom failures. See the attachment.

Furthermore, we consistently identify improving credits. Most of our ratings have been higher than S&P and Moody's over the past 3 years, thereby assisting issuers in obtaining more competitive

capital. Our success has been recognized by the Federal Reserve bank of Kansas City, which compared our ratings and has attached the conclusion of that.

Since missing the failures of Enron in 2001, Moody's operating revenues have more than doubled from approximately $400 million to $814 million, and S&P's have increased from $435 to $893, an indication of the severe lack of competition in this area. After all of these failures, S&P's and Moody's operating income has more than doubled.

The proposed legislation provides some hope for reform and real competition in the ratings area. It is artfully drafted to preserve freedom of speech protections. We continue to support the standards of practices for participants in the credit rating process published by the Association of Corporate Treasurers, the Association of Financial Professionals, and the Association in France.

Until the fundamental problems in the rating industry are addressed, investors, employees, pensioners, and ultimately issuers will needless be harmed. The SEC should gracefully withdraw from this area in the interest of protecting investors.

[The prepared statement of Sean Egan can be found on page 64 in the appendix.]

Chairman BAKER. Thank you. Mrs. Biggert has requested the right to make the next introduction. Mrs. Biggert.

Mrs. BIGGERT. Thank you very much, Mr. Chairman. I would like to welcome Mr. Alex Pollock back to the committee. And Mr. Pollock is an expert in banking and bond market matters.

I would particularly like to highlight his experience, much of which he gained in the Windy City; that is Chicago. He served for 12 years as president and CEO of the Federal Home Loan Bank of Chicago, and as principal at Nolan, Norton and Company, Chicago, and then a senior vice president of Corporate Planning, Research and Development at Continental Bank.

In addition, he received one of his masters degrees at the University of Chicago. In his current capacity as a resident fellow of the American Enterprise Institute, Mr. Pollock has dedicated much of his time to the issue that brings us here today. So welcome Mr. Pollock.

Thank you, Mr. Chairman.

Chairman BAKER. Please proceed, sir.

STATEMENT OF ALEX J. POLLOCK, RESIDENT FELLOW, AMERICAN ENTERPRISE INSTITUTE

Mr. POLLOCK. Thank you, and thank you very much, Congresswoman. Mr. Chairman, Ranking Member Kanjorski, members of the subcommittee, I greatly appreciate the chance to testify on this important topic today.

I spent 35 years in the banking business, dealt a lot with credit ratings, as you can imagine, including getting ratings for various entities. Thanks to the leadership of the chairman and the ranking member, I have spent a good bit of time over the last several months thinking about this issue while at the American Enterprise Institute.

Based on all of that, it is a real pleasure to speak today in support of H.R. 2990. This is a pro-competitive bill. It is going to lead,

if enacted, to more choice, more alternatives for the customers, and to reliance on market discipline, which is the best kind of discipline.

It does this by moving from a regime of designation by regulation, by the SEC of course, to a regime of disclosure and competition. Having had the AEI be good enough to publish a paper of mine called ″End the Government-Sponsored Cartel in Credit Ratings,″ and I guess we should add, Mr. Chairman, ″cartel″ to the ″opolies″, my view is summarized by that title.

It is my view that decisions about credit ratings and which credit rating agencies should prosper and which not prosper, should be made by investors, financial firms, issuers, and, in general, the market.

I think, as do a number of others, that it would be better not to have an NRSRO designation at all, and really have a market solution. But we have had a problem in thinking about that because, as has been referred to, there is a very large, very complex interlocking web of regulations and statutes, both at the State and Federal level, which refer to this term, NRSRO, as Congressman Kanjorski mentioned. How to move toward a market solution when faced with this interlocking web—or to change the metaphor, a Gordian Knot—of regulation and rules did puzzle me.

In my view, H.R. 2990 cuts this Gordian Knot in a quite brilliant and creative way by keeping the abbreviation but changing what the ″R″ stands for, from ″recognized″ to ″registered″. That actually completely changes the meaning of the term and how it would operate in the market, while leaving in place all of this complicated set of rules that can keep on referring to the term, but they will be referring to something different.

I find this both on the merits and also rhetorically a very pleasing and good solution. We ought to be moving toward a market discipline, as I said, where market actors are asked to make informed judgments and multiple decision-makers are acting on credit ratings. That will include multiple regulators because we have a lot of regulated entities using credit ratings.

It will also include multiple pricing models in the business so that you can have pricing models paid for by both issuers and investors and we see what the market likes best.

I would like to mention three clarifications. One is that there are high natural barriers to competition and barriers to entry in the credit rating business because of its dependence on judgment and on reputation and because of the conservative nature of risk policies. Therefore, when we do this, this is going to be an evolutionary transition.

In my judgment, I do not see any disruption to markets or behavior because we are going to be going through an evolution in the face of natural barriers.

The second is, whatever we do, we cannot hope to have no mistakes in ratings or perfect ratings. Anybody who is dealing with trying to anticipate the uncertainties and the risks of the future is going to make mistakes.

I would hate to have the list of my own financial mistakes published. We have to address that as reality. The best defense to that reality is to have a vibrant marketplace of many competitors, many

opinions, different kinds of analysis, different kinds of ideas for investors, and other users of ratings to choose from. That is the best possible defense.

A third clarification is we want to make sure that the first ″R″ in NRSRO doesn't inadvertently slip into changing from ″registered″ to ″regulated″. We don't want a nationally-regulated rating agency business. Fitch Ratings, in their written comments, suggested that this might be a risk.

I do think that we ought to look carefully at the language of the bill just to make sure that that does not inadvertently happen and that we do indeed carry out what is clearly the pro-competitive intent.

In summary, Mr. Chairman, H.R. 2990 is a very positive move toward a pro-competitive disclosure regime, as opposed to a regulatory designation regime. I believe this move would lead, as competitive markets always do, along with their greater competition, to more choice in the market for customers, better service, lower costs and more price competition, less duopoly profits and more innovation, the very benefits we always look to from a competitive world.

Mr. Chairman, thank you very much again for the chance to be here today.

[The prepared statement of Alex J. Pollock can be found on page 99 in the appendix.]

Chairman BAKER. Thank you, sir, for your statement.

Our next witness is Rita M. Bolger, managing director and associate general counsel, Standard and Poor's. Welcome.

STATEMENT OF RITA M. BOLGER, MANAGING DIRECTOR AND ASSOCIATE GENERAL COUNSEL, STANDARD AND POOR'S

Ms. BOLGER. Mr. Chairman, Ranking Member Kanjorski, members of the subcommittee, good morning. I am Rita Bolger, as introduced, managing director, global regulatory affairs and associate general counsel for Standard and Poor's, a division of the McGraw Hill Companies.

At S&P, we are extremely proud of our well-documented track record of providing the market with independent, objective, and credible rating opinions. Our ratings are publicly available without charge and our rating criteria and methodologies are published on our Web site and elsewhere.

As a result, we are subject to the scrutiny of the financial markets every day. On behalf of Standard and Poor's, I am pleased that the subcommittee has granted our request to be here. Standard and Poor's has been and remains committed to constructive change that would eliminate unnecessary barriers to competition in our industry.

However, we have serious concerns about H.R. 2990 and the disruptive effect it could have on the efficient operation of the capital markets. When the SEC asked market participants in connection with its 2003 concept release whether it should retain the NRSRO concept, the vast majority unequivocally said yes.

These commenters represented that eliminating the NRSRO concept would be disruptive to the capital markets and would be costly and complicated to replace.

We agree. As does the Bond Market Association, an organization that, according to their submission in connection with this hearing, speaks for the bond industry worldwide. As the BMA observed, the NRSRO designation serves a unique purpose in SEC regulations for which a substitute is either not available or not practical.

Additionally, we believe that intrusive regulatory oversight of the sort contemplated by the bill will result in ratings of lesser, not higher, quality because credit ratings are opinions, as to which reasonable analysts can and do disagree; there is no one correct way to go about forming them.

Comprehensive regulation could produce standardized approaches and rating opinions that do not reflect the uncompromised view of the rating committee. In addition, intrusive regulation is likely to erect new barriers to entry that will inhibit, rather than promote, increased competition as it will force new entrants to bear significant regulatory costs that they currently do not bear.

Importantly, and as has already been raised this morning, we also believe that H.R. 2990 as written is unconstitutional on its face. Rating agencies have consistently been afforded a high level of First Amendment protection by numerous State and Federal courts.

This is so because at their core, rating agencies such as S&P perform the journalistic activities of gathering information on matters of public concern, analyzing that information, forming opinions about it, and broadly disseminating those opinions to the general public. We believe that the bill would specifically violate the First Amendment by making it illegal for a credit rating agency to publish its opinions without first registering with the Government, providing mandatory disclosures about its business activities, and obtaining approval of that registration.

No legislation could constitutionally require the licensing of Business Week or the Wall Street Journal because they offer their opinions as to the credit worthiness of certain entities.

Also, intrusive Government involvement in the manner and method of generating credit ratings, such as contemplated by the bill, would be the equivalent of unconstitutional Government supervision of publishers from within their own newsrooms. This direct intrusion into the editorial process is precisely the type of governmental activity that the First Amendment prohibits.

As discussed more fully in my statement for the record, positive steps have been taken over the past 2 years by both the SEC and IOSCO, the International Organization of Securities Commissions, with input from a diverse array of market participants. These initiatives are being implemented and include as goals increased competition and enhanced oversight.

Based on these serious concerns about the bill, we believe the best approach would be to allow these initiatives to move forward. Once these initiatives have been given a chance, then Congress would be in a better position to assess the necessity of legislation, and it is our belief that after these initiatives have been tested, you will conclude legislation is not the best approach for the market.

In conclusion, on behalf of S&P, thank you again for the opportunity to participate this morning. I would be happy to answer any questions.

[The prepared statement of Rita M. Bolger can be found on page 47 in the appendix.]

Chairman BAKER.I thank the gentlelady for her statement.

Our next witness is Mr. James A. Kaitz, president and CEO, Association for Financial Professionals. Welcome.

STATEMENT OF JAMES A. KAITZ, PRESIDENT AND CEO, ASSOCIATION FOR FINANCIAL PROFESSIONALS

Mr. KAITZ. Good morning, Chairman Baker, Ranking Member Kanjorski, and members of the committee. AFP appreciates the opportunity to participate in today's hearings on the legislative solutions to the many issues and concerns raised with regard to the credit ratings market.

AFP represents more than 14,000 finance and Treasury professionals, representing more than 5,000 organizations. Our members are responsible for issuing short and long-term debt and managing corporate cash and pension assets for their organizations.

Previously, AFP has stated that the SEC's existing recognition process has created an artificial barrier to entry to the credit ratings market. This barrier has lead to a concentration of market power with the recognized rating agencies and a lack of competition and innovation in the credit ratings market.

To remove this barrier to entry and stimulate competition, AFP has long advocated that the commission clarify the recognition process. Further, we believe that recognition of credit rating agencies must be conditioned on whether an organization can consistently produce credible and reliable ratings based on adherence to published methodologies.

We have also urged regulators to require that rating agencies document internal controls that protect against conflicts of interest and anticompetitive and abusive practices and ensure against the inappropriate use of nonpublic information.

This past spring, the SEC issued a proposal that attempts to address some of the concerns we have raised. However, we do not believe that the SEC proposal would foster a truly competitive market and fails to address the need for ongoing oversight of the credit ratings market.

The Credit Rating Agency Duopoly Relief Act of 2005, introduced by Representative Fitzpatrick, would require the SEC to register credit rating agencies based on the criteria recommended by AFP. By eliminating the ambiguous NRSRO designation process in favor of a more transparent registration process, the Act will foster meaningful competition in the credit ratings market.

As such, AFP supports the legislative proposal before the committee today.

Mr. KAITZ. In nearly 30 years since creating the NRSRO designation, there has been no review of the ongoing credibility and reliability of the ratings issued by the NRSROs. Any effort to address these concerns, either through regulation or voluntary agreement, will be entirely ineffective without an oversight and enforcement mechanism.

AFP is pleased that the proposed legislation directs the Commission to censure, suspend, or revoke the registration of any reg-

istered statistical rating organization that violates certain sections of the act or ceases to meet the registration criteria.

If the credit ratings market is opened up to competition, it will be incumbent on the SEC to take an active role in the ongoing oversight of registered organizations to ensure that they continue to merit SEC registration. We believe that the proposed legislation gives the SEC the authority, flexibility, and guidance needed to conduct the necessary oversight without placing an overly restrictive legislative regime on either the Commission or the credit ratings agencies. For the committee's consideration, we believe there are several key areas where additional clarification will strengthen the act.

The first area is with regard to ratings performance measurement statistics. As AFP has consistently suggested, the key criteria for rating agency recognition should be whether the rating agency can consistently produce credible and reliable ratings. We believe that it is imperative that the applicant not simply file statistics, but also demonstrate that its ratings are, in fact, credible and reliable.

The second area in need of clarification is the registration requirement contained in section 4 of the legislation. The bill requires all credit rating agencies that meet the definition to register with the SEC, even those that do not seek to have their ratings approved for use by regulated portfolios. There are currently more than 130 ratings agencies, many of which have not sought and may not seek SEC recognition or registration.

Further, new rating agencies that are established will not be able to file long-term ratings performance measurement statistics required for registration, shutting out these new market entrants.

AFP recommends that the act limit registration requirements to those that seek approval for use by regulated portfolios or those that the Commission determines must be registered to protect the public interest.

We also recommended that the act explicitly direct the Commission to develop an oversight and an examination regime that ensures that registered statistical rating organizations continue to issue credible and reliable ratings, that they have and adhere to policies that protect nonpublic information and prevent conflicts of interest and unfair and abusive practices. Such an oversight framework is described in the Commission staff outline of key issues for a legislative framework for the oversight and regulation of credit rating agencies, developed at the request of Ranking Member Kanjorski. This type of oversight will protect capital market participants without injecting regulators into the decision making of the rating agencies or impinging on their First Amendment rights.

We believe that the registration process proposed in the Credit Rating Agency Duopoly Relief Act of 2005 will minimize barriers to entry and foster competition among existing NRSROs and those that may be later registered. The enactment of the bill, along with the development by the Commission of an oversight regime that ensures that registered statistical credit rating organizations continue to meet the registration requirements will improve investor confidence in the rating agencies and global capital markets.

Thank you, Mr. Chairman.

[The prepared statement of James A. Kaitz can be found on page 72 in the appendix.]

Chairman BAKER. I thank the gentleman for his statement.

I would like to start my questions with Mr. Partnoy.

As I understand the pending SEC proposal, it requires a firm to be generally accepted in the marketplace in order to be a first step to NRSRO designation by the SEC. In your observation, how would one become generally accepted in the market for some period of time, in other words, be utilized, if you don't have the SEC designation to begin with? Is that a workable remedy to enhance competitive opportunity?

Mr. PARTNOY. No, Chairman Baker, I think that is a very good point. It is what I would call a Catch 22. It is virtually impossible for an agency to establish that it is generally accepted if the NRSRO framework is in place and they are not a designated NRSRO.

Chairman BAKER. So you would have to be in the rating business, expend the money to do the analyticals, convince companies to pay you, do that for some period of time on a national basis, when the companies know that it has no merit or impact on their publicly disclosed rating standard?

Mr. PARTNOY. That is absolutely right. And companies know that loud and clear because they know about the proliferation of regulations that virtually require that you get a rating from an NRSRO so that you can sell it to folks who have to have one of those ratings.

Chairman BAKER. So at the moment, we are not clear how we get additional competition in the marketplace because you have to be generally accepted, but you can't be generally accepted without the designation? But that is the standard by which we gauge whether you can become one?

Mr. PARTNOY. That is precisely right. And that is why it is a Catch 22, an intractable problem. And that is one reason why the idea of eliminating this notion of an NRSRO entirely is an attractive one.

And that has a host of difficulties, as Mr. Pollock mentioned, but I completely agree.

Chairman BAKER. Thank you.

Mr. Egan, you have been critical this morning of rating agency performance. Is there, in your view, any consequence to a rating agency today that doesn't meet, let's just call it ″fiduciary obligations,″ in rating appropriately? Is there a professional standard of conduct which someone holds up and measures you and say, Oops, you didn't do your job; here is the penalty box?

Mr. EGAN. For the non—

Chairman BAKER. I think you just cut yourself off.

Mr. EGAN. Thank you.

Chairman BAKER. Thank you.

Mr. EGAN. For the non-S&P and -Moody's of the world, there is a very tough standard. In our case, we are paid by institutional investors. If we don't succeed in issuing timely accurate ratings, clients will cut us off. It is just that simple. Their concerns are a little bit different from the issuers; issuers want the lowest cost of capital generally.

On the national recognition, though, we do have that national recognition, have had it for a long period of time, and we still don't know what the SEC wants for us to get—

Chairman BAKER. So you are saying you are nationally recognized with a record of accurate performance, and yet you are still mystified by what constitutes the remaining step for you to become nationally recognized?

Mr. EGAN. That is correct. In fact, there is a study of our recognition versus DBRS, a Canadian firm.

The SEC's prior regulation is that an NRSRO has to be nationally recognized in the United States. We had more than four times the recognition of DBRS; and AM Best, I think we had five times recognition among users of credit ratings. These are institutional investors, mutual funds. We had more than four and five times the recognition of the other firms. We brought this to the SEC's attention, and they said nothing.

Chairman BAKER. It is your view, then, it is no longer an inability to meet their standard? You are meeting the standard, but you still can't get an approval?

Mr. EGAN. That is correct. And what they have said is they are going to wait until this NRSRO process plays out.

Chairman BAKER. Is that like a 30-year wait?

Mr. EGAN. I don't know. They won't set a time frame for it, which is very frustrating.

Chairman BAKER. Let me get to Mr. Pollock before my time runs out.

Do you believe, given your analysis of the market performance of S&P and Moody's in a parallel path in a free market system, it is likely that two companies could own 80 percent of any market without some governmental grant of privilege?

Mr. POLLOCK. Mr. Chairman, in my opinion, their market position and the market power reflects Government sponsorship through the NRSRO process, not unlike the Government sponsorship we have often discussed in the GSE world.

Chairman BAKER. I don't want not to get to Ms. Bolger. It is my expectation we will get to another round of questions, but with the number of members, I am going to stick to the 5-minute rule and recognize Mr. Kanjorski.

Mr. KANJORSKI. Thank you, Mr. Chairman.

Ms. Bolger, exactly why do you think that H.R. 2990 violates the First Amendment in specific?

Ms. BOLGER. The proposed bill, the bill has a requirement, in effect, for—it is a licensing regime. There is a procedure for filing your application, documents, certain policies and procedures, all on issues that we believe are important to the market and to quality. But then the SEC would have the ability to accept or deny, and there is a process for denial of that application.

So there is some—there is a mechanism built in here for not just notice filing of information to the SEC, but their evaluation and, ultimately, approval. And that licensing, in effect, requirement is not constitutionally viable.

Publishers are free, by long-standing case law, to freely disseminate their opinions. And rating agencies are members of the financial press, the financial press being equally protected by case law.

Mr. KANJORSKI. Thank you. To all of our witnesses, could I request that you review the SEC staff outline and send specific comments to the committee before the end of August? Is that a reasonable request?

This is a very delicate area. I guess in the best of all worlds—and I appreciate Mr. Egan's problem; I have lived with his frustration on several hearings. Is there a possibility of having both the recognition and the registration concept? I mean, it seems to me that I don't want the Good Housekeeping Seal of Approval out there to 100 different agencies who can qualify and register and then just offer themselves up for bidding purposes. Not that most would do that, but a few probably would.

On past occasions I have expressed my concept of the ″bastard rule″. It is my rule about why we have so many laws and regulations. It is not that most of us need those rules or regulations, but there are always 3 to 5 percent of participants in any sector that go to the edge of the envelope or beyond for greed or for value. I assume that we would have to recognize that rule in this industry, that greed would be particularly attractive.

So how would we avoid encouraging, recognizing, or registering agencies that are literally up for grabs to the highest bidder?

Mr. KAITZ. I think we recommended in our oral testimony, sir, that, first of all, only those that would want to be in regulated portfolios would be one alternative. And as long as there is a process to determine credible and reliable ratings, I think that is going to put market disciplines on those ratings agencies or agencies shopping for the best deal.

So I think you have to distinguish between 130 and those that would want to be in the regulated portfolios, and then make sure that there is a criterion to ensure that credible and reliable ratings are given over a period of time.

Mr. KANJORSKI. But isn't that an after-the-fact situation?

Mr. KAITZ. No. You could look at—you could do some correlation analysis of their methodologies and go back and see how they did in the marketplace.

The reality is, though, you would not probably look at a new organization that would want to be in a regulated portfolio. They likely would be already established agencies with a track record that the SEC could take a look at.

Mr. KANJORSKI. So are we only arguing here whether or not we have just a limited number of recognized entities and we want to enlarge that number? Or are we just looking for a methodology to enlarge that number?

Mr. KAITZ. I think if you put the right discipline in the market, then you are going to get those agencies that are going to be the major players. Also, as an organization that represents the issuers, it is not in the issuers' best interests to use a rating agency that is not going to be credible, that you now have to defend before the audit committee and the board. So our members have a fiduciary responsibility to make sure those ratings are accurate.

Mr. KANJORSKI. If we open it up by registration, what is to prevent investment banking houses from making the decision of where the business goes and who makes the ratings? Aren't they doing that to some extent today?

After all, companies are doing that with the accounting firms that they hire and the legal firms that they hire. They are saying, you know, we are just not going to deal with this security unless these people put their opinions in place. They just don't open it up to the whole bar or to the whole accounting profession.

Mr. KAITZ. Again, from our—I don't want to dominate here, but from our perspective, that is why it is critical that there is SEC oversight of the rating agencies and that they are really looking at credible and reliable ratings. I think that is the role, from AFP's perspective, that we have envisioned.

Mr. KANJORSKI. Mr. Egan, didn't you suggest that the SEC should withdraw from this field? Is that the key point of your testimony?

Mr. EGAN. Yes, I did.

Mr. KANJORSKI. And who would be the regulator? Who would be the protector of the investor and the public if they withdraw?

Mr. EGAN. I think you need a board of industry participants to be involved in the oversight.

Mr. KANJORSKI. Self-regulatory?

Mr. EGAN. Perhaps, but it would be broader, as it represents some individuals.

The Bond Market Association is held up as representing the industry; we disagree with that. In our experience, they represent the interests of the larger rating firms and the larger broker-dealers. The interested parties is much broader than that.

We don't understand why the SEC has not taken action faster than this, but obviously, there must be some pressures there or they would have acted. So we think there should be a broad group that is represented.

Mr. KANJORSKI. Isn't it sort of underfunded? While the SEC was given all kinds of regulatory authority, they just don't have the personnel and money to do the job?

Mr. EGAN. I find that hard to believe.

Mr. KANJORSKI. Well how about the problem we have here in Washington on unavailability of office space? You're indicating another bureaucracy, if I understand it, or another agency or quasi-governmental agency to do this work?

Mr. EGAN. I think it could be a rotating board of industry participants that are charged with overseeing this area until some—or perhaps with a new SEC commissioner, there will be some reasonable—

Mr. KANJORSKI. What kind of enforcement would be available if we have an industry board? What powers would they have?

Mr. EGAN. I think, start with the recognition of ratings firms; and that has been a bottleneck for quite some time. There isn't any real competition. Even with these new firms, they don't present any real competition.

As far as the oversight, I think that there has to be some review of the anti-competitive practices that are being undertaken by S&P and Moody's. They have been raised a number of times; they are not addressed in the current NRSRO designation definition, and those should be addressed.

So I think it would be this rotating advisory board that could be both in the front end of identifying companies and on the review process.

Mr. KANJORSKI. Do you want to defend the monopolistic practices of your organization, Ms. Bolger?

Ms. BOLGER. Yes.

S&P has been on record for quite a long time as being fully supportive of more competition in the industry. We do, though, of course, see tremendous value in the market recognition and acceptance portion of the NRSRO designation. It is really the fundamental criterion to be an NRSRO and upon which—a premise for which a lot of regulations have embedded NRSRO ratings. So to strip that out, as the current bill does, would be—would have, we believe, a vast effect; and we believe other people have enunciated that view as well.

In terms of any anti-competitive practices, we just feel that there is a tremendous amount of value out in the marketplace. And we believe that the initiatives that are already moving forward, both with the SEC's proposed rule, which does enunciate criteria to judge market acceptance, which does open up the market to geographic-specific rating agencies and those with some industry specifics, that those initiatives should be allowed to proceed.

I also want to mention in terms of oversight, a lot of work has been done internationally. You may have seen the IOSCO code of conduct that was concluded in December 2004.

I believe the rating agencies have taken that very much on board, have been part of the process. These are global ratings agencies, and that has been the decision after some of these same questions have, over the last 2 years, been debated in Europe primarily. Things like an arbitration board or just having a few people decide has been ruled out in favor of more of a code industry standard and self-regulation to some extent, but knowing that credibility, if we don't abide by a code, could certainly impact the bottom line.

Chairman BAKER. The gentleman's time has expired.

Mr. Shays.

Mr. SHAYS. Thank you very much. I am conflicted because I basically believe in open markets, and yet I have such a tremendous respect for McGraw-Hill and Standard & Poor's.

So that conflict notwithstanding, Mr. Partnoy, in your testimony you stated the philosophical approach the Commission has suggested with respect to NRSROs is inconsistent with its approach in other areas and, indeed, with legislation purposes, security laws.

Could you please elaborate on this idea?

And let me just throw this out as well. Are there other entities that the Securities and Exchange Commission approves? In the manner in which it approves rating agencies, does the Commission approve brokers, investment advisors, mutual funds?

Mr. PARTNOY. Those are very good questions, and I think gibe well with the ranking member's questions about how to have registration and recognition coupled in some way.

The philosophical, the general philosophical approach is to permit companies to register and then have the markets work on the back end as the disciplining measure. And the attractiveness of that is that it ideally does precisely what the ranking member has

said he would like legislation to do because it provides a disciplining function. But it also provides an initial screening function, so you can really have it both ways.

And I think the U.S. Securities markets are the best in the world for precisely this reason, that we have achieved this balance by having oversight at the beginning in terms of who can register, which companies can raise money, and then let the markets do the oversight at the end. So that is what I meant by those sentences.

And in terms of other—the second part was, with respect to other similar kinds of areas, there aren't any explicit areas where the SEC, for example, will say, only these entities can come in, but there are somewhere implicitly.

Accounting firms and underwriters are given special privileges. And to the extent there is not as much competition as people would like in the investment banking business or in the accounting Industry, where we see also not as much concentration as in credit ratings, but some concentration, I think that part of it is due to that at least implicit requirement that you be a Big Four accounting firm or you have a certain amount of reputational capital or that you are registered or licensed in a certain way.

And let me just respond: This notion that licensing financial institutions somehow is a violation of the First Amendment is not something that—that argument shouldn't apply uniquely to credit rating agencies. It should also apply in all these other areas that I think your question is getting to. And I don't think it is correct to say that, for example, investment banking fairness opinions which are made public, or accounting opinions, which are in every Form 10-K filing, are subject to the same kinds of problems.

Mr. SHAYS. Would any of the other panelists care to respond?

Ms. BOLGER. If I could just address briefly to Mr. Partnoy's point also, to point out that Standard & Poor's is submitting a detailed memo on the First Amendment issues that are raised under the bill. So that will be submitted shortly.

But there are distinctions in the case law, and I certainly won't go into all the cites and details, but between—and among, actually—auditors, investment advisors, and ratings agencies, namely, based on the core function, a rating agency's core function is the publication of rating opinions, whereas auditors are required by regulation to publish. Rating agencies, on the other hand, have the option; they have full editorial control. And unlike the case law on rating agencies, there simply is not case law that covers auditors to that extent.

Mr. PARTNOY. May I briefly say one thing?

Chairman BAKER. Really quick, and then we will go to Mr. Pollock.

Mr. PARTNOY. The core function of a rating agency is not publication. It is not publication; it is not a publishing firm.

Moody's market capitalization is more than three times that of the New York Times. We don't know what the S&P's value is because they don't say publicly. But that kind of value doesn't come from publishing; it comes from selling ratings that unlock the keys to this regulatory compliance in the capital markets, not from publishing.

Mr. SHAYS. If I have time, I want to get into the whole issue of shopping for ratings.

But, Mr. Pollock.

Mr. POLLOCK. Congressman, I think there is an interesting positive analogy of ratings and publishing. So I think we ought to think about applying the NRSRO concept as a mental experiment to publishing.

Suppose we said we are going to have nationally recognized publishing companiesand a whole range of regulated entities—banks, pension funds, mutual funds—are only allowed to use the publications of these nationally recognized companies. I think we would all agree that would be a pretty foolish situation.

What I like about this bill that is it moves the credit rating sector, which is a business, which does have analogies to publishing, into a competitive market like most, at least, of our market economy—namely, a disclosure and competition model, as opposed to a regulatory designation model. That seems to me very positive.

Thank you.

Mr. SHAYS. Thank you, Mr. Chairman.

Chairman Baker. Gentleman yields back.

Mr. Hensarling.

Mr. HENSARLING. Thank you, Mr. Chairman.

Ms. Bolger, I have listened a couple of times now, and it is a matter of great interest; and I look forward to reading the brief on the First Amendment implications because I am struggling a little bit with them in some respects.

How would you address the argument that the SEC, de facto, has registered two rating agencies today through their regulations, and to this proposed legislation, as opposed to putting their imprimatur on two or perhaps five ratings agencies, they may end up putting their imprimatur on 100?

So why don't the same First Amendment concerns apply to the status quo?

Ms. BOLGER. The status quo is not—rating agencies don't have to be designated as an NRSRO, so there is not the same level or approach. With this front door, one must have a license before one can even speak or else it is an illegal type of approach.

So there is a fundamental difference in the way the existing system works and even, we believe, with the proposed rule that the SEC has promulgated. There will certainly be, as we understand it, more clarity around the process than the actual criteria for designation. But we don't take a position as to whether there is an ultimate perfect number of NRSROs or even credible rating agencies, but we do believe it is very important to still maintain that market acceptance factor, even putting aside the legal First Amendment issues just from a policy and market protection perspective.

Mr. HENSARLING. Next question I have—and, first, I do have a bias in favor of competition and open markets. And I certainly respect and appreciate the approach of my colleague, Mr. Fitzpatrick, on this piece of legislation, and I haven't studied it in detail.

I have one issue that causes me a little bit of concern, and that might be the revelation of certain methodologies involved in ratings of various companies. I just want to know, is there any concern in the revelation of perhaps something that can be seen as propri-

etary, data that could actually prove to be an anti-competitive measure, as opposed to a pro-competitive measure?

I understand that transparency is quite good and seeing one's batting average and prognosticating on what has actually occurred, but I just wonder if there is any concern that at some point we cross the line to revelation of proprietary today and become more anti-competitive?

Is there anyone who would like to take a shot at that?

Mr. Egan, you look like you are going to the microphone.

Mr. EGAN. I would be happy to because I think many market participants recognize our ratings as being the most timely and most accurate, not only domestically but internationally. We are not concerned about any sort of technology being distributed out into the marketplace and impeding us.

I think at the base, it is really an understanding of the business. It is judgment. We got WorldCom right because we were concerned about the bear market in long distance capacity. We were concerned about Bernie Ebbers' $400 million loan from the company. We are concerned about the deterioration in the company. You know, if we send the technology out into the marketplace, it is not going to hurt us very much.

The technology is not proprietary. It is the judgment.

Mr. PARTNOY. I will say briefly, I believe both Moody's and S&P describe a fair amount of their process already.

Mr. HENSARLING. Another question for you, Ms. Bolger. In your testimony, you talked about how Mr. Fitzpatrick's bill could actually erect new barriers to competition through its burdensome mandates. Clearly, your opinion appears to be in the minority on this particular panel.

But could you explain in a little greater detail because I don't think I understand your position.

Ms. BOLGER. I think, fundamentally, the issue is setting up a structure, this approval licensing regime, and the breadth of entities that would be covered essentially, since one would need a license in order to issue opinions. And if that is your primary business over, I believe, 3 consecutive years, it picks up a large group of entities, maybe intended, maybe unintended. That is not clear.

But the cost of doing, of abiding by that type of system, of preparing the policies, of submitting to that, and adhering to the whole process, the 90 days here and there, could definitely pose an issue, we believe, for newcomers to the market.

Mr. HENSARLING. But isn't it true that the vast majority of your competitors, who don't enjoy your designation, are on other side of this issue and believe it would be pro-competitive?

Ms. BOLGER. Well, yes, and we don't have a problem with that whatsoever. But our position is, the aim to open the industry up to more competition can be addressed in a way other than this bill. We really believe, after a lot of thought, that the bill simply doesn't work, both for legal and policy reasons. And we would turn, as I mentioned, to some of these other initiatives that have opening up the market in mind as one of their goals.

Mr. HENSARLING. Thank you. My time has expired.

Chairman BAKER. Thank the gentleman.

Mr. Fitzpatrick.

Mr. FITZPATRICK. Thank you, Mr. Chairman. I appreciate the time and testimony and expertise of all the panelists. We have all found it very helpful in this process.

I agree with Mr. Egan that there are questions to be answered, and I am perplexed as to why the SEC has not dealt with this in a more timely fashion, just following up on that question Mr. Hensarling asked of Ms. Bolger and her answer.

Going to Mr. Partnoy, could you explain the SEC staff designation process and how that only adds to the duopolistic position of Moody's and S&P?

Mr. PARTNOY. Well, it is difficult to explain. It has been a bit of a black hole because there is not much specification. And you hear the frustrations from Mr. Egan here in trying to get designated. And he is certainly not alone; there are many entities that have tried.

Formally, the process works through no-action letters. So it is an informal process, and the goal is to try to get the SEC to write a no-action letter. But just as we, Chairman Baker and I and others, have said, there isn't even a definition of an NRSRO. There isn't much guidance. So I describe it as a ″black box.″ I don't think that anyone knows precisely what they need to do in order to qualify.

Sorry I can't give you a better answer to that, but I just don't think there is one.

Mr. FITZPATRICK. Mr. Pollock, you were at one time head of the Federal Home Loan Bank of Chicago, and you have significant experience in the financial services market.

Could you explain your comments that you believe—and we have heard some concern here about disruption to the markets as a result of this bill. Do you believe that there would be no—I think you said ″no disruption″ to the fixed income markets, that there is a more competitive rating agency sector?

Mr. POLLOCK. Congressman, that is my opinion, as I said in my testimony. These are big markets; they are full of sophisticated people. They will also, in my judgment, move in an evolutionary fashion because there are natural, conservative tendencies in anything that revolves around the question of estimating risks and estimating future losses and uncertainties.

I think we should be moving the market to where all financial actors, both issuers and buyers of securities, creditors, and all users of these ratings, are asked to exercise their judgment, have that judgment as informed as possible, and then let the market action decide which ratings are successful, which pricing models they like, which ratings models the market will prefer.

But I am convinced that all that would happen in an evolutionary, nondisruptive way because everybody is going to be very careful about this so that what we will see is a smooth transition from what we have now, the Government-sponsored cartel, to what we should have, which is a real competitive market.

Ms. STROKER. If I can address that, as well, representing Fitch's view. We are sort of the man in the middle here where we are an NRSRO and yet we are not S&P or Moody's; we don't have their market strength.

I think the big concern that we share is that the process of getting from here to there, that it be constructive and evolutionary.

And as Congressman Kanjorski pointed out, ratings are infused in numerous statutes—in the financial markets, in mutual funds—and simply opening up the ability to be included to these 140 market participants, or whatever the number is, could be quite disruptive.

Mr. EGAN. I would like to put things in perspective. You know, you have had major failures here, billions of dollars lost. And we are concerned because one, probably two, of the major rating firms whose revenues operating income, by the way, has doubled in the last couple of years, they are concerned about moving forward because they might lose the freedom of speech defense because they don't want to be registered under this new scheme.

It makes no sense to me. But then again, neither does the SEC's registration process. So you really want to put the whole thing in perspective; people are getting hurt badly. And it has been 15 years since the SEC has been studying this.

We have had an application in for 8 years. I am a patient man, but this is getting absolutely ridiculous. What do we need, another couple of Enrons to fail?

Mr. FITZPATRICK. One more question, Ms. Bolger. In your written testimony, page 8, you liken this bill to—"throwing the baby out with the bath water" is the analogy you use.

I am wondering, who is the baby in this particular case and what is the bath water?

Ms. BOLGER. The baby would be the test for market recognition since that would disappear under the bill. And we do believe, in response to some of the other statements and questions this morning, that this is not just a matter of terminology and changing "recognized" for "registered" or whatever the term might end up being, because the premise, the fundamental premise upon which States and Federal regulations have embedded NRSRO ratings, has been market recognition.

I think that has been the SEC's key criteria for a long time, and while, perhaps, the process is not clear—and we are also on record as being very much in favor of a more transparent process and a more formalized process to increase competition and provide the quality ratings out there—it just seems that to eliminate the market recognition or acceptance, that is, you know, for independent credible ratings, is the wrong way to go. We think it is just too fundamental, the system.

Chairman BAKER. I thank the gentleman and want to compliment him on his good work in this matter.

I want to try to put in a construct that makes sense to me, the concerns that I think Mr. Fitzpatrick is addressing with the legislation.

As indicated earlier by Mr. Pollock, there isn't a Government agency that says, okay, you can be a newspaper. Under the First Amendment, not only are newspapers protected, I am protected.

I am going to make a statement you are going to disagree with it. I have the right to make the statement; I don't have to be licensed to make the statement, and there are no consequences when I make the statement. Now, if Mr. Kanjorski and I agree and we introduce a bill, that might have consequences, but short of that, the statement itself has no effect.

You were arguing that you have a First Amendment privilege as a result of your reaching and opining as to someone's financial condition. Very similar in concept and scope to that of a CPA, now subject to the PCAOB in multiple regulatory levels.

At the same time, you are saying that to be designated an NRSRO is of no consequence, but statutes make repetitive, duplicative reference to NRSRO; hence, the reason why we didn't change NRSRO to another acronym, but rather ″registered″ as opposed to ″recognized,″ so we didn't have to change all the other statutes. It was a way to address the structural problems without getting into all that legislative, legal detail.

The current system is a system which designates NRSROs as a result of an SEC governmental determination and establishes a status on those so designated. That is not an operative principle distinguished from a registration process.

I have, as Exhibit Number 1, Mr. Egan, who is now an 8-year advocate for registration ″recognition,″ for nationally ″recognized.″ He can't get there. So it is a barrier in performance of NRSRO obligations.

The very thing you say you do not wish to see occur with the adoption of 2990, I suggest the current system, therefore, is unconstitutional and subject to First Amendment privilege. If we agree that you are now designated by governmental enterprise, and I even cede to you the point that there are First Amendment questions, I will refer you to Hudson v. New York in 1980, in which the Court held that should there be an overriding governmental reason and the remedy prescribed by the Government is reasonable and properly prescribed, then there even can be a prescription of First Amendment privilege based upon an overwhelming necessity for governmental action, the capital markets.

If S&P determines that an enterprise is—an issuer's ratings should fall below BBB, no longer investment grade, there are consequences. If an issuer wishes to go into the debt markets to provide security investments into its firm and does not get a rating of at least two independent enterprises, there is a market consequence.

A newspaper writes a bad editorial; people get mad, but there is no measurable, quantifiable market effect. When you issue an opinion contrary to an issuer's interest, there is a measurable, consequential effect. Therefore, preservation of a stable capital market is clearly in the interests of this committee and of the Federal Government, and it should have been under the purview of the SEC. And that is what gets us to the current moment.

The SEC has not acted; for 30 years it has not acted. And we have a handful of individuals granted the responsibility to engage in this enterprise conduct, which is specifically referenced by Federal law for which there are market consequences if they are engaged and they, the issuers, do not meet your standards of performance.

I am a free market guy. I find this extraordinarily troubling. You are what you are because of an act of a governmental agency.

Now let's take a look for a moment at your owner, McGraw-Hill. They are a publisher. They should be availing themselves of the

First Amendment privilege, which you prescribe for your own interests since they are in the publishing business.

I went to the Internet, and strange as it seems, I found on the Internet all of their financial disclosures, annual operating revenues of $5.25 billion—I won't bore you with the details. Suffice it to say, they are Sarbanes-Oxley compliant and make all the disclosures that anyone should make in the current market environment for a corporate governance standard of conduct. While at the same time, S&P makes no disclosures of financial income or resources. There is no accountability for conduct which might not be a market standard of professional conduct. It is a large black box into which a lot of stuff goes and a few opinions leak out the back door.

Now, according to another First Amendment-protected source, which shall remain named, the New York Times, alleged that 65 percent of McGraw-Hill's net operating profit was generated from Standard & Poor's, which according to the numbers I calculated, that is only 491 million. Mr. Egan was referencing an $800 million figure. I don't know who is right, but between 5 and $800 million, this leads me to conclude this could possibly be about money. I don't know. Maybe that is a too pessimistic view.

But you then have to look at the market performance and others have called into question market performance relating to the last decade. The response by S&P has been, well, people lied to us. What standard of due diligence does an analytical person have to look at the numbers?

I read through the protocols provided to me by S&P and what is done in order to determine an issuer's status; and there is no reference to a requirement to look at audited statements or to conduct an audit. It really is the best guess that one can make, given what is commonly available in the public markets.

If one were really that good in a open competitive marketplace—I want to make clear, if Moody's and S&P could control 80 percent of the market in a free, open system, I would defend that right. I defend the right of anyone to go out and make money. It is my opinion, whether well-founded or not, that the current circumstance is the consequence of the governmental designation to the prejudicial effect of all those others who wish to compete in the marketplace.

If 2990 is, on its face, defective, I need to hear specifics other than what I consider a specious First Amendment argument. And I know you will have briefs to forward for us to later review, and I look forward to that.

But as to the elements of having someone register, putting that aside, knowing that your difficulty with registration is that you think that is an arbitrary and capricious inhibition to market function, what is the down side of what Mr. Fitzpatrick has established as the guiding principles for governance of a rating agency in the market structure we have described?

Ms. BOLGER. You raised a number of very important issues—

Chairman BAKER. I hope so.

Ms. BOLGER. —and a number that we very much agree with in terms of concerns.

Putting aside the First Amendment issues, pure legal issues—again, the main policy concern we have—I would suggest we cer-

tainly would like to discuss this with you further. It is this whole element of market recognition. And I understand that that is not always well articulated or perhaps enunciated.

I believe there is an effort, though, to more formally enunciate standards, to measure it. But to take that out of a system that has been in existence—and we would say, based on what others have also said, it is not just Standard & Poor's; it has really worked extremely well.

Chairman BAKER. Well, then is it that keeps Mr. Egan from getting his approval? What deficiency is there in his application?

Ms. BOLGER. I cannot speak for the SEC. And, yes, we too have been, on occasion, frustrated with the SEC as well. We have a proposal in for an oversight framework, which I think has been alluded to this morning, that we have been working on at the SEC's request and are awaiting comments from them on. And we do hope it proceeds.

And I can go into a little more detail if you would like.

Chairman BAKER. Let me rephrase it a different way.

It is, rather than being so specific to another applicant, are there others who perform this function in the market today whom you believe should be designated NRSROs?

Ms. BOLGER. I personally—and I don't believe S&P has a view that there is one specific entity out there because we don't necessarily know who may have applied or—

Chairman BAKER. In the general function of credit ratings, are there other companies who perform this duty in a manner which you think would be satisfactorily compliant with the SEC's standards?

Ms. BOLGER. Yes, I believe there probably are and probably not just here in the United States. This is a global business. So we also tend to look at these issues from a global perspective.

So, yes.

Chairman BAKER. So you would conclude that there are people that should be approved, but have not been, and we don't know why?

Ms. BOLGER. Well, again, I can't speak to what the deficiencies might be or where they might be in the queue here and certainly, again, for what may be the situation with Egan-Jones. But we do share the goal of opening up the market to whomever it might be, but keeping in place some of the key fundamental standards, making them more formal, making them more transparent. I think to your point—

Chairman BAKER. But you are arguing, with due respect, against yourself. You are saying we need to have standards, we need to make sure we have the right people doing this work who are responsible in conduct, but at the same time you are telling me we should not have governmental oversight of the function. How is that consistent?

Ms. BOLGER. The standards are ones that the SEC would articulate for designation. We don't believe the current system of designating, because not everyone has to be an NRSRO, raises again the constitutional issues that we feel that the bill—

Chairman BAKER. Well, stay away from the Constitution. We are doing good here. We are getting disclosure.

We agree there are other people who are out there who should be approved NRSROs. We don't know the reasons within the SEC why they have not been. We are not sure who in the SEC is making the determinations.

But moving forward, you are arguing that when we let those people in, they should meet certain standards of conduct. And those standards of conduct look pretty much to me, whether you call them "registration," if you don't fit this box, you don't get in. That is where we are now.

Ms. BOLGER. Yes. Let me clarify a couple of points.

First of all, in terms of the whole NRSRO regime, we have been in favor and on record as having market participants also weigh in on the process, be it the initial designation or be it some ongoing surveillance, should one continue to be an NRSRO. I believe the SEC is looking at time frames to be an NRSRO.

In terms of the standards issue, what we are looking at—and I believe the other rating agencies have also or are in the process of implementing our codes of conduct. These are not mandatory by regulation or law, but they are effectively industry standards. And given that this is a business largely built on credibility and reputation, one, we believe—I won't talk for everybody, but I believe—just in our conversations, we all feel that this is very necessary.

This code goes to the transparency of the process, it goes to how we do our business, and it goes to a number of other issues that are both covered by the bill as concerns and the SEC has enunciated as policy issues. But they are not mandatory by law, and that is why there is a distinction in approach.

Chairman BAKER. Well, I have gone way beyond reasonable time, and I should afford Mr. Kanjorski an opportunity, if he chooses, to make another round.

Mr. KANJORSKI. Just a few questions.

Chairman BAKER. Mr. Kanjorski, let me conclude.

I hope I have made clear the basis on which Chairman Oxley and I are both concerned about the current methodology. We are strongly supportive of Mr. Fitzpatrick's approach, but we would welcome constructive comment going forward about how we get out of this conundrum where we have five—at most, two—controlling 80 percent of the market. It is very restrictive, noncompetitive.

But we are not in the business of promoting nonprofessional individuals to frivolously rate issuers and create havoc in markets. That is not where we want to wind up. We want what you want, respected people doing professional work for the benefit of an active and vibrant capital market, and we think we can enhance that opportunity.

And there are reasonable questions, we believe, on our side of table to be resolved. And I thank you.

Mr. Kanjorski.

Ms. BOLGER. Yes. And thank you, Mr. Chairman. We share your concerns and hope to continue the dialogue.

Mr. KANJORSKI. Maybe I should raise the question, Mr. Chairman, but rather than having this panel here today, we should have had the SEC here again today and in order to find out how they put this scheme together, as well as why and what they are doing about it to make it a fairer situation.

It is very difficult on my side of the aisle to argue against H.R. 2990 or anything else in terms of total competition, in which you, Mr. Chairman, always state you are for. Then why should we have any designation? We could just let the marketplace play out.

Chairman BAKER. I will sign on.

Mr. KANJORSKI. Well, why then are we looking for a regulatory scheme of any sort? Let's just declare it open, because it is my thought that ultimately we would end up with a somewhat similar structure. Investment banking houses, investors, and the consuming public has to have had some insight as to where to put their money before the designation of NRSROs, like Standard & Poor's, Moody's, Fitch, and others existed, didn't they? Yes, sir.

Okay, what happened when they existed without this designation? Did they occupy a large portion of the market? Did they get that market share because of their credibility or did they get it because they were monopolistic?

Mr. PARTNOY. May I address that?

The business was significantly different. It was actually more like a publishing business and more like the business that Mr. Egan's company engages in. It was actually a very well functioning market, and those same entities participated. There was lots of competition during the 19—

Mr. KANJORSKI. Why did we change it?

Mr. PARTNOY. We changed it because the SEC promulgated one rule in 1975, and then it was off to the races. And people saw that it was easy. Instead of making a determination on their own as a regulator as to, for example, what net capital requirements could be, it was easy just to push that off onto the private sector and in this peculiar way pushing it off only onto a handful of folks.

And it really hasn't been done in other areas before, but it was easy, and it just—it was a monster; it got out of control. And if you look, I have written a couple of articles on this and just shown the simple chart that shows growth in regulations, and it goes up, up, up, up, up.

Mr. KANJORSKI. What is your opinion and the rest of the panel; should we go back to the pre-1975 world?

Mr. PARTNOY. I think there is a strong argument for going back to eliminating this concept of NRSROs entirely. I have said there are alternatives.

For example, you could have decisions made based on the market spreads, the credit spreads that exist in the market, which would be a nice way of capturing all of the information in the market, not just the information associated with credit rating agencies. I think that is a viable alternative.

I have submitted that to the SEC. I don't think that it has been considered adequately. It would be something on the plate for this committee to think about.

I think it is a very difficult problem. I think that the bill that we were talking about now is actually a nice compromise. But going back to pre-1975, ironically, even with all the modernization of financial markets, actually a nice way to think about what we should try to do is go back before we had this regulatory superstructure.

Mr. KAITZ. It might be a nice way to think about it, but it is totally unrealistic. You have to undo legislation and regulation and all those regulated portfolios to do away with the NRSRO—

Mr. KANJORSKI. Congress doesn't have to do anything?

Mr. KAITZ. It is embedded in insurance, mutual fund, banking regulation. You would have to then address each one of those separate pieces of legislation.

Mr. KANJORSKI. We have created a monster. Now we have to dress that monster?

Mr. KAITZ. I am afraid you have to. I don't think it is realistic to just go back to 1975.

Mr. KANJORSKI. Mr. Egan, would that solve your problem if we went back to pre-1975?

Mr. EGAN. The short answer is, I don't know. I know it is not working right now. It is not working because of the odd process for becoming an NRSRO, the fact that applicants are not told specifically what the requirements are, what has to be done.

Mr. KANJORSKI. We are going back. We are going to throw that out and go back to pre-1975. Would that solve your problem?

Mr. EGAN. I think there are some suggestions about spreads and other quantitative measures. We use them internally. And, in fact, there is a big—there is an organization called KMV that uses equity-based information.

The problem with some of these approaches is that they have some flaws that when you have the rating firm overlooking, you offset those flaws. For example, spreads, if there is a spread-based system, you get traders together and you could manipulate the spreads.

I think the core issue—and I agree, you can't go back to the old system because it would be too disruptive to the market. I think what really needs to be done is, the process has to be cleaned up. It is a mystery why the SEC is acting the way it is, but you need somebody else to look over it, to review the industry.

But I don't think you can go back to what was done before because it would be too disruptive in the short run to the market.

Mr. KANJORSKI. But if I hired all of Mrs. Bolger's analysts in a new company called Apex, I couldn't qualify for an NRSRO rating, yet I would have all her expertise, a new entity, and a want to go into business.

Now why shouldn't I then be able to issue opinions if I have got the best analysts in the field, assuming Standard & Poor's has the best in the field? Yeah, I know that you would argue that point, but I assume that they are and I hire them in bulk. I am a John Mack.

Mr. EGAN. You would go bankrupt.

Mr. KANJORSKI. I am going to the start a whole new business.

Mr. EGAN. You would go bankrupt in a short period of time because you wouldn't have the revenues to offset expenses. The competition will come from firms like us, that are fast, aggressive, know what they are doing, are recognized by the market, and don't have the size of S&P and Moody's, but have the—

Mr. KANJORSKI. So nobody in the marketplace really cares how qualified the analysts are or how good they are; they care about a name. If I understand what you are saying, I would go bankrupt.

There is maybe really little value to having all this analysis and all these formulas and all these models.

Mr. EGAN. It is the weight of the name in the marketplace.

Everybody knew that the auto companies were under pressure a couple of years ago in fact. But the market moved dramatically when S&P changed the rating—I forget whether it was GM or Ford, just because there is so much tied into it.

Mr. KANJORSKI. Only because of their name?

Mr. EGAN. Correct.

Mr. KANJORSKI. If Apex did it with all their analysts, nobody would pay any attention.

Mr. EGAN. It is the typical thing with a monopoly. Is Microsoft software the very best software for an operating system? The answer is probably no, it is not. It is just that they have all these different tie-ins.

That is the core problem here. The term used by the Justice Department for describing this industry is a ″partner monopoly″, and it has all the problems associated with a monopoly. It is not that S&P and Moody's are incredibly smart. It is not that they are fast. In fact, you can show time and time again that they are slow, and yet, at the same time, the operating revenues are double.

Mr. KANJORSKI. But it sounds to me like you want to break up this monopoly in a little way and put a few more people into the game to maintain the monopoly. If you are really competitive, let's wipe them out and let everybody play the game.

Mr. EGAN. Too disruptive to the market.

Mr. KANJORSKI. Mr. Pollock, I see you are smiling and being entertained by my examination.

Mr. POLLOCK. I think your examination is very good, Congressman. It raises the question that you rightly asked, how did all of the current dominant rating agencies start? They were all started early in the 20th century in 1910-1920 era by entrepreneurs doing exactly what you just said, hiring some analysts, starting to publish ratings, going around trying to get customers, getting people to pay. Standard & Poor's was originally the Poor's Publishing Company, I believe, and John Moody, and I guess there was a Mr. Fitch.

Ms. STROKER. Yes.

Mr. POLLOCK. And they all succeeded doing exactly what you just said. I agree that ought to be an opportunity that is open in this sector, as it should be open in every other sector.

But as has been pointed out—and as you, yourself, Congressman, pointed out—we have got dozens and dozens of regulations and laws affecting thousands of regulated entities with this term ″NRSRO″. That is why I thought the bill's approach was so clever in making a move toward a disclosure registration competitive regime that could live with the existing complex, interacting regulations. Moving toward a more competitive regime would allow entrepreneurs like you to try to get into this business if you wanted to.

Mr. KANJORSKI. Does anyone else want to respond?

Ms. STROKER. I would just add, I wouldn't give up on your business plan yet. I think Fitch has demonstrated over the past several years that we have been able to grow and compete by offering inno-

vative research and good criteria and price competition and different things that the market values.

So while you might not have the NRSRO status on the first day that you open your doors, I think others have proven the ability to grow and be recognized without it.

Mr. KANJORSKI.Isn't really the essence of one of the problems here is where the funds come from and how the profit is made, as opposed to on the publishing side or on the getting paid for the analysis? If in some way we didn't have that conflict, and the money is to be made on the publishing side, wouldn't that release the pressures that are here? It would probably dozens Standard & Poor's an awful lot of money. I suspect they are not making it on the publishing side; they are probably making it on the fee side to get in there. But maybe that, in itself, is an inherent conflict.

Mr. EGAN.It is an inherent conflict. However, that is a secondary problem to the structure of the industry.

There is no question that the problems that existed in the equity research side of the business, whereby Jack Grubman was getting paid via investment banking fees and that the same problem does exist in the rating industry. I think it makes total sense to address the conflict problem. It is just that I think you want to address the industry's structural problems first, and that is a lack of competition.

In fact, it is kind of odd that on the one hand, the SEC is fining all of those broker-dealers because they are getting paid by investment banking fees, but at the same time, in the latest NRSRO definition, they are locking it in that you must get paid by the issuers, by the very fact that they are insisting that those ratings be made free to the public. And perhaps that is an indication of the influence of the current market participants.

Chairman BAKER. Mr. Fitzpatrick I think had a follow-up.

Mr. FITZPATRICK. Just following up on that issue of anticompetitives leading to potential conflict. There has been little discussion of some of the anticompetitive practices that you have witnessed, such as offering unsolicited ratings.

I was wondering if any of the panelists have any comment on those practices and, specifically, whether you think that they should be prohibited?

Ms. STROKER. I would like to take that, because Fitch does engage in unsolicited ratings, and we do it to be procompetitive rather than anticompetitive.

In order to establish our name and reputation in the marketplace, we have had to grow our coverage to a level that interests investors and grabs their attention and gives us an opportunity to comment across a wide range of credit categories. So we feel that it has been an important tool for us to grow. And we do it in ways and in a style that is not meant to be abusive or coercive or any of those bad words, but it is meant to inform investors.

Mr. PARTNOY. Let me just mention one other area that has not been covered so far that I think should be in the back of everyone's mind, and that is structured finance.

Increasingly, institutions are using structured finance techniques to game ratings, to take advantage of ratings. And the ranking member was discussing what would it matter. It often helps when

a rating is wrong, paradoxically. When ratings are wrong, that can create incentives for people to create transactions, and there are now trillions of dollars of credit derivatives in particular, or collateralized debt obligations, which were essentially created just because there are regulations that gives a ratings benefit.

And it goes back. It is the same rationale, going back to Orange County, where there were created all of these AAA-rated instruments that were really wolves in sheep's clothing. The same sort of thing is happening right now in the collateralized debt obligations market.

And if you look at the fastest growth area of the NRSROs and where a lot of the profit is coming from, you will see that it is from structured finance. And that is a deeply troubling piece of this market, where institutions are trying to take advantage of the fact that regulations depend on ratings to have transactions that are rated inaccurately.

Mr. KAITZ. I would just suggest that if you are an issuer that gets an unsolicited rating with no competition in the marketplace, you have absolutely no place to go. And while it might be pro-business for Fitch, it is certainly not viewed that way by the issuer, who is then faced with having to essentially give in or be coerced or have to pay for a rating, especially if they are going to be issuing debt. So what looks as pro-business from Fitch's perspective, is not the same from the issuer perspective.

Chairman BAKER. I would like to ask for a point of clarification. If you are the victim of an unsolicited rating and there is some confusion about whether you should pay or not, is that a segue into being on a watch list?

What is the consequence of nonpayment?

Ms. STROKER. There is absolutely none. The analysts that are opining on the creditworthiness of the issuers and the securities they rate are blind to whether there is compensation involved or not. So there is no consequence.

In fact, we have arrayed our ratings to see if there are any difference between unsolicited ratings across the spectrum and solicited ratings.

Chairman BAKER. But I understand your point, that the analyst conducting the evaluation may be blind to the revenue situation, but somebody in management back in Fitch has got to measure and match those things up or you are going to have a lot of unpaid bills and nobody is watching. How does that work?

Ms. STROKER. Again, it is based on our need to have coverage, sufficient coverage to serve investors well.

Chairman BAKER. I understand the point and why it is done. But I am just saying that as a practical matter, somebody within an organization has to know to whom invoices were sent and whether they are paid or not; and that has some consequence at some point, if the issuer calls you up and says I would like to now have a rating, and are you delinquent on an unsolicited?

Ms. STROKER. Right.

Mr. KAITZ. The unsolicited rating forces the issuer to then engage in formal discussions. That is essentially how it works.

Chairman BAKER. That is what I was trying to get at: What is the consequence?

Mr. KAITZ. The consequences is, in most cases, having to then engage with the rating agency.

Chairman BAKER. You have no other choice. The friendly monthly payment plan.

Mr. EGAN. By the way, the Washington Post had a very good description of that process whereby the Washington Post said that Moody's shook down a German insurance company. They issued an unsolicited rating. They asked for payment. They did not get payment. And over a period of about 2 years, Moody's kept asking. When the issuer refused, Moody's would take a negative action. And that documents some of the negative publicity surrounding unsolicited ratings.

Keep in mind, though, for firms such as Egan-Jones that are not paid by the issuers, by definition all of our ratings are unsolicited.

Mr. FITZPATRICK. Does Fitch also engage in the practice known as notching?

Ms. STROKER. No, we don't. Just to clarify the point, notching would be if we penalized the ratings of other ratings service in the way we analyze a portfolio of securities.

We do not notch the ratings of S&P and Moody's

Mr. FITZPATRICK. Do other firms notch?

Ms. STROKER. Yes. S&P and Moody's notch Fitch ratings and each others' ratings.

Mr. KANJORSKI. Mr. Chairman, maybe I can direct this inquiry at the author of H.R. 2990. Maybe using the SEC as the enforcement mechanism for competitiveness in this field is the wrong way to go. In most instances, I think of the SEC as an entity that determines disclosure and transparency in corporate life, as opposed to the enforcement of competitiveness.

I think of enforcement of competitiveness as being in the jurisdiction of the Federal Trade Commission or the Justice Department. Maybe that is one of the hang-ups that I have. This bill is sort of looking to change the culture of the Securities and Exchange Commission. Maybe they are resisting it because it is not in their nature to worry about competition; that is not one of their considerations. Their major consideration is to make sure that there are rules and regulations in place for full and adequate disclosure.

Should we look at changing the enforcement mechanism in this situation? Maybe if the panel wants to look at that, we should.

Mr. EGAN. The primary obligation is protecting investors. That is what they say. Job number one is protecting investors. They have not protected investors.

Mr. KANJORSKI. But they do not do it by nurturing competition. That has never been their charge.

Mr. EGAN. Perhaps not. But why not recognize some rating firms that have succeeded in pointing out the problems with Enron and WorldCom. They have refused to.

Mr. KANJORSKI. Mr. Egan, you get a 30-second advertisement in here regardless of how we decide.

Mr. EGAN. I am sorry. If you were looking at this area for 8 years and got no response, you would feel the same way.

Mr. KANJORSKI. I understand. I just want to compliment you. Whoever is your PR firm, fire them and hire yourself.

Chairman BAKER. I thank the gentleman for his observations. And I had previously erred in not submitting for the record a letter from the Investment Company Institute signed by Mr. Schott, its president, relative to their position on H.R. 2990. I would make that part of the record.

I also want to express my appreciation to you and disclose a side bar conversation I had with Mr. Kanjorski, the content of which is in going forward there is no rush to judgment. The Fitzpatrick measure is a point of departure, but it is a meaningful statement, I think, on at least our thinking of where we might go. And we appreciate the exchange of views presented here today. It is indeed helpful to the committee's work in going forward.

I would just make the comment that although we will not move precipitously or with an unwarranted proposal, we certainly do want to move because we believe this is an area where action is fully appropriate and necessary for the conduct of a vibrant capital market.

And with that, I would adjourn our meeting. Thank you.

[Whereupon, at 12:10 p.m., the subcommittee was adjourned.]

A P P E N D I X

June 29, 2005

Prepared, not delivered
Opening Statement

Chairman Michael G. Oxley

Financial Services Committee

Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
Legislative Solutions for the Rating Agency Duopoly

June 29, 2005

Good morning. I would like to commend Chairman Baker for holding this important hearing, our fourth on this subject over the past few years.

Credit ratings serve a vital function in our capital markets system. Therefore, we need to take very seriously all of the concerns that have been raised regarding the role and performance of rating agencies and the SEC's regulatory approach. Today's hearing will focus on legislative responses to the problems that have been identified through the good work of this Committee over the last two congresses.

I am troubled by the extreme concentration in this industry. Two firms control the vast majority of market share. To put it mildly, this is not an efficient market with robust competition. Rather, it has been identified, accurately I might add, as a "duopoly," a "shared monopoly," and a "partner monopoly." This is not a healthy situation in a free enterprise system, especially when the firms wield quasi-governmental power.

Additionally, I have concerns about some industry practices that inhibit competition such as notching and tying. And I am troubled by the conflicts of interest which plague the industry. Ratings firms have expanded into new areas which have further compromised their objectivity.

I want to commend Congressman Fitzpatrick for his efforts in drafting legislation to address these problems. I am also pleased with the leadership that the Ranking Member of the Subcommittee, Congressman Kanjorski, has provided on these issues and look forward to continue working on a bipartisan solution with my friends on the other side of the aisle.

Significantly, Congressman Fitzpatrick's bill removes the national recognition requirement, which has been called a "nearly insurmountable barrier to entry" by the Department of Justice. This provision is vital to any reform effort. Without it, we will be left with the status quo.

Congressman Fitzpatrick's legislation would inject some long overdue competition into the ratings industry, make the ratings process more transparent, reduce the cost and improve the quality of ratings, and ensure adequate oversight of ratings firms. These reforms would provide enormous benefits to the market participants using these ratings.

Importantly, the legislation provides these benefits with a market-based approach. It does not create any undue regulatory burdens. Rather, it generally requires full and fair disclosures, which is the bedrock of our Federal securities laws.

Finally, I would mention that any suggestion that this legislation infringes on anyone's First Amendment rights is a red herring not to be taken seriously, in my view. The bill provides much needed oversight of the industry, but does not regulate the ratings themselves.

I look forward to the testimony. We have an excellent panel this morning.

I yield back.

OPENING REMARKS OF THE HONORABLE RUBEN HINOJOSA
HOUSE COMMITTEE ON FINANCIAL SERVICES
SUBCOMMITTEE ON CAPITAL MARKETS
"LEGISLATIVE SOLUTIONS FOR THE DUOPOLY RATING AGENCIES
JUNE29, 2005

Chairman Baker and Ranking Member Kanjorski,

I want to express my sincere appreciation for you holding this fourth in a series of hearings on credit rating agencies.

This hearing is of particular interest to me as a Member of the Texas delegation. The Enron bankruptcy and the harm it caused to its employees, smaller businesses, the community and to public trust in corporations and the Nationally Recognized Statistical Rating Agencies was enormous! So this hearing is timely and necessary despite the number of years that have passed since Enron declared bankruptcy just four days after the NRSROs were declaring it a safe issuer.

Chairman Baker, I want to thank you for doggedly pursuing the reform of the definition and oversight of the agencies.

Ranking Member Kanjorski, I commend you for working with the Securities and Exchange Commission to arrive at appropriate legislative language. Hopefully, it will not only increase competition among the credit rating agencies, and make the system more transparent, but also ensure that the legislation does not violate the Nationally Recognized Statistical Rating Organizations' (NRSROs) First Amendment right to free speech.

I also believe that your actions, Congressman Kanjorski, have supplemented and complemented the Securities and Exchange Commission's work with the Nationally Recognized Statistical Rating Organizations on a "Voluntary Framework" that would establish an SEC oversight regime. In essence, this would not only result in the creation of an appropriate framework but also possibly lead to a "best practices" of sorts for the NRSROs.

Some Members of Congress and the SEC have suggested that legislation might be needed to give the SEC the "oversight authority" to increase its regulation of the NRSROs. The SEC has proposed a rule that would codify the definition of an NRSRO. I understand that my colleague across the aisle, Congressman Fitzpatrick, has introduced legislation to address the current oversight of the NRSROs. This panel of witnesses is heavily weighted with those in support of the legislation. Mr. Chairman, I would like to hear from a more balanced panel in the future.

Chairman Baker and Ranking Member Kanjorski, I believe that Congress should give the SEC, the NRSROs and you, Congressman Kanjorski, additional time to work on a Voluntary Framework and to develop and introduce any legislation needed to provide the SEC with the appropriate authority to oversee the NRSROs prior to moving forward prematurely with legislation.

Having said that Mr. Chairman, I yield back the remainder of my time.

OPENING STATEMENT OF
RANKING DEMOCRATIC MEMBER PAUL E. KANJORSKI

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

HEARING ON LEGISLATIVE SOLUTIONS FOR CREDIT RATING AGENCIES

WEDNESDAY, JUNE 29, 2005

Mr. Chairman, we return this morning to once again explore the issue of regulating credit rating agencies. As I have noted during our past hearings, entities like Standard and Poor's, Moody's, and Fitch have long published their views on the creditworthiness of the issuers of debt securities, and the significance of these opinions has greatly expanded in recent years.

Although rating agencies received some scrutiny after the recent surge of corporate scandals, we have not yet mandated any substantive changes in their practices. We have, however, since our last hearing begun to consider potential legislative reforms in this area. A bill, H.R. 2990, has been introduced by my colleague from Pennsylvania. In addition, at my request, the experts at the Securities and Exchange Commission have put together a conceptual legislative outline for our consideration.

While I agree with you, Mr. Chairman, that something needs to be done in this area of the securities marketplace to improve transparency and oversight, H.R. 2990 as introduced is not the solution to this problem. It would eliminate the current Nationally Recognized Statistical Rating Organization framework that we have had in place for three decades. Instead of casting this accepted framework aside, we should build on the work of the Commission in these matters.

H.R. 2990 is also, as one witness will note in her testimony today, "inconsistent with the overwhelming majority" of commenters in the most recent Commission concept release. As I understand, less than ten percent of the respondents to this concept release supported the elimination of the NRSRO framework.

Additionally, we now have a classic "quantity" versus "quality" debate. H.R. 2990 focuses on increasing the quantity of raters. To protect investors, we should focus on the quality of ratings as the Commission's conceptual legislative outline seeks to do.

In my view, the problems encountered by investors before Enron's downfall, WorldCom's bankruptcy, and New York City's debt crisis, among others, were related to the quality of ratings, not the quantity of raters. Nevertheless, Mr. Chairman, I understand the desire to increase competition in this field and I am willing to explore these matters further.

Additionally, in a statement prepared for today's hearing, the Bond Market Association notes that the bill "could ultimately dilute the important role credit rating agencies play in the capital markets." Mr. Chairman, I ask unanimous consent to insert this statement into the record.

Beyond quality issues, I am also concerned that H.R. 2990 could cause serious disruptions in the marketplace if enacted into law. Eliminating the recognition process and replacing it with a registration process could cause unintended consequences. The NRSRO concept, after all, has become embedded in many areas of the law. The term is used in about 8 federal statutes, 47 federal rules, and more than 100 state laws.

It is also used in laws related to communications, education, transportation, in addition to banking and securities statutes. Moreover, changing the phrase could cause uncertainty and

potential turmoil for any mutual fund that relies on a strategy of purchasing only those debt securities of investment grade, as determined by an NRSRO.

We must further be very sensitive to the First Amendment issues posed in these debates. The courts have previously ruled on matters such as the permissibility of registration requirements for publishers, which the NRSROs contend that they are. The courts have also ruled that we must be very precise in crafting statutes that impede upon the First Amendment. H.R. 2990 is vague in its present construction and needs work to withstand judicial scrutiny.

Ultimately, we need to move deliberately in these matters. From my perspective, we need to focus on the prior work of the Securities and Exchange Commission. We should also put a great deal of weight on their conceptual legislative outline as a roadmap for our work in the months ahead. The outline seeks to establish an effective supervisory system to ensure that credit rating agencies operate in a transparent manner with adequate policies and procedures.

To help us in these efforts, last week I called upon all interested parties to examine the roadmap of proposed reforms developed by the Commission's experts at my request, and I request unanimous consent to insert this document into the record. Today, I again call upon all parties to review this legislative outline and offer comments on it before the end of August.

In the meantime, I hope that the Commission and the rating agencies will expedite their deliberations over a voluntary agreement to improve transparency in the coming months. The success of these negotiations and the effectiveness in enforcing any final voluntary accord will help to determine the need for a compulsory bill and the speed of legislative action.

In conclusion, Mr. Chairman, this issue is one on which we should focus in the 109th Congress. I commend you for your leadership in these matters and hope that we can work together to identify an appropriate consensus in the months ahead.

TESTIMONY OF RITA M. BOLGER
MANAGING DIRECTOR AND ASSOCIATE GENERAL COUNSEL
FOR STANDARD & POOR'S,
A DIVISION OF THE McGRAW-HILL COMPANIES, INC.

BEFORE THE CAPITAL MARKETS, INSURANCE, AND GOVERNMENT
SPONSORED ENTERPRISES SUBCOMMITTEE
OF THE HOUSE FINANCIAL SERVICES COMMITTEE

UNITED STATES HOUSE OF REPRESENTATIVES

JUNE 29, 2005

Mr. Chairman, Ranking Member Kanjorski, Members of the Committee, good morning. I am Rita M. Bolger, Managing Director, Global Regulatory Affairs and Associate General Counsel for Standard & Poor's ("S&P"), a division of The McGraw-Hill Companies, Inc. On behalf of S&P and S&P Ratings Services, the S&P unit responsible for the preparation and publication of credit ratings, I am pleased that the Committee has granted S&P's request to be permitted to offer our concerns about legislative proposals regarding the credit rating industry and their potential effect not only on S&P, but on the capital markets here and abroad. While my comments are focused primarily on H.R. 2990, the "Credit Rating Agency Duopoly Relief Act of 2005," which has been formally proposed, many of them would likely be relevant to any legislative proposal incorporating the potential legislative framework prepared by staff of the Securities and Exchange Commission ("SEC" or "Commission") at the request of Congressman Kanjorski ("SEC Legislative Framework"), to the extent such a proposal included a licensing scheme for rating agencies and regulation of the manner and method by which they form and disseminate credit ratings.

While S&P has consistently supported increased competition among rating agencies and lower barriers of entry into our industry, we have serious concerns about H.R. 2990 and

the disruptive effect its sweeping provisions could well have on the efficient operation of the capital markets. Abolition of the Nationally Recognized Statistical Rating Organization ("NRSRO") designation would be inconsistent with the overwhelming majority of private sector comments received by the Securities and Exchange Commission and is not necessary to achieve pro-competition objectives. Moreover, we believe that H.R. 2990, or a proposal based on certain aspects of the SEC Legislative Framework, could unnecessarily inject the Commission into the substance of the credit ratings process and result in a dilution of the quality and diversity of ratings, thus undermining the benefits of ratings to the market. We have also been advised by independent counsel that licensing and oversight schemes such as those contemplated by H.R. 2990 and the SEC Legislative Framework are facially unconstitutional. The very notion that a *bona fide* publisher — whether it be *BusinessWeek*, *The Wall Street Journal*, or S&P — can be required under the threat of penalty or other retribution to obtain a government license, adhere to government dictates about its policies and procedures, and/or submit to intrusive examinations before being permitted to disseminate its opinions to the public is inconsistent with core First Amendment principles.

In addition to these concerns, we believe that sweeping federal legislation governing the credit rating industry would be inconsistent with oversight initiatives recently approved by international securities authorities that have relied on adherence to codes of conduct, as opposed to rigid government mandates. We also believe that such legislation would be unnecessary in light of recent efforts by the SEC (which we support) to increase competition among rating agencies, as well as the progress that the SEC and the existing NRSROs have made in crafting a more effective regulatory oversight framework that, unlike H.R. 2990,

preserves the critical, constitutionally protected independence of rating agencies to publish their opinions without intrusive government mandates.

Background on S&P Ratings Services and the Nature of Credit Ratings

Attached for the Committee's information as Exhibit A to this submission is a short description of S&P's background and an explanation of the process by which our credit ratings are formed and published to the market.

S&P's Concerns About H.R. 2990 and Other Potential Proposals

Abandonment Of The NRSRO Concept And Comprehensive Regulation Of The Credit Rating Process Will Inhibit The Efficient Operation Of The Capital Markets

At the core of H.R. 2990 is the abandonment of the long-standing and generally successful NRSRO concept and the substitution of a new regime that would govern the behavior of all rating agencies (or at least those that have chosen to make their ratings widely available to the public via the Internet), requiring licensing by the government of those agencies and placing the Commission in a new, central role with respect to the expression of opinions by these rating agencies. The NRSRO concept was first utilized by the Commission in 1975 as part of the net capital rule for broker dealers. S&P Ratings Services was designated as an NRSRO in 1976, although it did not affirmatively seek that status. In designating S&P Ratings Services as an NRSRO, the Commission was acknowledging a market reality — that our ratings were and are widely recognized by the market as an effective and credible way to assess the creditworthiness of issuers and issues.

Since the formation of the NRSRO framework, investors and other market participants have come to view the NRSRO designation as a useful means by which to identify those rating agencies that consistently issue independent, objective and credible rating opinions.

Indeed, when the Commission asked market participants in connection with its 2003 Concept Release whether it should retain the NRSRO concept, the vast majority unequivocally said "yes". According to the Commission, these commenters, including investors, trade associations, rating agencies and other market participants, "generally represented that, among other things, eliminating the NRSRO concept would be disruptive to the capital markets, and would be costly and complicated to replace." Only four out of 46 commenters supported elimination of the NRSRO concept. While S&P supports lowering barriers to entry and increasing competition in the credit rating industry, we think the sudden, wholesale withdrawal of the NRSRO concept will create a dangerous vacuum, depriving the market of a system of designation that it has looked to for thirty years and which, by almost universal acknowledgment, has served it well.

Second, it is important to recognize that the "new role" for the Commission envisioned by H.R. 2990 and, for that matter, any potential proposal closely based on the SEC Legislative Framework, would require the Commission to engage in comprehensive regulation of the credit rating process. This inherently intrusive regulatory oversight — which, among other things, calls for evaluations by the SEC of the "procedures and methodologies" used by rating agencies in determining ratings — will, we believe, result in ratings of lower, not higher, quality. Because credit ratings are opinions as to which reasonable analysts can and do disagree, there is no one "correct" way to go about forming them. Comprehensive regulation of the manner and method used by rating agencies to determine ratings would thus be impractical and unwise. Such regulation could produce ratings opinions designed to avoid governmental "second-guessing" rather than ratings reflecting the uncompromised view of a committee of analysts. Commission oversight of the

ratings process would also encourage rating agencies to standardize their approaches so as to avoid penalties and censure, thus inhibiting the diversity and creative innovation the market has come to expect from NRSROs. The quality of ratings information available to the market would inevitably suffer as a result. In addition, while S&P joins the SEC and the members of this Committee in supporting increased competition in the credit rating industry, the sort of regulation envisioned under H.R. 2990 and the potential SEC Legislative Framework is likely to have the opposite effect, erecting new barriers to entry through burdensome mandates that will inhibit, rather than promote, increased competition. Under these proposals, new entrants in the credit rating industry may be required, for example, to have in place specific policies and practices that are costly to implement and may be required to submit to burdensome, time-consuming government evaluation before they are even allowed to publish their opinions legally. These cost barriers do not exist today.

It is important to consider the effects of these proposals on international markets as well. Indeed, many of these same concerns recently led the Committee of European Securities Regulators ("CESR"), at the request of the European Commission, to recommend oversight of rating agencies based on adherence to codes of conduct and market forces, not comprehensive government mandates like those contemplated by H.R. 2990 and the SEC Legislative Framework. Similarly, the International Organization of Securities Commissions ("IOSCO") determined this past December after months of deliberation and an extensive market comment period that its "Code of Conduct Fundamentals" should be flexible, allowing rating agencies to incorporate its principles into their own respective codes of conduct, but not creating rigid, universally applicable regulations. SEC Commissioner Campos, who also served as Chairman of the IOSCO Task Force, said that IOSCO's flexible approach would be

"more effectively enforced" than a "universal code for all credit rating agencies to sign on to." Commissioner Campos explained that a degree of flexibility was appropriate because rating agencies vary considerably in size, business model and rating methods. S&P Ratings Services agrees that IOSCO's flexible approach will better preserve the independence and integrity of the credit rating process around the world. The flexible, adaptable, IOSCO approach is much less likely to chill analysis and innovation or erect new and undesirable barriers to entry than a rigid regulatory scheme.

Abandonment Of The NRSRO Concept And Comprehensive Regulation Of The Credit Rating Process Is Unnecessary

S&P believes that abandonment of the NRSRO designation and sweeping legislation is not only undesirable, but also unnecessary given the success of the NRSRO concept, recent SEC initiatives to increase competition in the credit rating industry, and the ongoing development of a meaningful, effective oversight framework that preserves rating agency independence.

The NRSRO Framework Has Been, And Continues To Be, Successful

First, H.R. 2990 disregards the well-documented and long-standing success of the NRSRO framework in general and individual NRSROs in particular. The Director of the SEC's Division of Market Regulation observed in testimony before this Committee in April 2003 that "in general the credit rating agencies have done remarkably well." Studies on rating trends and performance have repeatedly confirmed the point. These studies show that S&P's ratings, for example, have been highly effective year after year in alerting the market to both deterioration and improvement in credit quality.

The unprecedented wave of corporate fraud that shook the capital markets has led to some persistent criticism of NRSROs, criticism that we believe is unfair and unfounded. There can now be no doubt, based on criminal and civil proceedings related to the scandals arising out of the fraudulent conduct of Enron and Worldcom, that S&P, like many other market participants, was deliberately misled by the parties who committed these frauds. In the Enron case, for example, key Enron personnel have now expressly admitted, and entered into plea agreements based on, their role in deliberately misleading S&P and other rating agencies. It was their intention, they said, to defraud the rating agencies by making false representations and failing to disclose material facts related to Enron's financial position and cash flow. It should also be noted that, contrary to what has been sometimes mischaracterized as a "strong" or "high" rating, S&P rated Enron the lowest investment grade level and had it on "CreditWatch negative," meaning it could be downgraded at any time. This rating was dependent on the outcome of a possible merger with an investment grade company, which ultimately did not occur.

Nevertheless, these scandals have led to constructive responses by market participants and rating agencies alike. S&P, for example, has enhanced its rating process through a number of measures including the addition of specialized accounting expertise, expanded liquidity analysis and recovery assessment, enhanced use of quantitative tools and modeling, increased public commentary, enhanced focus on corporate governance practices, and expanded training programs. In September 2004, S&P Ratings Services published its policies and procedures in a Code of Practices and Procedures, available at our Web site, www.standardandpoors.com, which includes a significant number of policies, procedures and structural safeguards.

Consistent with IOSCO's Code of Conduct Fundamentals, this Code of Practices and Procedures requires, for example, restrictions on securities ownership and trading so as to minimize any conflicts of interest in the conduct of the credit ratings process. The proven success of these safeguards was demonstrated in the SEC's January 2003 "Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets," prepared pursuant to Congress' direction in the Sarbanes-Oxley Act of 2002 and following an extensive review of credit rating agencies. In that Report, the Commission noted that market participants generally believed that any potential conflicts of interest have been "effectively addressed by the credit rating agencies." We believe these existing policies and new initiatives will permit S&P Ratings Services to maintain its long-standing reputation as a widely recognized provider of independent, objective and credible credit ratings.

As a result, we believe it would be precipitous and ill-advised to discard an NRSRO system that has served the capital markets so well for so long and to impose intrusive regulations because companies like Enron and WorldCom set out to deceive deliberately the market and the rating agencies. H.R. 2990, however, would have such a "baby out with the bathwater" effect.

Sweeping Legislation Is Unnecessary In Light Of Recent Initiatives Of The SEC And The Ongoing Development Of A More Effective And Less Intrusive Oversight Framework

We recognize that a primary goal of H.R. 2990 and a concern of this Committee is to increase competition in the credit rating industry. But the radical departure from the proven NRSRO system contemplated by H.R. 2990 is unwarranted to achieve that goal in light of recent initiatives by the Commission. These initiatives, described below, are based on thorough study and analysis of the NRSRO framework by the Commission with a view

toward serving the best interests of investors and the marketplace. They represent an approach that attempts to promote competition while at the same time avoid compromising the demonstrated benefits of the NRSRO framework. They should be given time to take effect and be evaluated before any wholesale abandonment of a proven approach is put into place.

The Commission's actions include the recent designation of two new NRSROs and its proposal of a rule designed to provide greater transparency regarding the definition of an NRSRO and guidance to rating agencies on how to meet that definition. While S&P believes the proposed rule has its faults and requires modification (as stated in our comment letter to the SEC), we simply disagree with the "finding" of H.R. 2990 that this proposed rule — which would, among other things, make the NRSRO designation available to credit rating agencies that confine their activities to a limited sector of the debt market or a limited geographic area — will "codify and strengthen" barriers to entry.

The SEC and the existing NRSROs have also been active in taking steps to provide for effective Commission oversight of NRSROs. More particularly, the SEC and the NRSROs have engaged in ongoing, productive negotiations on a proposed regulatory framework that would closely track the IOSCO Code of Conduct Fundamentals, providing, among other things, that all NRSROs adopt and comply with policies and procedures regarding the handling of confidential non-public information and the management of conflicts of interest that may arise in the credit ratings business. In addition, this oversight framework would include a compliance mechanism to provide the SEC with information regarding an NRSRO's fulfillment of its terms. The oversight framework is also being carefully crafted to best preserve the constitutionally protected independence of NRSROs and to avoid the harms

resulting from regulatory second-guessing of particular credit ratings decisions in the industry. The SEC staff and existing NRSROs have made real progress on the nature and scope of this regulatory framework. Indeed, almost one month ago the NRSROs provided for the SEC's consideration a final proposal for such a framework. We believe this process should continue and be given time to work prior to the enactment of sweeping legislation that eliminates an approach that the market and the Commission agree has been generally successful.

Mandatory Licensing Of Rating Agencies And Regulation Of The Manner And Method By Which They Form And Disseminate Credit Ratings Would Be Unconstitutional

Finally, we believe that H.R. 2990, as written, is facially unconstitutional. The same would likely be true of any legislation closely based on the SEC Legislative Framework. Rating agencies have been afforded a high level of First Amendment protection by numerous state and federal courts. This is so because, at their core, rating agencies such as S&P perform the journalistic activities of gathering information on matters of public concern, analyzing that information, forming opinions about it and broadly disseminating those opinions to the general public. Indeed, the text of H.R. 2990 itself recognizes that rating agencies are publishers. In decision after decision, courts have held that these journalistic activities entitle S&P and other rating agencies to robust rights under the First Amendment that would, of course, similarly apply to any judicial analysis of the constitutionality of H.R. 2990 or other legislation. Recently, the federal district court in Texas overseeing the various Enron litigations held unequivocally that S&P is protected by the same First Amendment standard that extends to other *bona fide* publishers. We believe that these First Amendment protections, which exist to foster robust debate and to avoid the chilling effect that would

inevitably accompany governmental intrusion into the formation and dissemination of opinions about matters of public interest — including the assessment by rating agencies of the likelihood that debt will be repaid — would weigh heavily in the decision-making of any court passing upon the constitutionality of the proposed legislation. Indeed, SEC Chairman William Donaldson recently recognized in testimony before the Senate Banking Committee that congressional action to regulate the rating agencies would raise "a number of important policy considerations that would need to be examined, including First Amendment issues."

In particular, H.R. 2990 or any similar proposal would likely violate the First Amendment rights extended to S&P and other credit rating agencies. By making it illegal for a credit rating agency to publish its opinions without first registering with the government and providing mandatory disclosures about that agency's business activities, H.R. 2990 or similar legislation would place an unconstitutional licensing requirement on First Amendment protected activity. No legislation could constitutionally require the licensing of *BusinessWeek* or *The Wall Street Journal* because they offer their opinions as to the creditworthiness of certain entities. The same is true of S&P and other rating agencies.

Second, intrusive government involvement in the manner and method of generating credit ratings such as that contemplated by the proposed legislation would also strike at the heart of the First Amendment. H.R. 2990 specifically contemplates an evaluation and judgment by the SEC on, among other things, the "procedures and methodologies [a] statistical rating organization uses in determining ratings" before that rating agency would be allowed to publish its opinions legally. Such government mandated policies and procedures for generating and issuing rating opinions would be the equivalent of unconstitutional governmental supervision of publishers from within their own newsrooms. This direct

intrusion into the editorial process and the "chilling" effect that such oversight would inevitably have on the ability of S&P and other publishers to disseminate the opinions that they, based on their independent editorial judgment, deem newsworthy, is precisely the type of governmental activity the First Amendment bars.

Indeed, these very issues were before the Supreme Court twenty years ago in the case of *Lowe* v. *SEC*, 472 U.S. 181, 210 (1985), in which the Court unanimously rejected the position of the SEC that a publisher of newsletters of general circulation containing factual information and commentary on market conditions and trends could be deemed an "investment advisor" under the Investment Advisor's Act of 1940 ("IAA") and thereby subjected to Commission regulation. Although the majority opinion sidestepped the constitutional question presented by the case, it observed that there could be "no doubt" that publications containing factual information and commentary on market conditions and trends, were protected by the First Amendment. The concurring opinion of Justice White in *Lowe* (joined by Chief Justice Burger and then-Justice Rehnquist), expressed these constitutional concerns even more sharply, observing that the case involved "a collision between the power of the government to license and regulate those who would pursue a profession or vocation and the rights of freedom of speech and of the press guaranteed by the First Amendment." *Id.* at 228 (White concurring). The concurring Justices made plain their rejection of the proposition that the government could enact a licensing scheme directly affecting speech (including a registration requirement), finding that, "[t]he principle that the government may restrict entry into professions and vocations through licensing schemes has never been extended to encompass the licensing of speech *per se* or of the press." *Id.* at 229. Other federal courts have similarly concluded that the financial press deserves the full protections of

the First Amendment and may not be subject to licensing requirements or government inspection.

Our outside counsel, Floyd Abrams of Cahill Gordon & Reindel LLP, is in the process of preparing a more detailed submission that we intend to provide to the Committee on the specific constitutional issues raised by H.R. 2990 and the SEC Legislative Framework. We would also be happy to make Mr. Abrams available to testify before this Committee or to meet with individual Members and staff about the serious First Amendment threats presented by any potential legislation.

Conclusion

While we at S&P Rating Services share the Committee's goals of increasing competition among rating agencies and lowering barriers to entry in our industry, we believe that a legislative scheme such as H.R. 2990 would be undesirable, unnecessary and almost certainly unconstitutional. The proposed legislation overlooks the success of the NRSRO concept and individual NRSROs; rejects the prevailing views of the SEC, regulators around the world and the predominant users of credit ratings; and is unwarranted given recent initiatives by the SEC. We believe that the oversight regime currently being developed by NRSROs and the Commission addresses the concerns of the Committee and would be an effective alternative to H.R. 2990 or an alternative legislative scheme based on the SEC Legislative Framework.

On behalf of S&P Ratings Services, thank you again for the opportunity to participate in these hearings. I'd be happy to answer any questions you may have.

EXHIBIT A

Background on S&P Ratings Services and the Nature of Credit Ratings

S&P Ratings Services began its credit ratings activities almost ninety years ago, in 1916, and today is a global leader in the field of credit ratings and risk analysis, with credit rating opinions outstanding on approximately $30 trillion in debt representing 745,000 securities issued by roughly 42,000 obligors in more than 100 countries. S&P Ratings Services has established a market-tested track record of providing the market with publicly-available, independent, objective and rigorous analytical information in the form of credit rating opinions. A rating from S&P Ratings Services represents our opinion, as of a specific date, of the creditworthiness of either an obligor in general or a particular financial obligation. Unlike equity analysis, a credit rating opinion:

- is not a recommendation to buy, sell, or hold a particular security;
- is not a comment on the suitability of an investment for a particular investor or group of investors;
- is not a personal recommendation to any particular user; and
- is not investment advice.

More detail on the nature of our rating opinions is available on our Web site: www.standardandpoors.com.

Credit ratings are an important component of the global capital markets and over the past century have served investors extremely well by providing an effective and objective tool to evaluate credit risk. Credit ratings provide helpful standards for issuers and investors around the world, facilitating efficient capital raising and the growth of new markets. Indeed, credit rating opinions have supported the development of deeper, broader and more cost effective global debt markets. S&P Ratings Services itself has made significant contributions

to this development. We have taken credit research into new markets and new asset classes. Our sovereign ratings have assisted numerous countries in their attempt to access global capital markets they may not have otherwise had access to, hastening capital formation and economic development. S&P has contributed to a greater flow of information in the markets and has enabled the development of a wider array of tools for understanding credit risk and far greater transparency in the marketplace today than ever before.

Critical to a credit rating agency's ability to serve this role in the market is its commitment to, and achievement of, the highest standards of independence, transparency and quality. At S&P Ratings Services, these principles are the cornerstones of our business and have driven our longstanding track record of analytical excellence. Indeed, studies on rating trends have repeatedly shown that our ratings are highly effective in alerting the market to both deterioration and improvement in credit quality. For example, over the past 15 years, less than one percent (1%) of issuers initially rated in the "AAA" category have defaulted while approximately sixty percent (60%) of those initially rated in the "CCC" category have failed to meet their obligations.

The Credit Rating Process

At the heart of this market-tested and accepted track record is a proven process by which S&P Ratings Services arrives at its credit rating opinions. This rating and editorial process begins with the assignment of qualified analysts to a particular issuer. The analysts gather economic, financial and other information directly from the issuer, from public filings and from other sources deemed to be reliable. Because publicly available information about an issuer is an important component of the ratings process, we support the actions taken by

Congress in enacting the Sarbanes-Oxley Act of 2002 to strengthen the process by which financial information is audited and provided to the market. In addition, as part of our rating process, we press issuers to respond to comprehensive questions that help our analysts develop a full picture of the issuer's true credit quality. Our analysts also rely expressly and necessarily on issuers to provide timely and accurate information. We may, depending on the circumstances, decline to issue a rating or may even withdraw an existing rating if an issuer refuses to provide requested information. That said, our analysts are not auditors and are not in a position to perform an audit of information provided by a rated company.

Our rating analysts examine information carefully as it is gathered. When sufficient information to reach a rating conclusion has been received and analyzed, we convene a rating committee comprised of S&P Ratings Services personnel who bring to bear particular credit experience and/or expertise relevant to the rating. A lead analyst makes a presentation to the rating committee that includes an evaluation of the issuing company's strategic and financial management, its business and operating environment, an analysis of financial and accounting factors and the issuer's business and financing plans. Our rating committee meetings involve serious and lengthy discussion that includes frank, and often animated, exchanges.

Once a rating is determined by the rating committee, the issuer is notified and S&P Ratings Services disseminates the rating opinion to the public. Along with the rating, we publish a narrative rationale explaining to the marketplace the key issues considered in the rating. Similarly, when a rating change occurs, our analysts report on the change and the rationale for it. We have a longstanding policy of making our public credit ratings and the basis for those ratings broadly available to the investing public as soon as possible and

without cost. Public credit ratings are disseminated via real-time posts on our Web site, and through a wire feed to the news media as well as through our subscription services. Members of the investing public receive credit ratings at the same time as subscribers. This rating and editorial process is fully transparent. We publish our criteria and explain, often in great detail, the rationale for each of our public ratings decisions. We believe that transparency of the ratings process is a critical and indispensable component to our success and to maintaining our reputation, earned over nearly a century, as a global provider of independent, objective and credible credit ratings.

We believe that the independence and integrity of this process would be jeopardized by any regulatory scheme that sought to replace our analysts' judgment with the judgment of regulators or otherwise seeks to intrude upon or control the manner and method by which we form and disseminate credit ratings.

Egan-Jones Ratings Company
Tel. 1-888-837-4878 Research@Egan-Jones.com

Providing timely, accurate credit ratings to Institutional Investors

Testimony of Sean J. Egan, Managing Director, Egan-Jones Ratings Company Before the House Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
June 29 Hearing – The Credit Rating Agency Duopoly Relief Act of 2005

We strongly support the proposed legislation for reforming the ratings industry since it does not impair the freedom of speech defense afforded rating firms and it addresses the two major problems that have long plagued the industry:

1. the dearth of competition, and
2. the failure of the current rating firms to provide timely, accurate ratings for protecting investors.

Perhaps the most appealing aspect of the proposed legislation is that it removes the SEC from the role of recognizing rating firms (i.e., NRSRO firms), a role in which it has failed miserably. The SEC's primary mandate is protecting investors ("The primary mission of the SEC is to protect investors" to quote the SEC website, sec.gov – Who We Are). Within the past three years we have experienced two of the largest credit failures in US history, Enron and WorldCom, failures that resulted in the loss of hundreds of billions of dollars, tens of thousands of jobs, and the pensions of thousands. After these colossal failures, one would expect that the agency charged with recognizing rating firms would have shown some initiative for addressing the problems so that they do not occur again. Unfortunately, this has not been the case. Instead, the SEC is continuing its study of the industry; a study which began in the early 1990's and is continuing today. While the first NRSRO firm was recognized in 1970, it was only 90 days ago that the SEC finally devised a definition of NRSRO's (it seems obvious that a definition should have existed before the first NRSRO was designated). Furthermore, the SEC's proposal for NRSRO's requires that rating firms provide their ratings free to the public which effectively means that the rating firms have to seek compensation from the Enrons and Worldcoms of the world, which in many people's view is a system rife with conflicts. Yes, the SEC has recognized two new NRSRO's during the past 18 months. However, neither firm warned investors about the recent major failures, nor do they provide any significant competition to the two partner-monopoly firms, S&P and Moody's.

The SEC has indicated that it consults with the major rating firms before proposing any changes to their regulation of the industry. Perhaps they should have also consulted with investors who have been and continue to be hurt by the flawed industry structure. Conspicuously absent from the SEC's proposed definition of NRSRO rating firms are the following requirements:

Sever ties between rating firm personnel and issuers and dealers- the ex-chairman of Moody's should not have served as a director of WorldCom, nor should ratings firm personnel be tied to broker/dealers or broker/dealer industry associations such as the NASD.
Discourage insider trading – The proposal addresses the misuse of non-public information given to rating firms but does not address the misuse of information generated by the rating firms themselves such as Moody's informing CitiGroup of its intention to downgrade Enron below investment grade.

Take timely action – it has been over three years since the failure of Enron and yet the SEC still has not made any significant changes in the ratings industry.

Regarding, Egan-Jones Ratings, Kafkaesque (see Franz Kafka, The Trial) is probably the best description of our experience with the SEC. We have regularly issued timely, accurate ratings and provided warning for the Enron, Genuity, Global Crossing, and WorldCom failures (see the attachment). Furthermore, we consistently identify improving credits; most of our ratings have been higher than S&P's and Moody's over the past three years thereby assisting issuers in obtaining competitive capital. Our success has been recognized by the Federal Reserve Bank of Kansas City which compared all our ratings since inception in December 1995 to those of S&P and concluded:

> "Overall, it is robustly the case that S&P regrades from BBB- moved in the direction of EJR's earlier ratings. It appears more likely that this result reflects systematic differences between the two firms' rating policies than a small number of lucky guesses by EJR."

Stanford University and the University of Michigan drew a similar conclusion in a September 2004 study. We applied for NRSRO designation in July 1998, approximately eight years ago. Despite our success in issuing timely, accurate ratings, we are not designated and even after multiple requests, have not been told what is needed to be designated. In 2003, an SEC official told us that the SEC hesitated to tell us what the specific criteria were since we would probably meet them and the SEC would have to designate us. Throughout the process we have been told that progress would be made after Arthur Levitt was joined by other commissioners, after Harvey Pitt was installed, after the SEC completed the study mandated by the Sarbanes-Oxley Act, after the SEC held hearings on the ratings industry, and after Mr. William Donaldson became the new SEC Chairman. It has taken us time to lose faith in the SEC's ability to take action in the ratings industry, but after eight years of effort, we have come to believe that the SEC is incapable of acting in investors' interest in this area when it does not meet with the approval of the two partner-monopoly firms. Since missing the failure of Enron in 2001, Moody's operating revenues have more than doubled from $398M to $814M, as have S&P's with an increase from $435M to $893M, an indication of the severe lack of competition in the area.

The proposed legislation provides some hope for reform and real competition in the ratings area. It was artfully drafted to maintain the Freedom of Speech protections for ratings. Perhaps some review might be needed for purely quantitative ratings, but this can easily be accomplished. We continue to support the Code of Standard Practices for Participants in the Credit Rating Process published by the Association of Corporate Treasurers (United Kingdom), The Association of Financial Professionals (United States), and Association Francaise Des Tresoriers D'Entreprise (France).

Until the fundamental problems in the rating industry are addressed, investors, employees, pensioners, and ultimately issuers will be needlessly harmed. The SEC should gracefully withdraw from this area in the interest of protecting investors. We strongly support the proposed legislation.

Egan-Jones Ratings Company

Selected Quotes – Egan-Jones Ratings Co.

Research Division, Federal Reserve Bank of Kansas City February 2003
"Overall, it is robustly the case that S&P regrades from BBB- moved in the direction of EJR's earlier ratings. It appears more likely that this result reflects systematic differences between the two firms' rating policies than a small number of lucky guesses by EJR."

Stanford University and the University of Michigan September 2004
"we believe our results make a strong case that the non-certified agency [Egan-Jones] is the leader and the certified agency [Moody's] is the laggard."

New York Times
Gretchen Morgenson (Pulitzer Prize Winner July 7, 2002
"Egan-Jones makes a practice of alerting investors to corporate credit problems well before they are acknowledged by management... As early as November 2000, for example, Egan-Jones cut its ratings on WorldCom to the lowest investment-grade level, citing its deteriorating profit margins and credit quality."

Fortune's "Against the Grain"
Herb Greenberg January 21, 2002
"The best balance-sheet snoops are often way ahead of the pack in finding signs of trouble. Sometimes, however, the big credit-rating firms, Standard & Poor's and Moody's, which get paid by the companies they rate, are slow off the mark--slower, as a rule, than independent bond-rating services like Egan-Jones.

Investment Dealers Digest (cover)
Dave Lindorff August 13, 2001
"It didn't take long for Sean Egan, managing director of Egan-Jones Ratings Co., a small ratings agency outside Philadelphia, to figure out last fall's California power crisis would eventually put the state's utilities in a bind. "We saw a train wreck ahead for these companies," recalls Egan, who says his analysts quickly fired off two reports to clients warning them of the troubles facing the state's two utilities-Pacific Gas & Electric Corp. and Edison International, the parent company of Southern California Edison. On Sept. 27, the firm lowered EIX's rating from A- to BBB-, and PG&E's rating from A to BBB+."

Bloomberg News
Mark Gilbert October 14, 2004
"S&P wouldn't be the first to pin a non-investment grade rating on Ford. Egan-Jones Ratings Co., a private company run by Sean Egan in Pennsylvania, cut the automaker's grade in January 2002."

Grant's Interest Rate Observer
Jim Grant Annual Conference, October 2002
"The big two-and-a-half rating agencies have not exactly covered themselves in glory during the current credit debacles. Sean Egan, co-founder of Egan-Jones Ratings Co. (which saw many disasters coming before they landed in the newspapers), will discuss debacles and opportunities yet over the horizon."

Egan-Jones Ratings Co.
June 29, 2005
Page 4

Enron's Senior Unsecured Ratings

The bold indicates non-investment grade

Date	Egan-Jones*	S&P	Moody's
4/19/2001	BBB+	BBB+	Baa1
→**6/27/2001**	**BBB**	BBB+	Baa1
8/15/2001	BBB/ BBB-	BBB+	Baa1
10/16/2001	BBB/ BBB-	BBB+	Baa1 (neg.)
10/23/2001	BBB-	BBB+	Baa1 (neg.)
10/24/2001	BBB-/ BB+	BBB+	Baa1 (neg.)
10/26/2001	**BB+**	BBB+	Baa1 (neg.)
10/29/2001	**BB+/ BB**	BBB+	Baa2 (neg.)
10/31/2001	**BB+/ BB**	BBB+	Baa2 (neg.)
11/1/2001	**BB**	BBB (neg.)	Baa2 (neg.)
11/6/2001	**BB**	BBB (neg.)	Baa2 (neg.)
11/7/2001	**BB-/ B-**	BBB (neg.)	Baa2 (neg.)
11/9/2001	**BB**	BBB- (neg.)	Baa3 (neg.)
11/21/2001	**BB/ BB-**	BBB- (neg.)	Baa3 (neg.)
11/26/2001	**BB-/ B+**	BBB- (neg.)	Baa3 (neg.)
11/28/2001	**B+/ B-**	**BBB- (neg.)**	**Baa3 (neg.)**
11/28/2001	**C/ D**	**B-**	**B2 (neg.)**
11/29/2001	**D**	**B-**	**B2 (neg.)**
11/30/2001	**D**	**CC (neg.)**	**B2 (neg.)**
12/3/2001	**D**	**D**	**Ca**

* Current and projected ratings

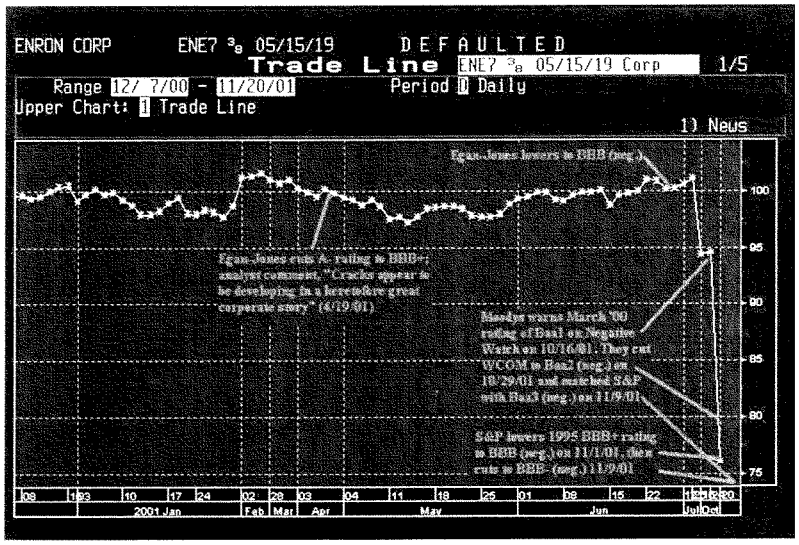
Egan-Jones Ratings Co.
June 29, 2005
Page 5

WorldCom's Senior Unsecured Ratings

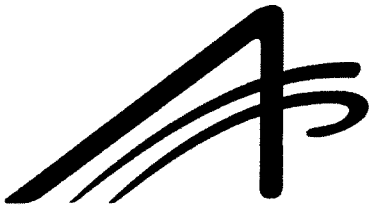
The bold indicates non-investment grade

Date	Egan-Jones*	S&P	Moody's	Action
11/1/2000	A- (neg. watch)	A-	A3	EJR issued neg. watch (A-)
11/ 3/00	A- (neg. watch)	A- (neg. watch)	A3	S&P issued a neg. watch (A-)
11/17/2000	BBB+ (neg. watch)	A- (neg. watch)	A3	EJR cut A- to BBB+ (neg. watch)
2/8/2001	BBB	A- (neg. watch)	A3	EJR cut BBB+ to BBB
2/27/01	BBB	BBB+	A3	S&P cut A- to BBB+
6/25/2001	BBB-	BBB+	A3	EJR cut BBB to BBB-
7/26/2001	**BB+ (neg. watch)**	BBB+	A3	EJR cut BBB- to BB+ (neg watch)
1/29/2002	**BB (neg. watch)**	BBB+	A3	EJR cut BB+ to BB (neg watch)
2/ 7/02	**BB- (neg. watch)**	BBB+	A3	EJR cut BB to BB- (neg watch)
2/ 7/02	**BB- (neg. watch)**	BBB+	A3 (neg. watch)	Moody's issued a neg. watch (A3)
2/19/2002	**B+**	BBB+	A3 (neg. watch)	EJR cut BB- to B+
4/12/02	**B+**	BBB+ (neg. watch)	A3 (neg. watch)	S&P issued a neg. watch (BBB+)
4/22/02	**B+**	BBB	A3 (neg. watch)	S&P cut BBB+ to BBB
4/23/02	**B**	BBB	A3 (neg. watch)	EJR cut B+ to B
4/23/02	**B**	BBB	Baa2	Moody's cut A3 to Baa2
4/25/2002	**B-**	BBB	Baa2	EJR cut B to B-
5/ 9/02	**B-**	BBB	**Ba2**	Moody's cut Baa2 to Ba2
5/10/02	**B-**	**BB**	**Ba2**	S&P cut BBB to BB
6/14/2002	**B- (neg. watch)**	**BB**	**Ba2**	EJR issues neg. watch
6/17/02	**B- (neg. watch)**	**B+**	**Ba2**	S&P cut BB to B+
6/20/02	**CCC (neg. watch)**	**B+**	**Ba2**	EJR cut B- to CCC (neg. watch)
6/20/02	**CCC (neg. watch)**	**B+**	**B1**	Moody's cut Ba2 to B1
6/26/02	**D**	**B+**	**B1**	EJR cut CCC to D
6/26/02	**D**	**CCC-**	**B1**	S&P cut B+ to CCC-
6/26/02	**D**	**CCC-**	**Ca**	Moody's cut B1 to Ca
7/ 1/02	**D**	**CC**	**Ca**	S&P cut CCC- to CC
7/17/02	**D**	**D**	**Ca**	S&P cut CC to D

Egan-Jones Ratings Co.
June 29, 2005
Page 6



Egan-Jones Ratings Co.
June 29, 2005
Page 7



Association for
Financial Professionals®

Statement of James A. Kaitz

President and CEO

The Association for Financial Professionals

Before the House Financial Services Committee
Subcommittee on Capital Markets, Insurance and Government
Sponsored Enterprises

Legislative Solutions for the Rating Agency Duopoly

Wednesday, June 29, 2005

James A. Kaitz, President and CEO
The Association for Financial Professionals
Before the House Financial Services Committee Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
Legislative Solutions for the Rating Agency Duopoly
Wednesday, June 29, 2005

Good morning, Chairman Baker, Ranking Member Kanjorski, and members of the Committee. I am Jim Kaitz, President and CEO of the Association for Financial Professionals. AFP welcomes the opportunity to participate in today's hearing on legislative solutions to the many issues and concerns raised with regard to the credit ratings market. Specifically, my testimony will focus on the recently introduced "Credit Rating Agency Duopoly Relief Act of 2005" and the Securities and Exchange Commission's (SEC) staff legislative framework.

AFP represents more than 14,000 finance and treasury professionals representing more than 5,000 organizations. Our members are responsible for issuing short- and long-term debt and managing corporate cash and pension assets for their organizations.

AFP believes that the credit rating agencies and investor confidence in the ratings they issue are vital to the efficient operation of global capital markets. AFP's research has consistently shown that confidence in rating agencies and their ratings is low and has continued to diminish over the past few years. Despite this erosion of confidence and more than ten years of examination, the Securities and Exchange Commission (SEC) has yet to implement any meaningful reform to address the concerns of issuers and investors.

In previous appearances before this Committee and the Senate Banking Committee, as well as in comments on the SEC's recent proposed *Definition of Nationally Recognized Statistical Rating Organization* (comment letter attached), AFP has stated that the SEC's existing recognition process has created an artificial barrier to entry to the credit ratings market. This barrier has led to a concentration of market power with the recognized rating agencies and a lack of competition and innovation in the credit ratings market.

To remove this barrier to entry and stimulate competition, AFP has long recommended that the Commission clarify the recognition process. We have recommended that recognition of credit rating agencies be conditioned on whether a credit rating agency can consistently produce credible and reliable ratings based on adherence to published methodologies. We have also urged regulators to require that rating agencies document internal controls that protect against conflicts of interest and anti-competitive and abusive practices, and ensure against the inappropriate use of non-public information. This past spring, the SEC issued proposed regulations in which it acknowledged the need for a transparent recognition process. The proposed *Definition* attempts to address some of the concerns we have raised. Unfortunately, we do not believe that the SEC proposal would foster a truly competitive market and fails to address the need for ongoing oversight of the credit ratings market.

The Credit Rating Agency Duopoly Relief Act of 2005 would require the SEC to register credit rating agencies within 90 days of application based on the criteria recommended by AFP. By eliminating the ambiguous NRSRO designation process in favor of a more transparent registration process, the Act will foster meaningful competition in the credit ratings market. The recent SEC proposal falls short in this regard. As such, AFP supports the legislative proposal before the Committee today.

The SEC's recent proposal also fails to address investor concerns regarding the ongoing oversight of rating agencies. In nearly thirty years since creating the NRSRO designation, there has been no review of the ongoing credibility and reliability of the ratings issued by the NRSROs. Any effort to address concerns about the credit rating market, either through regulation or voluntary agreement, will be entirely ineffective without an oversight and enforcement mechanism. It is now an appropriate time for Congress to act.

AFP is pleased that the proposed legislation directs the Commission to censure, suspend or revoke the registration of any registered statistical rating organization that violates certain sections of the Act or ceases to meet the registration criteria as recommended by AFP and outlined in the Act.

If the credit ratings market is opened up to competition, it will be even more important for the SEC to take an active role in the ongoing oversight of registered statistical rating organizations to ensure that they continue to merit SEC registration. We believe that the proposed legislation gives the SEC the authority, flexibility, and guidance needed to conduct the necessary oversight without placing

an overly restrictive legislative regime on either the Commission or the credit rating agencies.

Ongoing oversight must ensure that registered statistical rating organizations continue to issue credible and reliable ratings. Further, the Commission must periodically verify that registered statistical rating organizations have *and adhere to* policies that protect non-public information and prevent conflicts of interest and unfair and abusive practices.

For the Committee's consideration, we believe there are several key areas where additional clarification will strengthen the Act. The first area relates to "ratings performance measurement statistics." As AFP has consistently suggested, the key criteria for rating agency recognition should be whether the rating agency can consistently produce credible and reliable ratings. The proposal requires a rating agency seeking registration to file performance measurement statistics. We believe that it is imperative that the applicant not simply file statistics, but also demonstrate that its ratings are, in fact, credible and reliable. This is particularly important since NRSROs are currently widely relied upon in regulation and practice. If registered statistical rating organizations will take the place of NRSROs throughout Federal regulation, it is crucial that the Commission ensure that those who are registered serve the regulatory purpose for which the SEC first recognized credit rating agencies.

Market acceptance, which the Commission currently uses when assessing credibility and reliability of credit ratings, is one acceptable measure. However, it should not be the only measure. For example, an analysis of the required performance measurement statistics that shows a high correlation between a rating agency's expected and actual default experience or other quantitative methods should be acceptable for demonstrating credibility and reliability.

The second area in need of clarification is the registration requirement contained in Section 4 of the legislation. The bill requires all rating agencies that meet the definition to register with the SEC, even those that do not seek to have their ratings approved for use by regulated portfolios. There are currently more than 130 rating agencies, many of whom have not sought and may never seek SEC recognition or registration. Further, new rating agencies that may be established may not be able to file long-term ratings performance measurement statistics required for registration, shutting out these new entrants entirely.

AFP recommends that the Act limit registration requirements to those that seek approval for use by regulated portfolios or those that the Commission determines must be registered to protect the public interest. Those that do not seek or obtain SEC registration should not be prohibited from conducting their business as they see fit, unless this prohibition is deemed by the Commission to be in the public interest.

AFP also recommends that the Act explicitly direct the Commission to develop an oversight and examination regime that ensures that registered statistical rating organizations continue to issue credible and reliable ratings and that they have *and adhere to* policies that protect non-public information and prevent conflicts of interest and unfair and abusive practices. Such an oversight framework is described in the Commission's "Staff Outline of Key Issues for a Legislative Framework for the Oversight and Regulation of Credit Rating Agencies", developed at the request of Ranking Member Kanjorski. This type of oversight will protect capital market participants without injecting regulators into the decision making of the rating agencies or impinging on their First Amendment rights.

We believe that the registration process proposed in the "Credit Rating Agency Duopoly Relief Act of 2005" will minimize barriers to entry and foster competition among existing NRSROs and those that may later be registered. This competition will stimulate innovation and creativity in the credit ratings market and improve the quality of information available to investors. The enactment of the bill, along with the development by the Commission of an oversight regime that ensures that registered statistical rating organizations continue to meet the registration requirements, will be meaningful and necessary steps in improving investor confidence in the rating agencies and global capital markets.

We commend you Mr. Chairman, Ranking Member Kanjorski, Representative Fitzpatrick and the Committee for recognizing the importance of this issue and taking action for the benefit of all institutional and individual participants in global capital markets. We hope the Committee will aggressively pursue enactment of the "Credit Rating Agency Duopoly Relief Act of 2005" and its rapid implementation by the Securities and Exchange Commission.

Association for Financial Professionals

June 7, 2005

Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549-0609

Re: File No. S7-04-05

Dear Mr. Katz:

The Association for Financial Professionals (AFP) welcomes the opportunity to comment on the Securities and Exchange Commission's proposed *Definition of Nationally Recognized Statistical Rating Organization*. We are pleased that the Commission has recognized the need to clearly define the criteria and process used to designate a nationally recognized statistical rating organization (NRSRO), which AFP has advocated for nearly three years. Further, we acknowledge that the Commission has adopted many of the recommendations made by AFP in our comment letter on the Commission's Concept Release *Rating Agencies and the Use of Credit Ratings under the Federal Securities Laws*[1] and in our *Code of Standard Practices for Participants in the Credit Rating Process*[2]. We believe that ambiguity in the recognition criteria and process has served as an artificial barrier to entry into the credit ratings market that has stifled competition.

While AFP is encouraged that the Commission has recognized the need for a definition of NRSRO, we do not believe that the proposed definition will allow market participants to fully recognize the benefits of a truly competitive market. The proposed definition does not adequately accommodate rating agencies that may employ innovative methodologies to produce credible and reliable ratings that are not currently recognized by the Commission. Rather, the proposed definition largely requires methodologies that closely resemble those used by existing NRSROs. As such, it appears to limit competition only to those that look substantially similar to the current dominant market players.

[1] http://www.afponline.org/pub/pdf/clkatz072803.pdf
[2] http://www.afponline.org/pub/pdf/CSP_final.pdf

7315 Wisconsin Avenue • Suite 600 West • Bethesda • Maryland 20814
Phone: 301.907.2862 • Fax: 301.907.2864 • www.AFPonline.org

We believe that the recognition criteria must be focused on whether a credit rating agency can consistently produce credible and reliable ratings based on adherence to published methodologies, not on a predetermined notion of the methodology and inputs required to do so. In both current practice and the proposed definition, the Commission relies heavily on "national recognition" or "general acceptance" of a credit rating agency when granting NRSRO recognition. However, the proposed definition implies that the Commission believes it is capable of determining the methodology and inputs required for a credit rating agency to issue credible and reliable ratings. AFP believes that the Commission's heavy reliance on market acceptance, coupled with prescriptive input and methodology requirements, will erect an even more formidable barrier to entry into the credit ratings market than already exists. This barrier to entry will further hinder competition and deprive the market of the benefits of innovate rating methodologies that may be developed.

AFP is also very concerned about the lack of any proposal to conduct ongoing oversight of NRSROs. We acknowledge the Commission's determination that it does not have the requisite regulatory authority to do anything more than define nationally recognized statistical rating organization at this time. However, we strongly encourage the Commission to seek the authority needed to conduct limited ongoing oversight of the NRSROs. As we have recommended to the Commission, the Subcommittee on Capital Markets[3] of the House Committee on Financial Services, and the Senate Banking Committee[4], the Commission must ensure that, on an ongoing basis, NRSROs continue to issue credible and reliable ratings. Further, the Commission must periodically verify that NRSROs have and adhere to policies that protect non-public information and prevent conflicts of interest and unfair and abusive practices. We encourage the Commission to actively pursue this authority and will proactively support appropriate authorizing legislation.

The Commission's proposed definition of the term "NRSRO" includes three components. An NRSRO would be defined as an entity (i) that issues publicly available credit ratings that are current assessments of the creditworthiness of obligors with respect to specific securities or money market instruments; (ii) is generally accepted in the financial markets as an issuer of credible and reliable ratings, including ratings for a particular industry or geographic segment, by the predominant users of securities ratings; and (iii) uses systematic procedures designed to ensure credible and reliable ratings, manage potential conflicts of interest, and prevent the misuse of nonpublic information, and has sufficient financial resources to ensure compliance with those procedures. AFP's comments on each of these components, detailed below, are consistent with our comment letter on the Commission's Concept Release[5], AFP's *Code of Standard Practices for Participants in the Credit Rating Process*[6], and Senate[7] and House[8] testimony.

---

[3] http://www.afponline.org/pub/pdf/091404_kaitz_testimony.pdf
[4] http://www.afponline.org/pub/pdf/pr_20050208_kaitz.pdf
[5] http://www.afponline.org/pdf/cfkatz072803.pdf
[6] http://www.afponline.org/pub/pdf/CSP_final.pdf
[7] http://www.afponline.org/pub/pdf/pr_20050208_kaitz.pdf
[8] http://www.afponline.org/pub/pdf/091404_kaitz_testimony.pdf

First Component of Proposed Definition

The first component of the proposed definition would require an NRSRO to issue publicly available credit ratings that are current assessments of the creditworthiness of obligors with respect to specific securities or money market instruments. AFP opposes the requirement that NRSROs disclose their ratings at no cost. An NRSRO business model that charges subscribers a fee for ratings information and thereby eliminates the potential conflict of issuer payments should not be *per se* restricted. The willingness of a user to pay for credit ratings, especially with the prevalence of freely disseminated ratings, could serve as a powerful endorsement of the credibility and reliability of ratings that are generated without issuer payments. If an NRSRO's methodology is based on issuer payments for ratings, disseminating these ratings at no cost seems to be a reasonable requirement since substantial payment has already been received by the NRSRO. However, requiring a credit rating agency that develops ratings with no compensation from issuers and subsequently discloses those ratings only to subscribers to distribute its ratings at no cost is an unnecessary intrusion into the business model of the prospective NRSRO. Free dissemination would restrict competition and further entrench the market position of the current NRSROs while codifying and implicitly endorsing the business model that some believe is most prone to conflicts of interest. This requirement also seems counter to a free market approach, which bases recognition primarily on whether a credit rating agency issues credible and reliable ratings.

The potential selective disclosure of non-public information obtained by a credit rating agency under Regulation Fair Disclosure (FD), which the proposed definition attempts to address by requiring widespread dissemination at no cost, is already addressed by the Regulation FD exemption[9]. This exemption states that "for the exclusion to apply, the ratings organization must make its credit ratings publicly available." A credit rating agency that does not make its ratings publicly available would therefore not be exempt from Regulation FD and would not be privy to non-public information. Attempting to address the Regulation FD exemption by requiring NRSROs to widely disseminate ratings at no cost unnecessarily links the two issues and may discourage innovative rating methodologies that do not rely on access to non-public information or payments from issuers.

Given the widespread reliance on NRSROs in regulation and practice to assess the risk of default and loss on many types of securities, AFP believes it is appropriate for the Commission to limit NRSRO recognition to those that issue credit opinions on specific securities or money market instruments. While issuer financial strength ratings can be very useful for some purposes (e.g., trade credit), the risk of loss on different debt securities of the same issuer can vary considerably depending on the legal terms of each security. AFP agrees that a single issuer rating would be misleading and inadequate in assessing the risks of specific securities.

[9] http://www.sec.gov/rules/final/33-7881.htm

The Commission also proposes to require NRSROs to actively monitor credit ratings and update them appropriately on a "continuous" basis. While the goal of obtaining current credit ratings is desirable, AFP does not believe that "continuous" monitoring is either practical or necessary. Instead, NRSROs should be required to document and adhere to their published methodologies, which should stipulate the frequency with which ratings are reviewed. Further, NRSROs should be required to disclose the date of the last formal review of credit ratings and when they last updated each rating. We believe that adherence to published methodologies that have been determined to produce credible and reliable ratings is the appropriate standard by which to determine whether an NRSRO's ratings are current assessments of the creditworthiness of specific securities or money market instruments.

Second Component of Proposed Definition

The second component of the proposed definition would require an NRSRO to be generally accepted in the financial markets as an issuer of credible and reliable ratings, including ratings for a particular industry or geographic segment, by the predominant users of securities ratings. AFP is pleased that the Commission has adopted our recommendation[10] to grant NRSRO status to rating agencies that can demonstrate that they issue credible and reliable ratings for a certain industry or geographic region. However, we are dismayed that the proposed definition largely maintains the status quo and its primary recognition criterion. For nearly three years, AFP has argued that requiring a credit rating agency to be "nationally recognized" in order to be recognized as an NRSRO presents a nearly insurmountable barrier to entry into the credit ratings market. It is difficult to see how the change from "nationally recognized" to "generally accepted" meaningfully addresses this barrier to entry.

The Commission should establish stringent criteria and clear procedures that will eliminate unnecessary regulatory barriers to entry into the ratings market. The appropriate criteria should be based on whether an agency can consistently produce credible and reliable ratings, not simply on whether the market recognizes the credit rating agency's ability to do so. National recognition or general acceptance will be difficult to obtain absent the Commission's recognition. While market acceptance may be one measure of whether ratings are credible and reliable, an analysis of the correlation between an NRSRO's expected and actual default experiences or other quantitative methods may also be acceptable. The criteria should also focus on internal controls designed to prevent conflicts of interest and anti-competitive and abusive practices and to ensure against the inappropriate use of non-public information to which rating agencies are privy through their Regulation FD exemption.

Third Component of Proposed Definition

The proposed definition would also require that NRSROs use systematic procedures designed to ensure credible and reliable ratings, manage potential conflicts of interest, and prevent the misuse of nonpublic information, and have sufficient financial resources to ensure compliance

[10] http://www.afponline.org/pdf/clkatz072803.pdf

with those procedures. AFP is pleased that the Commission has adopted our recommendation that NRSROs be required to document, implement and adhere to policies and procedures designed to ensure against the inappropriate use of non-public information and protect against conflicts of interest and anti-competitive and abusive practices.

In addition to addressing the potential conflicts of interest associated with unsolicited ratings, NRSROs should be required to establish distinct and absolute separation between rating analysts and credit rating agency staff responsible for generating revenue from credit ratings, rating assessment services, corporate governance reviews, or other ancillary services offered by the credit rating agency. Further, the Commission should bar analyst compensation from being linked in any way to revenue generated from credit ratings or any ancillary services. The potential for a credit rating agency or individual analyst to abuse the market power associated with NRSRO recognition to boost revenue or personal earnings is obvious. The stimuli behind new auditor independence and investment research analyst independence rules provide compelling evidence of the need to address these conflicts within the credit rating industry.

Relationships between a rated company and the credit rating agency, its directors, management or staff also present opportunities for conflicts of interest. To address these potential conflicts of interest, any relationship between a rated company and the NRSRO or its directors should be prominently disclosed when a rating is issued. Further, NRSRO management and staff should be barred from having any business relationship with or interest in any company rated by the NRSRO.

With respect to conflicts of interest, AFP also broadly supports the International Organization of Securities Commissions' *Code of Conduct Fundamentals for Credit Rating Agencies*[11]. IOSCO's *Code* closely mirrors the major tenets of AFP's *Code of Standard Practices for Participants in the Credit Rating Process*. Specifically, AFP endorses IOSCO's recommendations regarding the integrity of the rating process, credit rating agency independence and avoidance of conflicts of interest, and the treatment of confidential information. We believe that these recommendations, along with periodic oversight of NRSRO compliance with these requirements by the Commission, would make a meaningful contribution to restoring investor confidence in credit ratings.

AFP supports the proposed requirement that NRSROs must reasonably validate the integrity of all the public and non-public information used in determining a credit rating. However, we are concerned that the proposed definition includes prescriptive structural requirements that reflect a comfort with the status quo, which will hinder the recognition of rating agencies that may employ innovative methodologies. AFP believes that the primary criterion that should be used to determine whether a credit rating agency should be recognized as an NRSRO is whether the agency has published and adhered to methodologies that generate credible and reliable ratings.

---

[11] http://www.iosco.org/pubdocs/pdf/IOSCOPD180.pdf

The proposed definition assumes too much about the inputs necessary for credible and reliable ratings. Specifically, the experience and training required of a firm's rating analysts may be quite different for each firm depending on the methodology employed. In some cases, extensive financial analysis training and even certification may be required. However, other methodologies may rely primarily on statistical or quantitative analysis that demands different training and expertise. Where a methodology relies primarily on statistical analysis, the average number of issues covered by analysts may be irrelevant or lack comparability with analysts of more traditional NRSROs. The extent of contacts with the management of issuers may also be irrelevant depending on a credit rating agency's published methodologies. It is ironic that, despite the Commission's assertions to the contrary, many of these proposed requirements would appear to preclude a primarily *statistical rating organization* from obtaining the Nationally Recognized *Statistical Rating Organization* designation. Rather than these highly prescriptive requirements, AFP believes that the Commission should examine whether a credit rating agency soliciting NRSRO recognition has the financial and human resources to adhere to its published methodologies on an ongoing basis, whatever those methodologies may be.

Additional AFP Recommendations

As previously stated, AFP believes that limited ongoing oversight of NRSROs is critical to restoring and maintaining investor and issuer confidence in credit ratings. We do not have an opinion on whether the Commission currently has the requisite authority to conduct ongoing oversight, but strongly encourage the Commission to proactively seek or support appropriate authorizing legislation if it is needed. We are pleased that the Commission staff states in the proposed definition that it intends to include expiration dates in future NRSRO no-action letters, but do not believe that this eliminates the need for a structured ongoing oversight regime.

AFP has recommended[12] that the Commission conduct periodic reviews of NRSROs no less than every five years. These periodic reviews should be limited to ensuring that NRSROs continue to meet the initial recognition criteria. Recognition as an NRSRO should be conditioned upon a credit rating agency publishing and adhering to methodologies that are demonstrated to produce credible and reliable ratings, as well as establishing and enforcing policies to protect non-public information and to prevent conflicts of interest and unfair and abusive practices in the ratings market. Greater regulatory intrusion into the credit ratings market is unnecessary. Such intrusion would likely erode the benefits that would derive from a competitive marketplace for credit ratings.

By clarifying the criteria and process by which it recognizes credit rating agencies and by exercising judicious ongoing oversight as recommended by AFP, the Commission will stimulate competition in the market for credit ratings. This competition will allow for innovative solutions that will improve the quality of information available to investors. A competitive market will also ensure that prices for credit ratings are market driven rather than a result of oligopolistic practices or other inefficient pricing mechanisms that raise the cost of borrowing for debt issuers.

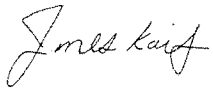
[12] http://www.afponline.org/pub/pdf/040203_kaitz_testimony.pdf

AFP has recommended that the Commission abandon the requirement that a credit rating agency be "nationally recognized" in order to be recognized as a Nationally Recognized Statistical Rating Organization. Consistent with that recommendation, we also propose that the Commission change the name of the designation bestowed upon recognized agencies to reflect the more active role we envisage for the Commission. We recommend that the Commission designate a credit rating agency that meets the suggested recognition criteria as a Registered Credit Rating Agency (RCRA). This designation would more accurately convey the active role we recommend the Commission take in recognizing and overseeing credit rating agencies and reduce investor confusion about the implications of the Commission's recognition.

AFP believes that rating agencies are critical to the efficient operation of the capital markets. The Commission must take steps to eliminate artificial barriers to entry into the credit ratings market and provide prudent oversight that ensures investor confidence. The Commission must improve its oversight by clarifying the criteria and process it uses to recognize a credit rating agency, and requiring policies to protect non-public information and to prevent conflicts of interest and unfair and abusive practices. By removing the artificial barrier to market entry that it has created, the Commission will foster additional competition in the market for credit ratings, which will result in more accurate and timely ratings. These actions will increase investor confidence in credit ratings and improve the efficiency of capital markets.

We appreciate the opportunity to comment on the Commission's proposed *Definition of Nationally Recognized Statistical Rating Organization* and urge your consideration of our recommendations. If you have any questions, please contact Jeff A. Glenzer, CTP, AFP's Director of Treasury Services at 301.961.8872.

Sincerely,



James A. Kaitz
President and CEO

Testimony of Frank Partnoy
Professor of Law, University of San Diego School of Law
Hearings before the United States House of Representatives
Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
"Legislative Solutions for the Rating Agency Duopoly"
June 29, 2005

I am submitting testimony in response to this Subcommittee's request that I discuss my views of Congressman Michael G. Fitzpatrick's legislation, H.R. 2990, the Credit Rating Agency Duopoly Relief Act of 2005, and the Securities and Exchange Commission's staff's legislative framework.

I. Introduction and Overview

I am a law professor at the University of San Diego School of Law, where I teach and research in the areas of financial market regulation, derivatives, structured finance, and credit ratings. During the mid-1990s, I worked on Wall Street at Morgan Stanley and CS First Boston structuring and selling debt instruments, including derivatives, many of which received ratings by Standard & Poor's and/or Moody's Investor Service. Before becoming a law professor, I practiced law at Covington & Burling in Washington, D.C.

Since 1997, I have been conducting research and writing about credit ratings and credit rating agencies. I wrote the first major article illustrating the regulatory reliance on ratings by Nationally Recognized Statistical Rating Organizations (NRSROs).[1] I also have written a book chapter for a major conference on credit ratings,[2] and have submitted

[1] Frank Partnoy, The Siskel and Ebert of Financial Markets: Two Thumbs Down for the Credit Rating Agencies, 77 Washington University Law Quarterly 619 (1999), reprinted at 33 Securities Law Review 161 (2001).
[2] Frank Partnoy, The Paradox of Credit Ratings, in The Role of Credit Reporting Systems in the International Economy (Kluwer Academic Publishers 2002, Richard M. Levitch, Giovanni Majnoni, and Carmen Reinhart, eds.).

written comments on both the SEC's 2003 Concept Release on NRSROs,[3] and the SEC's recent Proposed Rule on NRSROs.[4]

I agree with Chairman Michael G. Oxley that this legislation marks the "starting point" for debate about this important issue. I also believe credit rating agency reform is an issue that naturally should have bipartisan support. The primary split in opinion is between those with a vested interest in preserving the status quo (namely, S&P and Moody's and a handful of their supporters) and virtually everyone else. I commend Congressman Michael G. Fitzpatrick for introducing this legislation. It is an excellent building block, and ultimately should provide a framework that will create more competition among rating agencies, greater investor protection, and better ratings.

Credit rating agencies pose an interesting paradox. On one hand, credit ratings are enormously valuable and important. Rating agencies have great market influence and even greater market capitalization. Moody's consistently has had annual revenues of more than a billion dollars and operating margins of more than 50 percent. Moody's shares are now worth $13 billion, almost as much as those of General Motors and Ford.

On the other hand, there is overwhelming evidence that ratings are of scant informational value. Particularly since the mid-1970s, the informational value of ratings has plummeted. There have been multiple unexpected defaults and sudden credit downgrades in recent years. The recent short-list includes Orange County, Mercury Finance, Pacific Gas & Electric, Enron, WorldCom, and most recently General Motors and Ford. Numerous academic studies have shown that ratings changes lag the market

[3] Concept Release, Rating Agencies and the Use of Credit Ratings Under the Securities Laws, Release Nos. 34-47972, IC-26066, File No. S7-12-03 (Jun. 4, 2003).

and that the market anticipates ratings changes. The rejoinder to these studies – that ratings are correlated with actual default experience – is misplaced and inadequate, because ratings can be both correlated with default and have no informational value. In other words, such a correlation proves nothing. Members of this Subcommittee easily could publish ratings that were correlated with default experience simply by reading the newspaper and upgrading or downgrading stocks the day after good or bad news. It would be stunning to find that the credit ratings issued by any agency, and certainly the biggest agencies, were not correlated with default.

In my writings, I have argued that this paradox – high market value, low informational value – is best explained by regulation, specifically the proliferation of legal rules that depend substantively on NRSRO ratings. This regulation explains how credit ratings could have high market value but low informational value. Put simply, credit ratings are important because regulations say they are. Credit ratings are valuable as keys to unlock the benefits (or avoid the costs) of various regulatory schemes.

How did we get into such a fix? It all started in 1975, when the Commission promulgated Rule 15c3-1 and set forth certain broker-dealer net capital requirements based on the ratings of what it called NRSROs. Bizarrely, although the Commission used this acronym, NRSRO, which appears to be a defined term in the regulation, it did not actually define NRSRO. Indeed, during the next three decades, numerous regulators, but especially the Commission, have established rules that depend on NRSRO ratings. And yet no one has bothered to say conclusively what NRSRO actually means.

---

[4] Proposed Rule, Definition of Nationally Recognized Statistical Rating Organization, Release Nos. 34-51572, IC-26834, File No. S7-04-05 (Apr. 19, 2005). My comments on the Proposed Rule are included below at the end of this testimony.

For example, Rule 2a-7 of the Investment Company Act of 1940 uses NRSRO ratings to determine permissible investments for money market mutual funds. Rule 2a-7 defines NRSRO "as that term is used in Rule 15c3-1." That definition is not very helpful, and yet it forms the basis for billions of dollars of investments. There also are numerous statutes passed by Congress that rely explicitly on NRSRO ratings. They include not only banking and securities laws, but also statutes related to education, highways, and telecommunications – all without defining the term NRSRO. Even George Orwell could not have imagined such a state.

How do these regulations explain the paradox? The reason is that because the regulations do not depend on the accuracy of ratings, and because they limit the number of NRSROs, they ensure that ratings from NRSROs such as S&P and Moody's will be valuable even if they are wrong. In other words, the problem with having regulations that depend substantively on NRSRO ratings is that companies will pay for ratings even if they do not provide informational value. Because the Commission rarely approves a new NRSRO, only ratings by a handful of agencies matter. Is it any surprise that S&P and Moody's maintain an 80 percent market share in such a regime? The Commission dictates which rating agencies can play, and which cannot. As a result, the ratings by the more than 130 credit rating agencies that have not qualified as NRSROs will never be of much value compared to NRSRO ratings.

II. Benefits of the Legislation

Fortunately, this legislation is a major step in the direction of resolving this paradox, and restoring fairness and efficiency to the debt markets. In my comments on

the Commission's recent Proposed Rule, I briefly discussed a registration system for NRSROs that would resemble the registration system for other companies. I wrote that, "Instead of setting substantive requirements for NRSROs, the Commission instead could require relevant disclosure by any company that wanted to qualify as an NRSRO, and then let the market select which companies were viable. Such a registration system would be more consistent with the letter and spirit of the securities laws. In other words, the Commission would take the same approach to NRSROs that it has taken in other areas, again pursuant to and consistent with Congressional authority. Perhaps the Commission should consider a registration system before moving ahead with the Proposed Rule."

The Commission has not considered this proposal, but fortunately this legislation does. And in doing so, it accomplishes at least two of the three key objectives of a successful regulatory regime for credit rating agencies. First, successful regulation should encourage competition among agencies. Second, successful regulation should ensure that agencies that provide poor informational value, or are negligent or reckless in the rating process, are punished. Third, successful regulation should ensure that the markets will reward those agencies that provide the best informational value.

This legislation clearly satisfies the first objective. It both permits the 130-plus non-NRSRO agencies to compete with current NRSROs, and it creates incentives for new rating agencies to enter the market. Perhaps most importantly, it encourages new rating agencies to use market based measures in assessing companies. In my academic work, I have argued that market based measures are the best alternative to current

NRSRO ratings, and I am pleased to note that this legislation would encourage precisely such approaches.

Some might argue that opening the market to competition would be disruptive and/or lead to rate shopping. Based on my experience and available evidence, I believe the opposite is true. When markets such as credit ratings are open to competition, they become more stable. Indeed, because ratings by S&P and Moody's distort the markets, they create incentives for massive amounts of dysfunctional regulatory arbitrage transactions. To the extent there is greater competition among agencies and diminished importance of the NRSRO designation, those incentives should diminish. Likewise, the incentives for rate shopping are greater under the current regulatory system, with only a handful of agencies whose ratings matter. If there were a greater number of alternative agencies, it would be more likely that market pressures would lead companies to choose the agencies with the most accurate ratings.

The legislation also appears to satisfy the second objective, by treating NRSROs in the same manner as other so-called "gatekeepers" (i.e., underwriters, accountants, and lawyers) for purposes of liability. Although NRSROs still would enjoy certain statutory exemptions, they also would be subject to liability for federal securities fraud and/or state law causes of action. I am aware that S&P and Moody's have asserted that their ratings are merely opinions, and that free speech principles should protect them from liability unless they are proved to have had actual malice in giving knowingly false ratings. The argument is a clever one, and a few courts appear to have accepted it. But in my opinion, appellate judges, and ultimately the Supreme Court, would decide this issue the other way. Credit ratings are not the kind of opinions typical of the free speech context.

Instead, they are more like the fairness opinions of investment banks, the audit opinions of accounting firms, the legal opinion of attorneys, the buy/sell ratings of securities analysts, and even the certifications of financial statements made by CEOs and CFOs. Those statements also are "opinions" of a kind, but an institution giving such "opinions" should not be immunized from liability if it otherwise violates the securities laws or common law. Moreover, rating agency "opinions" differ from many other opinions in that they are purchased by the subject companies. It seems unlikely that companies would pay Moody's more than a billion dollars a year merely for Moody's to express an opinion. To the extent this legislation insulates NRSROs from liability based on such a free speech claim, it would not satisfy the second objective.

The third objective is to reward those rating agencies that publish the best ratings. Unfortunately, as long as the various rules that depend on NRSRO status remain in place, rating agencies will compete at least in part based on whether their ratings lead to some regulatory consequence, such as making an investment permissible or lowering a capital charge. If statutes and regulations did not depend on NRSRO status, then rating agencies would compete based solely on the informational quality of their ratings. In my opinion, Congress should remove the NRSRO designation from federal statutes, and direct relevant agencies to remove the designation from federal regulations. This legislation seeks to achieve this objective by amending the eight federal statutes that contain the term NRSRO to replace "recognized" with "registered," and by directing the Commission to give notice to other federal agencies that it also will be amending the term and will be registering NRSROs, not designating them, as of January 1, 2007.

I believe Congress can work through the legislative process to improve the proposed law by eliminating the concept of an NRSRO entirely, and replacing it with market based measures. But even if this legislation were passed as written, with no changes, it would be a major improvement over the current, highly dysfunctional ratings regime. This legislation would be far superior to a voluntary framework or code of conduct, which would lack any enforcement mechanism and would further cement the NRSRO oligopoly. It also would be far less costly than the Commission's Proposed Rule and regulatory framework, which do not address the fundamental problems associated with NRSROs, and instead raise new questions and difficulties, which would require the Commission to engage in extensive review based on ambiguous and seriously flawed terms and standards. More fundamentally, the philosophical approach the Commission has suggested with respect to NRSROs is inconsistent with its approach in other areas, and indeed with the legislative purpose of the securities laws. Instead of conducting a searching substantive review, the Commission typically requires disclosure of material facts, and then permits market participants to make decisions based on those facts. With the Commission's suggested approach, it would enter an entirely new genre of regulation: deciding which companies pass muster under particularized substantive rules. It seems highly unlikely that the Commission would apply a similar substantive review outside the NRSRO context. And if that is true, why should it apply such a review to NRSROs?

The Commission is not an office of central planning, or at least it should not be. It has taken more than a decade for the Commission to work through two concept releases on NRSROs, and it still does not even have a rule defining the term. Yes, this legislation will impose some new costs – primarily from the Commission establishing a

mandatory disclosure regime, as it has done in other areas – but it would be far less costly and far more workable than the Commission's proposals.

Again, I congratulate and thank Congressman Fitzpatrick, and all of the members of this Subcommittee, for what I hope will become landmark securities legislation. For those members who have not yet decided how to approach this difficult area, I encourage you to think about who is here today and what interests they represent. There is one group that is not here today: millions of individual investors whose mutual funds and pension funds are in fixed income investments and whose faith in S&P and Moody's has been shattered by events of recent years. Those people have so much more to gain from this legislation than S&P and Moody's have to lose.

June 9, 2005

Mr. Jonathan G. Katz, Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549-0609

Re: Proposed Rule, Definition of Nationally Recognized Statistical Rating Organization, Release Nos. 34-51572, IC-26834, File No. S7-04-05 (Apr. 19, 2005)

Dear Mr. Katz:

Below are my comments on the Proposed Rule. I am a law professor at the University of San Diego, and have written several articles on the use of credit ratings in regulation, including: *The Paradox of Credit Ratings*, in The Role of Credit Reporting Systems in the International Economy (Kluwer Academic Publishers 2002, Richard M. Levitch, Giovanni Majnoni, and Carmen Reinhart, eds.) and *The Siskel and Ebert of Financial Markets: Two Thumbs Down for the Credit Rating Agencies,* 77 Washington University Law Quarterly 619 (1999), reprinted at 33 Securities Law Review 161 (2001). Instead of repeating arguments I previously have made, which are responsive to the Proposed Rule, I simply list those two articles for your reference.

It is my opinion that the Proposed Rule is unworkable, and that available alternatives would be preferable, including market-based measures and/or a registration system, described briefly below. I agree with comments by others, particularly Professor Lawrence White, that the Proposed Rule will exacerbate the problem of oligopoly in the credit rating industry. I also believe the Proposed Rule is contrary to the Congressional directive in Section 702(b) of the Sarbanes-Oxley Act of 2002. If the Commission adopts the Proposed Rule, Congress should – and, I believe, will – respond with legislation rejecting the Proposed Rule and instead adopting one of the available alternatives.

The Proposed Rule Is Unworkable

The Proposed Rule does not address the fundamental problems associated with NRSROs – regulatory dependence on NRSRO status – and it raises all sorts of unanticipated questions and difficulties. At the outset, the Commission does not appear to have considered the potential ill effects of granting rights to new NRSROs. For example, will newly designated NRSROs be exempt from liability under Section 11 of the Securities Act of 1933? Will they be exempt from Regulation FD? Is it the Commission's intention that new NRSROs should receive the (dubious) First Amendment protections that some courts have given extant NRSROs? Should non-NRSRO credit rating agencies have similar exemptions and rights? In other words, should the Commission's determination of NRSRO status be decisive as to the application of Section 11, Regulation FD, and the First Amendment? Any proposal to reform the NRSRO process should address these questions; the Proposed Rule does not.

More specifically, the criteria in the Proposed Rule are ambiguous, serious flawed, and would require extensive substantive review by the Commission in numerous cases. The

Commission proposes to define "NRSRO" as "an entity (i) that issues publicly available credit ratings that are current assessments of the creditworthiness of obligors with respect to specific securities or money market instruments; (ii) is generally accepted in the financial markets as an issuer of credible and reliable ratings, including ratings for a particular industry or geographic segment, by the predominant users of securities ratings; and (iii) uses systematic procedures designed to ensure credible and reliable ratings, manage potential conflicts of interest, and prevent the misuse of nonpublic information, and has sufficient financial resources to ensure compliance with these procedures." Proposed Rule at 20-21.

With respect to the first component, there are no credit rating agencies – NRSRO or not – whose ratings are "current" assessments in any meaningful sense of that term. As I have noted in the articles cited above, rating changes lag new information by at least several months, and the fact that ratings are correlated with actual defaults is more an indication that the NRSROs adjust ratings after-the-fact than it is evidence that ratings have informational value. (In turn, rating changes impact securities prices because important regulations depend on ratings.)

Moreover, it is not apparent from the Proposed Rule what the Commission means by the term "current." For example, how much of a lag would the Commission permit between the dissemination of news and a change in ratings? How would that lag be measured? For example, would the Commission say that the NRSROs had been "current" with respect to their ratings of Enron's debt securities? How frequently must an NRSRO be "current" (i.e., with respect to what percentage of ratings over what period of time)? Even if these questions could be answered, there remains the overarching question about why the Commission would recommend the Proposed Rule, given that market-based alternatives (discussed below) clearly would be more "current" than NRSRO ratings?

The Commission also has suggested with respect to the first component that NRSRO credit ratings must be "publicly available" and "must be disseminated on a widespread basis at no cost." Proposed Rule at 23. Again, the meaning of this requirement is unclear. For example, would a company that simply posted ratings on a website satisfy this requirement? Also, because NRSROs now charge issuers for ratings, it is fair to say they disseminate ratings "at no cost"? Even if the answer is yes, excluding rating agencies from the NRSRO process if they charge investors, rather than issuers, would be anticompetitive, as several comments have noted.

With respect to the second component, it is unclear what the Commission means by "generally accepted in the financial markets." Generally accepted by whom? Which financial markets? Specifically, who are the "predominant users of securities ratings"? Proposed Rule at 28. Which mechanisms will the Commission use to assess whether users are "predominant" over time? Does the Commission plan to conduct polls of various market participants? To the extent this component is a serious one, it likely will cement the oligopoly power of already approved NRSROs, which have an obvious advantage in being "generally accepted," primarily because various regulations effectively require their use. (I have documented these regulations in my two articles described above.)

The third component is even more problematic. Will the Commission publish guidelines giving notice to credit rating agencies as to what would constitute "systematic procedures," "conflicts of interest," "misuse of nonpublic information," and "sufficient financial resources"? Will rating agencies seeking NRSRO status be entitled to any process (e.g., a hearing) on these issues? How will the Commission assess the other numerous subjective factors in the Proposed Rule? See Proposed Rule at 32-33. For example, which kinds of "experience and training" would be required of analysts? How many issues on average must analysts cover? Which information sources would credit rating agencies be permitted to use? Which kinds of contacts with management would be appropriate? Which types of organizational structures would be acceptable? Which kinds of processes regarding conflicts of interest and compliance would be permissible? Which kinds of financial resources must a credit rating agency have? And, in general, how much guidance would the Commission be prepared to give to prospective NRSROs? For example, would the Commission closely scrutinize credit rating agencies' balance sheets or other accounting statements to determine their financial health, or would it examine more subjective factors?

The Proposed Rule inevitably will require that Commission answer these questions, and, obviously, such inquiries will open a Pandora's Box. The Commission does not appear to have taken these questions into account in assessing the benefits and costs of the Proposed Rule.

More fundamentally, the philosophical approach of the Proposed Rule is inconsistent with the legislative purpose of the securities laws. Instead of requiring searching substantive review, the Commission typically requires disclosure of material facts, and then permits market participants to make decisions based on those facts. With the Proposed Rule, the Commission would be entering an entirely new genre of regulation: deciding which companies pass muster under particularized substantive rules. Would the Commission apply a similar substantive review outside the NRSRO context? If not, why apply such a review to NRSROs?

Alternatives to the Proposed Rule

The Proposed Rule notes in passing that "there was limited discussion of regulatory alternatives" in the comments submitted to the Commission regarding its Concept Release, published on June 4, 2003 (more than two years ago). Proposed Rule at 17. It is unclear what the Commission meant by "limited." If it meant that a relatively small number of commentators suggested alternatives, that likely is true – it is the very nature of the notice and comment process that the vast majority of comments will consist of interested remarks articulating a particular agenda, not public policy perspectives directed at maximizing the net benefit of regulation to society overall. But it certainly is not the case that the Commission has been without alternatives. Indeed, if the discussion of regulatory alternatives has been "limited" in any way, it is in the Proposed Rule, not in the comments the Commission has received.

In my Comments on the NRSRO Concept Release, I noted that "I am encouraged to learn that the Commission is quite serious about exploring alternatives to the NRSRO

designation, and I believe members of Congress also are impressed by the evident shift in focus in this Concept Release." I now understand that I was wrong on both counts. The Commission does not appear to have been serious about assessing alternatives, at least not in the Proposed Rule. Nor does it appear to have taken seriously the Congressional mandate of Section 702(b) of the Sarbanes-Oxley Act of 2002, which directed the Commission to address the problems associated with NRSROs. During the past several years, the Commission has had the opportunity to consider various regulatory alternatives. Yet the Proposed Rule is silent on the question of why it is superior to available alternatives. In my opinion, the Commission, having requested comments on alternatives, is obligated to explain clearly the rationale for selecting the Proposed Rule from among the many regulatory alternatives available. Below, I briefly discuss two categories of such alternatives.

Alternative One: Market-Based Measures as a Substitute for NRSROs

I won't repeat in detail here my suggestions about market-based alternatives as set forth in my articles and in my Comments on the Concept Release. For illustrative purposes, I set forth below what I wrote about broker-dealer net capital requirements in my Comments. In discussing the effect of the Proposed Rule on the broker-dealer net capital requirements, the Commission did not explain why or how the Proposed Rule would be superior to market-based alternatives.

> First, I believe the Commission should allow broker-dealers (subject to certain restrictions, discussed below) to use market-based measures for purposes of determining the capital charges on different grades of debt securities under the Net Capital Rule. The use of NRSRO ratings under Rule 15c3-1 is problematic, and has been so for three decades. Rule 15c3-1 was the first rule to incorporate NRSRO ratings, and the tangle of NRSRO-based rules grew from this one mislaid acorn. Therefore, it seems appropriate for the Commission to begin its consideration of NRSRO alternatives with proposed rules amending the use of credit ratings under Rule 15c3-1.
>
> However, there are risks associated with allowing broker-dealers to use the alternative of internally-developed credit ratings alone. Firewalls between employees at broker-dealers are notoriously unreliable, and the voluminous evidence from recent scandals should make the Commission nervous and skeptical about relying on such firewalls in any rule. The Commission could minimize the opportunities for strategic behavior by broker-dealers by requiring that internally-developed credit ratings be consistent with - or constrained by - market information or market-based measures, such as the rolling average of credit spreads for particular instruments.
>
> Market-based information and market-based credit rating methodologies have the characteristics of public goods. Accordingly, encouraging numerous broker-dealers to develop their own information and methodologies would be inefficient, as each broker-dealer would be needlessly duplicating costs without benefit. A broker-dealer could generate additional value from this exercise only if its ratings were somehow skewed to reduce its net capital requirements, an unacceptable

> result from the Commission's perspective. Otherwise, all broker-dealers would be better off if the information and methodologies were provided by - or at least constrained by - the Commission; then broker-dealers could share costs while representing credibly to investors that that their ratings were reliable and accurate.
>
> The efficient regime would be for the Commission - with the input of the broker-dealer community and others - to institute a methodology for Rule 15c3-1 purposes. The Commission could set market based (i.e., credit spread) parameters and permit broker-dealers to use internally-developed credit ratings so long as the internal ratings fell within a specified range of these market parameters. Put another way, broker-dealers would not be permitted to use internal ratings if those ratings were inconsistent with market measures. For example, broker-dealers could be permitted to use an internally-generated rating for a particular debt security provided that the 90-day rolling average of that security's credit spread was within a specified range for that rating category (e.g., a range of one percent).
>
> Finally, if the Commission permits broker-dealers to use internally-developed credit ratings in any way, constrained or not, it should require that broker-dealers using such ratings disclose the particular information and methodology used in notes to their financial statements, along with examples sufficient to allow investors to assess a particular broker-dealer's safety and soundness based on the net capital it provides for particular securities. Otherwise, the internally-developed credit ratings will disappear into a "black hole," not unlike the types of information investors would have found relevant in recent scandals. Such lack of transparency was precisely what Congress was seeking to avoid in Sarbanes-Oxley, particularly in Section 702(b).

I also discussed in my Comments the likely objections to market-based alternatives. Again, the Commission did not address these issues in the Proposed Rule:

> Opponents of market-based alternatives to NRSROs have argued that such alternatives might be problematic because they either would be too volatile or not accurate. The volatility objection is easily overcome. First, if the securities are more volatile, that volatility should be incorporated into regulation. Indeed, the primary purpose of credit-rating-based regulation is to constrain the investment decisions of regulated entities for safety and soundness (and perhaps other regulatory) purposes. Second, it is a straightforward exercise to reduce the volatility of a market-based measure by lengthening the relevant historical period (e.g., one could employ the closing price each day or instead use a rolling average of any length of time, from a week to a year). If the Commission wishes to preserve the lagging characteristic of NRSRO ratings, it could do so by specifying its lag time of choice. Instead, of relying on the current NRSRO ratings, which lag the market in an indeterminate way, the Commission could precisely select a measure with, say, a 90-day lag.
>
> The second objection, that market-based measures would not be accurate, is perhaps a more serious one. According to this argument, for certain illiquid or new issues, it might be more difficult to assess a market measure, such as a credit

> spread. Some commenters, particular the NRSROs, even have claimed that NRSRO ratings are more accurate than market measures, a claim that is belied both by abundant evidence that NRSRO ratings generate little informational value, and by the more general logical point that market measures reflect market participants' best assessment of available information, including information available to NRSROs and NRSRO ratings.
>
> Moreover, market participants provide prices and quotations for nearly all debt issues, including illiquid and new issues, as part of their standard business practices. It is a straightforward exercise to obtain valuations for individual securities, whatever their liquidity, and most well-run institutions obtain such valuations periodically for their own reporting and risk management. For new issues, bankers and market participants typically engage in "price talk" to assess the value of a security before it is issued (the same is true even more explicitly in "when issued" markets), and there frequently are comparable securities already traded in the market. Even if it were impossible to obtain the same degree of accuracy for illiquid or new issues as for liquid, seasoned issues, market measures might nevertheless be preferable to NRSRO ratings for regulatory purposes. The point of using market-based measures in regulation is not to create a range of narrow trigger points. Indeed, the NRSRO ranges for regulatory purposes are quite wide (e.g., the difference between an investment grade and a non-investment grade rating is considerable). Similarly, market participants easily could use market-based measures to determine whether a particular security falls into one or the other of such broad categories. But market-based measures also could be used to make finer distinctions for regulatory purposes, something the current NRSRO-based categories cannot do.

Since I wrote my Comments, other market-based measures have emerged, including credit derivatives such as credit default swaps, many of which are quite liquid. Although these markets recently have exhibited short-term volatility, that volatility appears to reflect the underlying condition of particularly companies (e.g., General Motors and Ford) more accurately than NRSRO ratings, which again have lagged the market substantially. As a result, the volatility objection to market-based measures has become weaker during the past several years. In any event, a longer-term market-based measure – such as a 180-day average – would have performed reasonably even during recent times of increased volatility. Finally, there are no studies or evidence suggesting that any market participant would be able to manipulate a market-based measure such as credit spreads or credit default swaps over such an extended period of time; the argument about manipulation, which is not set forth in the Proposed Rule in any event, is mere speculation. Although the case for market-based alternatives to NRSRO ratings has gotten stronger since the Concept Release, the Commission did not explain why it rejected those alternatives.

Alternative Two: An NRSRO Registration System

Finally, the Proposed Rule raises an additional alternative the Commission apparently has not considered: a registration system for NRSROs that resembles the registration system for other companies. Instead of setting substantive requirements for NRSROs, the

Commission instead could require relevant disclosure by any company that wanted to qualify as an NRSRO, and then let the market select which companies were viable. Such a registration system would be more consistent with the letter and spirit of the securities laws. In other words, the Commission would take the same approach to NRSROs that it has taken in other areas, again pursuant to and consistent with Congressional authority. Perhaps the Commission should consider a registration system before moving ahead with the Proposed Rule.

I appreciate the difficulty of the task before the Commission, but I hope the Commission will take my suggestions seriously. The problems associated with NRSROs cannot be solved merely by defining the term "NRSRO." Nothing in the Proposed Rule suggests that the Commission could have avoided the problems associated with NRSROs if it had defined the term long ago. Indeed, the substantive approach suggested by the Proposed Rule would have serious drawbacks, as I have indicated. Instead, the Commission should consider the available alternatives to the Proposed Rule. And whatever the Commission decides, it should satisfy its obligations under Section 702(b) of the Sarbanes-Oxley Act of 2002, and not relegate its response to those alternatives – which the Commission raised its Concept Release – to part of one sentence and a footnote.

Sincerely,

Frank Partnoy
Professor of Law, University of San Diego

Testimony of

Alex J. Pollock
Resident Fellow
American Enterprise Institute

To the Subcommittee on Capital Markets, Insurance and GSEs

Of the Committee on Financial Services

United States House of Representatives

Hearing on Legislative Solutions for the Rating Agency Duopoly

June 29, 2005

H.R. 2990: Creating a Competitive Rating Agency Sector

Good morning, Mr. Chairman, Ranking Member Kanjorski and members of the Subcommittee. Thank you for the opportunity to testify today. I am Alex Pollock, a Resident Fellow of the American Enterprise Institute, and these are my personal views.

It is a pleasure to speak in support of H.R. 2990, a pro-competitive, pro-investor alternatives, pro-market discipline bill. In January, 2005, the AEI published an article of mine entitled, "End the Government-Sponsored Cartel in Credit Ratings": H.R. 2990 would do just that.

My article concluded with the following thoughts, to which I continue to subscribe:

"In the truly procompetitive and best case, not only would the term 'NRSRO" be dropped, but the regulatory requirement of designation of approved rating agencies itself would be eliminated. That requirement has produced unintended effects never imagined when it was introduced in 1975, and it is time for it to retire.

"In its place, the responsibility to choose among rating agencies and their services would belong to investors, financial firms, securities issuers, creditors, and other users of ratings—in short, to the market. Imagine that!

"Under these desirable circumstances, a competitive market test will determine which rating agencies turn out to be 'widely accepted by the predominant users of securities ratings,' and competition will provide its normal benefits of better prices, innovation, customer choice, and efficiency."

One practical problem this best case had to confront was that the SEC's "NRSRO" designation has over three decades become enshrined in a very large and complex web of interlocking regulations and statutes affecting all kinds of financial actors. The combined effect was to spread the unintended anti-competitive force of the SEC's regulation throughout the financial system, resulting in a rating agency sector marked by effective government sponsorship of the existing dominant firms, too few customer alternatives, too little price and service competition, and extremely high profits for the favored firms. How could we untangle this regulatory web, or (to change the metaphor) cut this Gordian knot of interacting rules?

H.R. 2990 cuts the Gordian knot in what I think is a brilliant and elegant fashion by keeping the abbreviation "NRSRO," but completely changing its meaning. By changing the first "R" from "Recognized" to "Registered," it moves from a restrictive designation regime, to a procompetitive disclosure regime. This change, it seems to me, is in the best tradition of the American financial market theory and practice: competition based on disclosure, with informed investors making their own choices, for use of credit ratings as well as other financial decisions.

Confirmation of the anti-competitive nature of the existing regulation comes from a recent investment recommendation to buy the stock of one of the rating agencies, which correctly states:

"Companies are not unlike medieval castles. The most successful are those that boast some sort of economic moat that makes it difficult, if not impossible, for competitors to attack or emulate. Thanks to the fact that the credit ratings market is heavily regulated by the federal government, [this rating agency] enjoys a wide economic moat." (emphasis added)

The government should not be in the business of creating such "economic moats" to protect certain rating agencies, and H.R. 2990 properly takes it out of this business.

An important advantage of the change H.R. 2990 would introduce is to allow multiple rating agency pricing models to compete for customer favor. While the dominant pricing model is now that securities issuers pay for credit ratings, it is arguable that having investors purchase the ratings creates a superior incentive structure. This was of course the original historical model. In my view, there should be no regulatory prescription of one model or the other: the market should use whichever credit rating providers best serve the various needs of those who use the ratings.

I believe the decentralization of decisions implied by a competitive disclosure-based regime is wholly positive. Investors and other market actors, as well as many regulators,

will have to think about how credit ratings should be used and what related policies they will wish to adopt. They will be expected to make informed judgments, rather than merely following an SEC rule about who is designated as "recognized." The SEC itself may wish to re-examine its regulation about how credit ratings must be used for calculating capital requirements.

Good legislation can create the environment for positive developments, but a fully competitive rating agency market will not happen all at once. There are significant natural barriers to entry in this sector, including the need to establish reputation, reliability and integrity; the prestige factor involved in the purchase of opinions and judgments; and the natural conservatism of institutional risk management policies.

Because the desirable transition to a more competitive rating agency sector would be evolutionary, I believe any concern about disruption of the fixed income markets is misplaced. This would be a change which, in my opinion, the bond and money markets would benefit from and take in stride.

No matter what the regime, we cannot hope for credit ratings ever to have uniform success in predicting future credit performance, or to create a world in which there are never ratings mistakes, any more than in any other endeavor which tries to deal with future risks and uncertainties. But this emphasizes the importance of a vibrant marketplace of analysis, ideas, forecasts, risk assessments, and credit ratings.

In summary, I believe H.R. 2990's approach is in the best tradition of competition and disclosure, rather than regulatory prescription and government sponsorship. As always, greater competition will in time bring about better customer service, more innovation, more customer alternatives, greater price competition, reduced duopoly profits, and greater efficiency in the credit rating agency sector.

Thank you again for the chance to be here today.

FitchRatings

Statement of
Nancy Stroker
Group Managing Director
Fitch Ratings
To
United States House of Representatives
Committee on Financial Services
Subcommittee on Capital Markets, Insurance
and Government Sponsored Enterprises
June 29, 2005

Introduction

Fitch Ratings traces it roots to the Fitch Publishing Company established in 1913. In the 1920s, Fitch introduced the now familiar "AAA" to "D" rating scale. Fitch was one of the three rating agencies (together with Standard & Poor's ("S&P") and Moody's Investors Service ("Moody's")) first recognized as a nationally recognized statistical rating organization (a so-called "NRSRO") by the Securities and Exchanges Commission (the "Commission") in 1975.

Since 1989 when a new management team recapitalized Fitch, the company has experienced dramatic growth. Throughout the 1990s, Fitch especially grew in the new area of structured finance by providing investors with original research, clear explanations of complex credits, and more rigorous surveillance than the other rating agencies.

In 1997, Fitch merged with IBCA Limited, another NRSRO headquartered in London, significantly increasing Fitch's worldwide presence and coverage in banking, financial institutions and sovereigns. Through the merger with IBCA, Fitch became owned by Fimalac, a holding company that acquired IBCA in 1992. The merger of Fitch and IBCA represented the first step in our plan to respond to investors' needs for an alternative global, full-service rating agency capable of successfully competing with Moody's and S&P across all products and market segments.

Our next step in building Fitch into a global competitor was our acquisition in April 2000 of Duff & Phelps Credit Rating Co., an NRSRO headquartered in Chicago, followed by the acquisition later that year of the rating business of Thomson BankWatch. These acquisitions strengthened our coverage in the corporate, financial institution, insurance, and structured finance sectors, as well as adding a significant number of international offices and affiliates.

FitchRatings

Because of Fitch's growth and acquisitions, it today has approximately 1,600 employees, including over 850 analysts, in 49 offices worldwide. Fitch currently covers 3,900 banks, insurance companies and other financial institutions, 1,300 corporations, 91 sovereigns and 73,000 municipal offerings in the United States. In addition, we cover over 8,500 different structured finance securities and structured finance remains one of our special strengths.

Testimony

Set forth below is a summary of our views on the legislative issues concerning rating agencies that the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises intends to consider at its hearing today.

Credit Rating Agency Duopoly Relief Act of 2005 and the Commission Outline

Fitch firmly believes in the power of competition and thus we fully support the objectives of the recently proposed Credit Rating Agency Duopoly Relief Act of 2005, H.R. 2990 (the "Act"), which are to provide greater competition and transparency in the credit rating industry. While we have significant reservations about whether the Act as currently proposed will provide either greater competition or transparency, the Act and the debate surrounding it will serve as a constructive first step in providing a pro-competition market based solution to foster competition in the credit rating industry, as pointed out by both Representatives Oxley and Baker at its introduction. We believe that the key to improving the transparency of the ratings process, while at the same time ensuring the continued reliability of ratings, is to foster competition.

We believe the *Staff Outline of Key Issues for a Legislative Framework for the Oversight and Regulation of Credit Rating Agencies* that was delivered earlier this month to Representative Kanjorski (the "Commission Outline") is not much different in its substance to the existing NRSRO system and the Commission's proposed definition of NRSRO. The most notable difference is the significant increase in the Commission's authority to regulate directly the rating agencies without adequate explanation as to how that regulation would work in practice or an evaluation of how the scheme would actually foster competition, transparency and reliability.

Both the Act and the Commission Outline as proposed impose a substantial and ill-defined regulatory burden on rating agencies, which itself could create a new barrier to entry. As for the Act, it does not provide clear legislative standards by which the Commission would assess the reliability of ratings and decide to approve the registration of a rating organization. We do not believe that increased regulation in a field typically fosters competition and the vague standards for registration will do little to advance a more transparent process at the Commission. The Commission Outline, on the other hand, appears to suggest using the recently proposed definition of NRSRO in a newly proposed registration system. We note that definition of NRSRO is little changed from the way in which the Commission has historically defined NRSRO, which has been

criticized as a barrier to entry for new competition in the rating industry. I have attached hereto as Annex A a copy of our comments to the Commission's recently proposed definition of NRSRO. We believe our comments to that proposed definition apply to much of the Commission Outline.

Anticompetitive, Abusive and Unfair Practices

While we commend the provisions of the Act that authorize the Commission to adopt rules to prohibit anticompetitive practices common to the credit rating industry, a provision echoed in the Commission Outline, if Congress believes legislation in this area is appropriate, the legislation should go further by legislatively prohibiting such practices outright.

Fitch believes that our emergence as a global, full-service rating agency capable of competing against Moody's and S&P across all products and market segments has created meaningful competition in the ratings market for the first time in years. Fitch's challenge to the Moody's/S&P monopoly has enhanced innovation, forced transparency in the rating process, improved service to investors and created much needed price competition.

Academic research confirms our belief that innovations in the ratings industry have often "been initiated by the smaller rating firms [Fitch and its legacy firms], with the larger two [Moody's and S&P] then following."[1] At Fitch, we are particularly proud of the work we have done in the development of innovative methodologies to analyze new structured finance securities. These innovations in the securities markets have had substantial economic benefits. For instance, academic research has found that securitization has had a positive impact on both the availability and cost of credit to households and businesses.[2]

Fitch firmly believes in the power of competition. We also believe that there is always a demand for insightful, independent credit research.

As noted at the introduction of the Act, while the NRSRO system is often cited as a barrier to entry for new rating organizations, we believe that the debate over the NRSRO system ignores the single most important barrier to entry in the ratings market: the Moody's/S&P monopolies.

---

[1] Lawrence J. White, *The Credit Rating Industry: An Industrial Organization Analysis,* June 2001 (paper presented at the conference on "Rating Agencies in the Global Financial System", presented at the Stern School of Business, New York University, June 1, 2001.

[2] Mark M. Zandi, *The Securitization of America,* Regional Financial Review, February 1998; Ali Anari, Donald R. Fraser and James W. Kolari, *The Effects of Securitization on Mortgage Market Yields: A Cointegration Analysis,* Real Estate Economics, 1998.

FitchRatings

Moody's and S&P are a dual monopoly, each possessing separate monopoly power in a market that has grown to demand two ratings. Each engages in practices designed to perpetuate its market dominance and extend it to otherwise competitive markets such as structured finance. As we have publicly stated for several years, through their discriminatory practice known as "notching," Moody's and S&P successfully alter competition in the commercial and residential mortgage–backed securities markets by leveraging their monopoly position in other markets.

If Congress wishes to address barriers to entry in the ratings market and ensure robust competition, legislation should be adopted that prohibits anticompetitive conduct by rating agencies outright including prohibiting rating agencies from discriminating against the ratings by other rating agencies for the purpose of preserving market share. Fitch believes that this is an area that would benefit from legislation to protect rating agency competition. Fitch believes that any rating agency found to be using anticompetitive practices or unfair business practices should be subject to a full range of appropriate sanctions.

Recognition/Registration Process and Criteria

If Congress believes a registration or recognition system is necessary, we believe that any legislation creating such a system should formalize the process by which a rating agency is either registered or recognized. The application process, specific criteria to be used for recognition or registration and time frames for action on all applications should be specified in the legislation and detailed in appropriate regulations. We believe public comment should be solicited on applications and an appropriate appeal process should be put in place.

As noted above, we believe that the Act does not provide clear legislative standards by which the Commission can assess the reliability of ratings and decide to approve the registration of a rating organization. Indicators of reliability, including a proven track record, should be the key because the public interest will not be served if the ratings of agencies without such a proven record are let loose on the public or indiscriminately used in safety and soundness regulations. Legislation should foster a well-designed regulatory system that should deter rating agencies from competing by issuing more favorable ratings than other rating agencies. It is easy to give favorable ratings to garner favor, and revenue, from issuers and investors. It is difficult to compete and grow while maintaining rigorous credit standards. Such a highly permissive approach to registration would also make less likely the achievement of the pro-competition objectives of Congress because such an environment is likely to strengthen the market position of the existing duopoly.

When considering the reliability of an organization's ratings, we believe the Commission should evaluate the default and transition experience of each one's ratings against a benchmark reflecting the aggregate, historical default and transition rates of all ratings issued by the rating agencies in the market. Ultimately, we believe the performance of

ratings over time relative to the performance of other rating systems is still the best judge of a rating agency.

Oversight and Enforcement

We also note that the Act implicitly provides the Commission with the authorization to regulate the substantive decision-making process of rating agencies, and the content of the ratings they assign, through unfettered examination and inspection authority. This authority goes beyond the authority that even the staff of the Commission has suggested is appropriate in the Commission Outline. In the Commission Outline, the Commission staff acknowledged that the "legislation should not, however, regulate the substantive decision-making of rating agencies or the content of the ratings they assign."

As the Commission Outline provides, any legislation in this area must, for legal and policy reasons, make clear that the decision-making process of rating agencies and the content of the ratings assigned are beyond the scope of any legislative or regulatory scheme. To do otherwise would greatly compromise the independence of the rating agencies, whose business is to gather information and publish independent opinions about that information, and will have a chilling effect on their ability to provide views of the credit of the companies they rate that are not managed by government in matters of either process or outcome.

Fitch acknowledges that the Commission's right to revoke recognition of any NRSRO that no longer meets the criteria for recognition may not be an adequate remedy, due to the all-or-nothing nature of such a sanction. Given the importance of unbiased credit ratings in the financial markets, we believe oversight and enforcement authority in matters such as conflict of interest and integrity are important. Beyond this, as we commented to the Commission in connection with their concept release and proposed rule on recognition, we believe that examination and oversight of the rating agencies should be focused principally on the performance of the organization's ratings over time relative to the performance of other rating systems.

We believe any oversight should be narrowly tailored so as to intrude as little as possible on the independence of rating agencies. In this way undue regulatory burden will be avoided and rating agencies will retain the flexibility in the ratings process, as well as the breathing space, for making the independent judgments that are critical to objective and timely ratings.

Within this framework, if Congress believes oversight is appropriate, legislation should provide a narrowly tailored oversight scheme specifically developed for rating agencies. We do not believe that the existing regulatory schemes under the Exchange Act or under the Investment Advisers Act are a plausible fit, however, as agencies function in a unique way to provide analysis and opinion and not as investment advisers, broker-dealers, clearing agencies, security exchanges or other regulated entities.

In the same vein, it would be unsound to seek to impose on rating agencies a diligence requirement either for creating a private right of action or for oversight purposes. Even putting aside the significant and in our view insurmountable issues of the constitutionality of imposing on those who publish information important to the public liability based on negligence, as already noted, rating agencies do not now audit or verify the information on which they rely and to impose such a requirement would duplicate the work of the various professionals (auditors, lawyers, investment bankers and fiduciaries) upon whom the law does place certain obligations of diligence and due care.

Unsolicited Ratings

Issuers and others have expressed concerns that certain practices regarding unsolicited ratings may be anticompetitive or constitute unfair practices. While there have been allegations of abuse leveled against the dominant agencies in the past, Fitch does not believe that the issuance of such ratings is inappropriate.

We believe it is important to the market that rating agencies be allowed to publish opinions on issuers they determine to be of interest to the investing public. We also believe this is extremely important to ensuring competition with Moody's and S&P for investor interest.

Moody's and S&P are so dominant that the market has grown to expect always to see their two ratings on every issue. Issuers believe that they must request and pay for ratings from Moody's and S&P. Their rating practices reinforce this. The cornerstone to competing with Moody's and S&P is building an investor following. Without it, you cannot attract interest from issuers. To get the attention of investors a rating agency must demonstrate that it has the breadth of coverage investors perceive Moody's and S&P possess. Without adequate coverage, you cannot build an investor following.

In 2001, Fitch introduced its Fitch Initiated Ratings program. Fitch Initiated Ratings target high-profile market participants or issuers about which there is a discrepancy in market opinions not traditionally rated by Fitch. Ratings initiated under this program are identified as such in the original publication concerning the rating. Fitch will only publish a Fitch Initiated Rating if we conclude that there is sufficient information available to us to allow us to express our opinion, and in all cases, such ratings are uncompensated and Fitch does not assess or seek fees for the analysis done in connection with these ratings. Fitch Initiated Ratings allow Fitch to get investor attention.

There is no difference in the analytical process or criteria used for Fitch Initiated Ratings, although the level of management involvement varies. Procedures relative to the publication of the ratings are also no different and we contact the issuer prior to publishing a new rating or subsequent rating action in accordance with our regular practices.

We believe that any legislative or regulatory action with respect to rating agencies must recognize that rating agencies seeking to compete with the market dominance of Moody's and S&P need to issue unsolicited ratings to ensure their ability to compete, while at the same time ensuring that no agency uses unsolicited ratings as a means to extract payment from an unwilling issuer.

Ratings Are a Reliable Indicator of Risk

One unfortunate misperception embodied in both the Act and the Commission Outline is that the failure to detect fraud at Enron and Worldcom is evidence that rating agencies have failed in their mission to provide an easy to use, efficient and reliable system by which investors can assess the credit risk of a variety of investments. While we do believe that increased competition will foster transparency, improve responsiveness, reduce costs and increase the value that rating agencies provide the users of their ratings, results that are usually achieved through increased competition, the reliability of ratings at all major agencies over a long history remains incontrovertible.

Though we in no way wish to belittle the tragedy of Enron and Worldcom, rating agency critics continually emphasize how the ratings agencies "missed" Enron and Worldcom. The criticism tends to ignore the reality of Enron and Worldcom, which is that a number of dishonest insiders conspired to perpetrate a massive financial fraud. Rating agencies were among those deceived by these frauds because, as we tell all our users, we rely on the accuracy of the information we are provided by issuers and their advisors and do not audit or verify that information.

We believe the reality is that credit ratings can assess credit risk in the overwhelming majority of cases and have proven to be a reliable indicator for assessing the likelihood that a security will default. The performance of our credit ratings over time is demonstrable and measurable by the default and transition studies we regularly publish.

Fitch's most recent corporate bond and structured finance default studies are summarized below.

[Remainder of the page left intentional blank]

FitchRatings

Fitch Average Annual Default Rates

	Corporate Finance* 1990 - 2004	Structured Finance** 1991 - 2003
AAA	0.00%	0.00%
AA	0.00%	0.01%
A	0.04%	0.02%
BBB	0.30%	0.11%
BB	1.51%	0.48%
B	1.84%	1.15%
CCC - C	24.32%	15.57%
Investment Grade	0.10%	0.03%
Non Investment Grade	3.48%	1.54%

* Based on Fitch-rated global corporate debt issuers.
** Based on Fitch-rated U.S. structured finance bonds.

The performance of ratings by the three major rating agencies is quite similar. We believe this similarity results from the common reliance on fundamental credit analysis and the similar methodology and criteria supporting ratings.

Rating agencies gather and analyze a variety of financial, industry, market and economic information, then synthesize that information and publish independent, credible assessments of the creditworthiness of securities and issuers, thereby providing a convenient way for investors to judge the credit quality of various alternative investment options. Rating agencies also publish considerable independent research on credit markets, industry trends and economic issues of general interest to the investing public.

By focusing on credit analysis and research, rating agencies can provide credible and professional analysis for investors more efficiently than investors could perform on their own.

We currently have hundreds of institutional investors, financial institutions and government agencies subscribing to our research and ratings, and thousands of investors and other interested parties that access our research and ratings through our free web site and other published sources and wire services, such as Bloomberg, Business Wire, Dow Jones, Reuters, and The Wall Street Journal.

In addition to their ease of use, efficiency and widespread availability, we believe that credit ratings are most useful to investors because they allow for reliable comparisons of credit risk across diverse investment opportunities.

Through the years, ratings have also been increasingly used in safety and soundness and eligible investment regulations for banks, insurance companies and other financial institutions. While the use of ratings in regulations has not been without controversy, we believe that regulators rely on ratings for the same reason that investors do: ease of use, widespread availability and proven performance over time.

Although one can use other methods to assess the creditworthiness of a security, such as the use of yield spreads and price volatility, we believe that, while valuable, such methods lack the ease of use, stability and record of performance to supplant ratings as the preferred method used by investors to assess creditworthiness.

However, in our view the market is the best judge of the value of ratings. We believe that if ratings begin to disappoint investors they will stop using them as a tool to assess credit risk, and the ensuing market demand for a better way to access credit risk will rapidly facilitate the development of new tools to replace ratings and rating agencies.

For all of these reasons, we believe that rating agencies do a good job of meeting the needs of investors and that it is important for any dialogue about how to improve ratings to focus on ways to build upon the considerable record of reliability of ratings over time.

Conclusion

We hope that you will consider our comments on the Act and the Commission Outline and hope to have the opportunity to continue discussing the important issues raised that profoundly affect Fitch, our industry and the capital markets. Thank you for your consideration of our views.

ANNEX A

FitchRatings

One State Street Plaza
New York, NY 10004

T 212 908 0500 / 800 75 FITCH
www.fitchratings.com

June 9, 2005

BY ELECTRONIC MAIL

Mr. Jonathan G. Katz
Secretary
United States Securities and Exchange Commission
450 5th Street, NW
Washington, D.C. 20549-0609

Re: *File No. S7-04-05*
Proposed Rule: Definition of Nationally Recognized Statistical Rating Organization

Dear Sir:

This letter is submitted by Fitch, Inc. ("Fitch") in response to the request for comments of the Securities and Exchange Commission ("SEC" or the "Commission") to the proposed rule *Definition of Nationally Recognized Statistical Rating Organization* (Release Nos. 33–8570; 34–51572; IC–26834, the "Proposed Rule").

Introduction

Fitch traces its roots to the Fitch Publishing Company established in 1913. In the 1920s, Fitch introduced the now familiar "AAA" to "D" rating scale. Fitch was one of the three rating agencies, together with Standard & Poor's ("S&P") and Moody's Investors Service ("Moody's"), first recognized as a nationally recognized statistical rating organization (a so-called "NRSRO") by the SEC in 1975.

Since 1989 when Fitch was recapitalized by a new management team, Fitch has experienced dramatic growth. Throughout the 1990's, Fitch especially grew in the new area of structured finance, by providing investors with original research, clear explanations of complex credits, and more rigorous surveillance than the other rating agencies.

In 1997, Fitch merged with IBCA Limited, another NRSRO headquartered in London, significantly increasing Fitch's worldwide presence and coverage in banking, financial institutions and sovereigns. Through the merger with IBCA, Fitch became owned by Fimalac, a holding company that acquired IBCA in 1992. The merger of Fitch

and IBCA represented the first step in our plan to respond to investors' need for an alternative global, full-service rating agency capable of successfully competing with Moody's and S&P across all products and market segments.

Our next step in building Fitch into a global competitor was our acquisition of Duff & Phelps Credit Rating Co., an NRSRO headquartered in Chicago, in April 2000 followed by the acquisition later that year of the rating business of Thomson BankWatch. These acquisitions strengthened our coverage in the corporate, financial institution, insurance and structured finance sectors, as well as added a significant number of international offices and affiliates.

Because of Fitch's growth and acquisitions, it today has approximately 1,600 employees, including over 850 analysts, in 49 offices worldwide. Fitch currently covers 3,900 banks, insurance companies and other financial institutions, 1,300 corporations, 91 sovereigns and 73,000 municipal offerings in the United States. In addition, we cover over 8,500 issues in structured finance, which remains our traditional strength.

The Proposed Definition of NRSRO

Through the years, NRSRO ratings have been increasingly used in safety and soundness and eligible investment regulations for banks, insurance companies and other financial institutions. While the use of ratings in regulations has not been without controversy, we believe that regulators, including the SEC, have relied on NRSRO ratings for the same reason that investors do: ease of use, widespread availability and proven performance over time.

The proposed definition of NRSRO reflects many years of discussion and debate over the topic of rating agency recognition and thirty years of experience actually recognizing various NRSROs by the SEC staff. We commend the SEC's balanced approach to the subject matter and manifest desire to show all sides of the issues highlighted in the Proposed Rule. We believe that the Proposed Rule presents a recognition system that, while not without issues, ensures that recognized organizations possess the competence to develop reliable ratings and protects against the establishment of rating organizations that would issue inflated ratings in an effort to achieve short-term competitive gain.

Set forth below are our comments on the Proposed Rule and answers to those questions for which we believe we can add to the dialogue on these important issues.

The First Component

Publicly Available Credit Ratings. *How should it be determined whether an NRSRO is making its credit ratings readily available on a widespread basis? Should our*

rule specify the manner and methods that must be used to distribute ratings? Should internet posting itself be sufficient?

We believe that the Proposed Rule appropriately conditions recognition upon the widespread dissemination of public ratings at no cost.

Fitch believes strongly in transparency in the ratings process. Accordingly, Fitch makes available free of charge on our web site all of our outstanding public ratings. Fitch also distributes announcements of public ratings actions through a variety of wire services. In addition, there are hundreds of criteria reports published highlighting the methodology we use to rate various types of entities and securities, together with detailed sector analysis on a broad array of sectors, companies, and issues, all available free on our web site (www.fitchratings.com). Fitch has also been a leader in publishing so-called presale reports in the areas of structured finance, global power, project finance and public finance where our published analysis of various transactions of interest to the market is made available free of charge on our web site prior to the pricing of the transaction.

We believe that the SEC should also consider when recognizing a rating agency the transparency of its process as evidenced by the availability of criteria and methodology reports and, of equal importance, annual publication of transition and default studies setting forth the performance of ratings over time by ratings categories or other statistical studies that demonstrate reliability.

Although Fitch believes that best practices for a rating agency ought to include making announcements of initial public ratings and subsequent rating actions available to wire services and similar media channels to assure the widest distribution, making public credit ratings available on a free web site should be sufficient for meeting the criteria of issuing publicly available credit ratings.

Issue-Specific Credit Opinions. *Should a credit rating agency that does not rate specific securities or money market instruments be included in the definition of NRSRO? If so, under what circumstances?*

This is a question best answered by the users of ratings. Fitch publishes both issuer and issue-specific ratings because we believe that investors find both valuable in understanding creditworthiness. If an investor uses ratings to allocate capital to a specific security owned, then it seems appropriate to use issue-specific ratings for that purpose as the risk of loss given default can vary among different securities issued by the same issuer. Investors, however, use credit ratings for a variety of purposes including assessing both the probability of default and loss given default.

Current Credit Opinions. *Should the Commission provide additional interpretation regarding what it means for a credit rating agency's credit ratings to be "current assessments"? Should the Commission specify the time period? Will the*

proposed rule's provisions provide sufficient assurance to the markets that ratings are current?

Fitch agrees that unless credit ratings reflect "current assessments" of creditworthiness they are of limited utility to the user of the credit ratings. Fitch believes that the SEC should consider what procedures a rating agency has in place to ensure that its ratings are reviewed, and if needed, updated to reflect the occurrence of material events and that the rating agency follows those procedures. Fitch has such procedures in place and follows them in order to ensure that our ratings are a current assessment of creditworthiness, except in the rare circumstance where we issue a credit rating that does not entail ongoing surveillance (so-called "point-in-time ratings").

We do not believe, however, that the SEC should identify a specific time period for such review or provide additional interpretation regarding the meaning of "current assessments." Instead, we believe that whether a credit rating is a "current assessment" of creditworthiness, and all issues relating to the reliability of credit ratings, are best judged by the organization demonstrating the performance of their ratings over time by publication of actual default rates experienced in rating categories and transition studies showing the movement of ratings over time or through other statistical studies that demonstrate reliability. When considering a rating organization for possible recognition, we believe the SEC should evaluate the default and transition experience of each organization's ratings against a benchmark reflecting the aggregate, historical default and transition rates of all ratings issued by rating agencies in the market[3]. Ultimately, we believe that recognition should be reserved for those organizations that prove the performance of their ratings over time relative to the performance of other rating systems. We believe this is the most effective manner in which to ensure that credit ratings are "current."

The Second Component

General Acceptance in the Financial Markets. *How else could the Commission define the term "NRSRO" in order for users of a credit rating agency's ratings to determine whether such ratings are credible and are reasonably relied upon by the marketplace? Are the approaches discussed above useful for determining whether a credit rating agency meets the second component of the proposed definition? Are there other types of information that would be appropriate? For example, should the fact that a credit rating agency has many subscribers support a finding that the credit rating agency satisfies the second component? What types of statistical data could be relied on to determine if a credit rating agency's credit ratings are relied on by the marketplace? What standards should be considered to assess such statistical data? Should the views of issuers be a relevant consideration in determining whether a credit rating agency meets the second component of the NRSRO definition?*

[3] For a further discussion of the use of benchmarks in evaluating ratings, *see The New Basel Accord (April 2003),* Basel Committee on Banking Supervision, Bank for International Settlements.

One criticism of the NRSRO system is that it poses a barrier to entry for new entrants. Currently in the United States, ratings by new entrants typically do not satisfy investing criteria for regulated institutional and other corporate investors unless the SEC recognizes the entrant as an NRSRO. Recognition requires that these institutional and corporate investors generally accept a credit rating agency as an issuer of credible and reliable ratings. This situation creates a challenge for the new entrant: how do you build acceptance among investors before recognition? In light of the recognition of six new NRSROs since the SEC recognized the original three NRSROs in 1975, a rating agency clearly can achieve acceptance absent formal recognition. Admittedly, the requirements to achieve NRSRO status pose some barriers to entry, but these barriers are necessary to fulfill the important purpose of ensuring that the recognized agencies demonstrate the performance necessary to create a reliable ratings system.

While Fitch believes that the criteria for recognition should include an evaluation of the extent to which market participants use an organization's ratings, as we note above, we believe the most important criteria to demonstrate that an organization is an issuer of credible and reliable ratings is the performance of their ratings over time. An organization can demonstrate the performance of ratings over time by publishing actual default rates experienced in rating categories and transition studies showing the actual movement of ratings over time or through other statistical studies that demonstrate reliability. We believe performance-based criteria are more objective and pose less of a barrier to entry than a general acceptance criterion.

Limited Coverage NRSROs. *Should a credit rating agency that is recognized by the financial marketplace for issuing credible and reliable ratings within a limited sector or geographic area meet the NRSRO definition only for its ratings within such sector or geographic area, or more broadly? If a credit rating agency meets the NRSRO definition only with respect to its ratings within a particular sector or geographic area, would the NRSRO classification interfere with the credit rating agency's ability to expand its business? How should ratings from such an NRSRO be identified so that broker-dealers and other users of NRSRO ratings for regulatory purposes can determine which credit ratings from the NRSRO may be used for regulatory purposes? We noted above that commenters mentioned that it would be difficult for limited coverage NRSROs to provide a full and accurate assessment of credit risks without a broader expertise in credit risk assessment. We request further comment on this view given our proposal to permit limited coverage NRSROs.*

We believe that the SEC should continue the practice of limited recognition that acknowledges the special expertise of smaller organizations in selected areas of specialty or geographic regions such as the prior recognition afforded to IBCA and BankWatch for their expertise in financial institution analysis. We do not believe, however, that organizations that are recognized for a specific expertise ought to be afforded full recognition unless, and until, they can demonstrate through default rates, transition studies or other statistical studies that their ratings in all areas are credible and reliable.

We do not believe that demonstrating expertise in one or two sectors or geographic areas should be sufficient for broad recognition.

If the SEC decides to grant limited recognition, we believe that it is reasonable to expect the users of an organization's ratings to be responsible for knowing the extent to which an organization is recognized.

The Third Component

Analyst Experience and Training. *The Commission recognizes that the evaluation of an analyst's experience would involve a degree of subjectivity. The Commission requests comment on the appropriate subjective criteria that a credit rating agency should use in assessing the experience and training of an analyst to meet the proposed NRSRO definition. In addition, what objective criteria are relevant? What level of importance should be given to the subjective and objective criteria? How can a credit rating agency in seeking to meet the proposed NRSRO definition demonstrate that it has adequate procedures designed to ensure that its analysts are competent? What factors should a credit rating agency consider in evaluating the background of its analysts and other members of its staff?*

Number of Ratings per Analyst. *Is the concern that a credit rating agency's ratings may become less reliable as the number of issues rated per analyst increase valid? If so, what type of workload is reasonable for the analytical quality of a credit rating agency's ratings to remain high? Should the Commission specify minimum standards for a credit rating agency's analysts to continuously monitor and assess relevant developments relating to their ratings so that users of the credit rating agency's ratings can determine whether the credit rating agency meets the NRSRO definition? If a credit rating agency relies primarily on quantitative models to develop credit ratings, how can such a firm's ratings reflect a thorough analysis of the specific credit characteristics of a particular security? Should the Commission require credit rating agencies to disclose the number of credit analysts they employ and the average number of issues rated or otherwise followed by those analysts, as suggested by commenters?*

While Fitch is committed to recruiting well-qualified professionals and providing ongoing, high-quality training, we believe that the criteria related to analyst's qualifications and number of ratings per analyst are attempts to use subjective, difficult to articulate standards to assess whether an organization issues reliable ratings when objective statistics can be used to demonstrate the reliability of ratings. Once again, we believe this is an area where the recognition criteria can best serve the market by focusing on the demonstrable performance of an organization's ratings over time.

Credit rating organizations employ a multidisciplinary professional staff combining people with expertise in economics, finance, accounting, law, statistics, mathematics and computer science, as well as diverse industry and sector experience. Unlike accounting, law and engineering where there is a common set of educational and professional credentials, it is extremely difficult to identify particular terminal degrees,

professional qualifications or certifications needed to succeed in an organization as diverse as Fitch. Many of our employees are certified public accountants, chartered financial analysts and lawyers, while others have no professional designations. While many of our employees hold master degrees in business and related fields, our employees' educational attainment ranges from entry level employees with bachelor degrees in the arts or social sciences to employees with doctorates. For these reasons, it would be difficult to devise a standard set of qualifications.

As to the number of ratings per analyst, we agree with the view generally shared by the commenters to the Concept Release that the number of analysts and the number of issues per analyst are best left to the credit rating agencies. In simple terms, an analyst covering a smaller number of ratings should be more effective than a similarly skilled and trained analyst covering a larger number of ratings. Technology, the experience of the analyst, the number of published commentaries the analyst is expected to author, the number of analysts in the sector and the size, complexity and transparency of the sector covered by the analyst all lead to significant variation in the number of ratings per analyst from sector to sector within an organization. For these reasons, we believe that the average number of ratings per analyst can be misleading and of limited relevance to the overall reliability of an organization's ratings.

With respect to evaluating the background of analysts, Fitch agrees that it is appropriate for credit rating organizations to have policies in place to ensure that we do not hire people of compromised integrity and that credit rating organizations have procedures in place to evaluate the background of the people they hire. Fitch has such a policy in place as well as procedures to evaluate the background of our prospective employees.

Information Sources Used in the Ratings Process. *Should a credit rating agency be required to test in some way the integrity of information provided directly by issuers (both public and nonpublic) and through third party vendors? Are there other appropriate objective methods for determining whether a credit rating agency has reasonably tested the integrity of the information on which it bases its ratings?*

Fitch believes that it would be inappropriate to require that rating agencies test or verify the data supplied to us from issuers or any other source. Fitch does not audit or verify any information provided to us and we believe that our position is the same as other leading rating agencies. We have always made our position publicly known and we have disclosed our position in our ratings definitions, in our code of conduct, in several places on our web site and in the disclosures that appear on our publications.

We believe that the SEC's proposal with respect to the information sources used by the rating agencies is unsound, as it appears to seek to impose a diligence requirement on rating agencies either for purposes of creating a private right of action or for oversight purposes. Even putting aside the significant and in our view insurmountable issues of the constitutionality of such an approach under the First Amendment, rating agencies do

not now audit or verify the information on which they rely. To impose such a requirement would duplicate the work of the various professionals (auditors, lawyers, investment bankers and fiduciaries) upon whom the law places certain obligations of diligence and due care.

In addition, we firmly believe that existing antifraud remedies are sufficient to address rating agencies intentionally or recklessly making material misstatements of fact.

Contacts with Management. *In designing and implementing systematic procedures to ensure credible and reliable ratings, should a credit rating agency seeking to meet the definition of NRSRO address how and the extent to which it involves an issuer's senior management in the rating process? To meet the proposed NRSRO definition, should a credit rating agency's procedures require that the credit rating agency request an issuer's senior management to participate in the credit rating agency's rating process without incurring a fee?*

While access to nonpublic information and senior levels of management at an issuer is beneficial, a reliable opinion about the creditworthiness of an issuer can be formed based solely on public information in many jurisdictions and, in particular, in the United States. Typically, it is not the value of any particular piece of nonpublic information that is important to the rating process, but that access to such information and senior management can assist us in forming a qualitative judgment about a company's management and prospects. Even in cases where there is no direct involvement of a company's senior management in a rating, analysts often have the opportunity to hear from and, occasionally, question senior management through participation in open conference calls and at industry and trade conferences.

It also appears to Fitch that this proposed recognition criterion can be perceived as detracting from the value of ratings done solely on the basis of publicly available information without the involvement of the issuer, which we believe creates significant competitive issues. Since Moody's and S&P are so dominant, many issuers believe that they must cooperate with, and pay rating fees to, Moody's and S&P. In order to compete with Moody's and S&P, other rating agencies must build an investor following. Without an investor following, a rating agency is unlikely to get cooperation from issuers. To build a following among investors, a rating agency must demonstrate that it has the breadth of coverage investors perceive Moody's and S&P possess. Without adequate coverage, a rating agency cannot build a following with investors. Since issuers are significantly less likely to cooperate with a smaller rating agency, the only way that a smaller rating agency can increase coverage is to rate issuers and issues based on publicly available information. Since there is no evidence that ratings based on publicly available information are inferior to interactive ratings, we do not feel it is appropriate to undermine the credibility of ratings based on publicly available information and thereby harm competition.

Fitch does agree, however, that best practices dictate that a rating agency should encourage management at an issuer to participate in the rating process without regard to whether or not the issuer pays rating fees.

In 2001, Fitch introduced its Fitch Initiated Ratings program. There is no difference in the analytical process or criteria used for Fitch Initiated Ratings, although the level of management involvement varies. Procedures relative to the publication of the ratings are also the same and we contact the issuer prior to publishing a new rating or subsequent rating action in accordance with our regular practices. Fitch will only publish a Fitch Initiated Rating if we conclude that there is sufficient information available to us to allow us to express our opinion, and in all cases, such ratings are uncompensated and Fitch does not assess or seek fees for the analysis done in connection with these ratings. Fitch Initiated Ratings target high-profile market participants or issuers about which there is a discrepancy in market opinions not traditionally rated by Fitch. Ratings initiated under this program are identified as such in the original publication concerning the rating. We believe our program is well-designed to enhance our coverage of important issuers and issues while providing an issuer every opportunity to participate in the rating process without regard to the payment of rating fees.

Organizational Structure. *Would information on a credit rating agency's organizational structure be useful to users of ratings? If so, what information would be useful?*

We believe how we structure our business and what we do from a structural standpoint to mitigate potential conflicts are relevant to users of ratings. Fitch would be happy to disclose any information about our organizational structure that the SEC might reasonably request of us to the extent that we do not already publicly disclose it.

We believe that it is important that rating agencies separate rating services from affiliated businesses. Accordingly, Fitch has in place a firewall policy with respect to affiliated businesses and affiliated businesses within the Fitch Group are contained in entities that are both legally and operationally separate from the rating business. Our firewall policy is available on our free web site www.fitchratings.com under the heading *Code of Conduct*.

Conflicts of Interest. *What specific conflicts of interest should be addressed in a credit rating agency's procedures and how should they be addressed? Should a credit rating agency that engages in activities that present potential or actual conflicts of interest be excluded from the definition of NRSRO? Alternatively, is it sufficient for a credit rating agency to impose and implement safeguards to prevent potential conflicts of interest from affecting the quality and independence of its credit ratings? Are there other practices that raise concerns similar to those raised by conflicts of interest, for example, those referred to in footnote 93 regarding unsolicited ratings, that should be addressed in a credit rating agency's procedures?*

The most often cited potential conflict of interest that an NRSRO must manage is the fact that the current NRSROs derive a significant portion of their revenue from the ratings fees charged to issuers of rated securities. Fitch does not believe that the fact that issuers generally pay the rating agency's fees creates an actual conflict of interest, i.e., a conflict that impairs the objectivity of the rating agency's judgment about creditworthiness reflected in ratings. Rather, it is more appropriately classified as a potential conflict of interest, i.e., something that should be disclosed and managed to assure that it does not become an actual conflict. We believe the measures Fitch (and, on belief, the other agencies as well) has in place to manage the potential conflict adequately prevent an actual conflict of interest from arising.

The practice of charging a fee to the issuer for the analysis done in connection with ratings dates back to the late 1960s. It is widely known by investors, who are the ultimate consumers of the rating agency product.

By way of context, Fitch's revenue comes from two principal sources: the sale of subscriptions for our research and fees paid by issuers for the analysis we conduct with respect to ratings. In this we are similar to other members of the media which derive revenue from subscribers and advertisers that include companies they cover. Like other journalists, we emphasize independence and objectivity because our independent, unbiased coverage of the companies and securities we rate is important to our research subscribers and the marketplace in general.

Fitch goes to great efforts to assure that our receipt of fees from issuers does not affect our editorial independence. We have a separate sales and marketing team that works independently of the analysts that cover the issuers. We believe that rating agencies must have in place policies and procedures to manage the potential conflict presented by the issuer pays model. Fitch has in place a written policy concerning fee discussions and negotiations that is set forth in our code of conduct, which is available on our free web site www.fitchratings.com under the heading *Code of Conduct*.

We also manage the potential conflict through our compensation philosophy. The revenue Fitch receives from issuers covered by an analyst is not a factor in that analyst's compensation. Instead, an analyst's performance, such as the quality and timeliness of research, and Fitch's overall financial performance determine an analyst's compensation. Similarly, an analyst's performance relative to his or her peers and the overall profitability of Fitch determine an analyst's bonus. The financial performance of analysts' sectors or groups do not factor into their compensation. Our policy concerning analyst compensation is also set forth in our code of conduct.

Fitch does not have an advisory relationship with the companies it rates. It always maintains full independence. Unlike an investment bank, our fees are not based on the success of a bond issue or tied to the level of the rating issued. The fee charged an issuer does not go up or down depending on the ratings assigned or the successful completion of a bond offering.

Our fee is determined in advance of the determination of the rating and we do not charge a fee for a rating unless the issuer agrees in advance to pay the fee. While we do assign ratings on an unsolicited basis, we do not send bills for unsolicited ratings. Any issuer may terminate its fee arrangement with Fitch without fear that its rating will be lowered, although we do reserve the right to withdraw a rating for which we are not paid if there is insufficient investor interest in the rating to justify continuing effort to maintain it.

Fitch believes that the disclosure of the arrangement by which an issuer pays fees to Fitch in connection with Fitch's ratings of the issuer is appropriate. Accordingly, Fitch currently discloses that it receives fees from issuers in connection with its ratings as well as the range of fees paid. This has been our practice for sometime.

Rating agencies must also guard against subscribers having preferential access to information about a rating action before it is available to the general public. Fitch takes great efforts to ensure that all members of the public have access to our public ratings and may discuss these ratings with our analysts, whether or not those interested parties are subscribers.

To guard against preferential access to ratings information, Fitch believes all public ratings and rating actions should be widely disseminated through web sites and, preferably, international wire services, as well. Except for prior notification to the issuer of a rating or rating action, Fitch never selectively discloses ratings and rating actions to any subscriber or any other party. As described above, Fitch's public ratings and related publications, including those detailing rating actions, are widely available through our public web sites and wire services free-of-charge and there are no prior communications of rating actions to subscribers.

Rating agencies also must thoroughly separate affiliates from the ratings business. There must be appropriate safeguards in place to prohibit the marketing by affiliates of non-rating products and services to issuers from influencing ratings in any way. Fitch has adopted a formal firewall policy that addresses a number of issues relating to the products and services offered by affiliates of Fitch Ratings to issuers and others. As part of that policy, we restrict ratings analysts from marketing or recommending any affiliate's products or services or to suggest or create the inference that the use of, or failure to use, any such products will affect the issuers' ratings. Our firewall policy is available on our free web site www.fitchratings.com under the heading *Code of Conduct*.

Fitch also agrees that rating agencies must have in place policies and procedures to assure that so-called unsolicited ratings are issued in a fair and balanced manner. We have such policies and procedures in place. Our policies and procedures relating to Fitch Initiated Ratings are described above under the heading *Contacts with Management*.

A final area of potential conflict where rating agencies ought to maintain strict policies and procedures is the management of the financial and personal interests of its analysts. While Fitch acknowledges that full disclosure of financial and personal interests by analysts can be an appropriate way to manage the conflicts presented by these interests, Fitch has chosen to prohibit its analysts from being involved in any rating action in which they have a financial or personal interest. Accordingly, Fitch prohibits its analysts from participating in any rating action if the analyst, or any member of the analyst's immediate family, own any security in the issuer. Our policy relating to employee conflicts of interest is available on our free web site www.fitchratings.com under the heading *Code of Conduct*.

In conclusion, we believe it is possible for rating agencies to manage the potential conflicts that they face, but rating agencies must have robust policies and procedures in place to manage these conflicts and the infrastructure in place to monitor and enforce those policies and procedures.

Misuse of Information. *As discussed above, to meet the third component of the NRSRO definition, should a credit rating agency demonstrate that it has systematic procedures designed to prevent the misuse of material nonpublic information? What types of procedures are reasonable for a credit rating agency to protect material nonpublic information? Should a credit rating agency have personnel dedicated specifically to verifying employees' compliance with such procedures? Should persons performing this function provide ongoing training of employees and act as a resource to answer questions as they arise? Should the procedures provide for a system by which employees can report violations of the controls in place to protect nonpublic information or other inappropriate activities? The Commission encourages commenters to provide information on appropriate procedures for receiving and adequately securing material nonpublic information.*

We believe that it is imperative that rating agencies have in place policies and procedures designed to prevent the misuse of nonpublic information. We also agree that rating agencies ought to have a compliance function, to provide specific training to its employees in the compliance area and to provide a means by which employees can report violations of policies and procedures without fear of reprisal. Fitch has in place a compliance function, offers regular training on compliance issues and provides employees with a means by which they can report compliance breaches that we are in the process of making totally anonymous at the employee's option. Our policies on confidentiality and compliance are set forth in our code of conduct and related policies, all of which are available on our free web site www.fitchratings.com under the heading *Code of Conduct*.

Financial Resources. *Should a credit rating agency make its audited financial statements readily available to users of securities ratings in order for such users to assess whether a credit rating agency has sufficient financial resources to satisfy the third component? What other types of financial information could a credit rating agency make available to users of securities ratings for purposes of the third component? Should a credit rating agency provide users of securities ratings with information relating to the percentage of revenue it receives from particular issuers or subscribers as compared to the credit rating agency's total revenues? Should a credit rating agency establish procedures to limit the percentage of revenues it receives from a single issuer or subscriber? How else can it be determined that a credit rating agency is financially independent of both subscribers and rated issuers?*

Fitch is a subsidiary of Fimalac, a French public company, and as such our financial results are publicly reported in Fimalac's annual and periodic reports, which are published in English, as well as French. There is already a hyperlink from Fitch's web site to Fimalac's web site, on which you can find Fimalac's financial reports. We believe that the current public reports of our parent company allow users of our ratings to assess the sufficiency of our financial resources. Accordingly, we do not object to a requirement with which we are already complying.

We note, however, that we believe that certain of the existing NRSROs are private, family-owned companies. They may not wish to publish their financial statements. We also believe that a requirement that an NRSRO publicly disclose their financial statements could put a chilling effect on other private companies' desire to seek recognition, which could create an unintended barrier to entry for future NRSRO candidates.

As noted above, Fitch discloses that it receives fees from issuers in connection with our ratings as well as the range of fees paid. While disclosing the percentage of total revenue that an issuer's fees represent in connection with a rating or the more extensive disclosure of the actual amounts paid by an issuer to Fitch would provide the users of ratings with more information, such disclosure would create competitive issues for Fitch.

Disclosure of the percentage of total revenue that an issuer's fees represent together with the existing public disclosure of our total revenue would allow our competitors, as well as users of our ratings, to know our revenue by client. We do not believe that it is necessary or appropriate to provide disclosure of the percentage of total revenue that an issuer's fees represent or to provide more extensive financial disclosure. We believe that the specific fees we charge and the revenue we derive from other sources are proprietary and if known by our major competitors, both of whom possess dominant market power in certain markets, will cause us competitive injury. We believe other existing NRSROs and potential NRSRO candidates would be caused similar competitive injury if required to disclose this information. We believe that the far more important disclosure is that the fee arrangement exists and the range of those fees.

Standardized Rating Symbols. *Should the Commission continue to rely on existing market-based standards for rating symbols and rating categories, or should specific standards be incorporated into the definition of the term "NRSRO"? If the latter, what standards are appropriate?*

NRSROs should be permitted to use the symbols and rating definitions they believe are most appropriate so long as they publicly disclose the meaning of the symbols, the related rating definitions and, most importantly, statistical studies that allow the users of the ratings to understand how the ratings perform over time.

It should be noted that Fitch does not believe that a criteria for recognition should be adherence to generally accepted industry standards. In fact, such industry standards do not exist in the case of credit rating agencies and we believe that it would be detrimental to introduce them. Ratings are opinions, and as such ratings are based on differing criteria, qualitative and quantitative, in each agency. The market benefits from this diversity of opinion and demands it. Requiring that a rating agency abide by strict standards would create a situation in which each agency would produce the same result on each credit, and there would be neither need for competing agencies nor any benefit from competing agencies. In addition, if every rating agency followed the same criteria, this would likely foster pro-cyclicality in ratings, which could lead to risk being underestimated in booms and overestimated in recessions.

Other Issues

Statistical Models. *Should a credit rating agency that relies solely or primarily on statistical models be able to meet the proposed NRSRO definition? If so, under what circumstances? The Commission also requests comment on guidelines for assessing the relevance and reliability of statistical models used in the ratings process.*

This is a question best answered by the users of ratings.

Provisional NRSRO Status. *Does the Commission's proposed NRSRO definition and approach for promoting competition address the competitive concerns raised by commenters' supporting provisional NRSROs?*

Yes.

Addressing Barriers to Entry and Anticompetitive Conduct

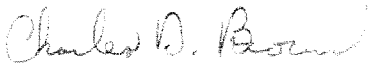
Fitch firmly believes in the power of competition. We also believe that there is always a demand for insightful, independent credit research.

As noted above, the NRSRO system is often cited as a barrier to entry for new rating organizations. Commenters also have expressed concerns that certain practices of rating agencies may be anticompetitive or constitute unfair practices.

If the SEC wishes to further address barriers to entry in the ratings market, ensure competition in the ratings market and address anticompetitive conduct, the Commissioners should enact rules prohibiting anticompetitive conduct by NRSROs and preclude NRSROs from engaging in conduct designed to preserve market share. Fitch believes that this is an area which would benefit from SEC regulation to protect NRSRO competition. Fitch believes that any NRSRO found to be using anticompetitive practices or unfair business practices should have their NRSRO designation revoked.

Please call me at (212) 908-0626 with any questions that you might have on our comments or to discuss this matter further at your convenience.

Very truly yours,



Charles D. Brown
General Counsel

INVESTMENT COMPANY INSTITUTE

PAUL SCHOTT STEVENS
PRESIDENT

June 29, 2005

The Honorable Richard H. Baker
Chairman
Subcommittee on Capital Markets,
Insurance and Government
Sponsored Enterprises
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Paul Kanjorski
Ranking Member
Subcommittee on Capital Markets,
Insurance and Government
Sponsored Enterprises
U.S. House of Representatives
Washington, D.C. 20515

Dear Chairman Baker and Ranking Member Kanjorski:

The Investment Company Institute* commends the House Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises for holding a June 29 hearing entitled "Legislative Solutions for the Rating Agency Duopoly." Creating an efficient credit rating process is critical to investors and to the U.S. securities markets as a whole. Accordingly, we support the Subcommittee's continued examination of these issues. While we have some technical concerns with H.R. 2990, the "Credit Rating Agency Duopoly Relief Act of 2005" recently introduced by Rep. Michael G. Fitzpatrick (R-PA), we support its goals – the promotion of competition among credit rating agencies and the protection of investors. We therefore look forward to working with the committee to ensure passage of legislation that achieves these goals.

The Institute and its members have a longstanding interest in ensuring appropriate oversight of credit rating agencies given the significant role that they play in the U.S. securities markets. The ratings published by credit rating agencies play an important part in the investment decisions of institutional investors, including mutual funds, and the Securities and Exchange Commission and other regulatory agencies rely upon these ratings as assessments of investment risk for various regulatory purposes. Given the importance of these credit ratings, we believe that maintaining the integrity and quality of the credit ratings process is essential to investor confidence and to the proper functioning of our capital markets.

Please feel free to contact me at 202-326-5901 if you have questions or if I can assist you with this or any matter.

With kindest regards.

Sincerely,

Paul Stevens

cc. The Honorable Michael Oxley
The Honorable Barney Frank

* ICI members include 8,541 open-end investment companies (mutual funds), 653 closed-end investment companies, 143 exchange-traded funds, and 5 sponsors of unit investment trusts. Mutual fund members of the ICI have total assets of approximately $7.838 trillion (representing more than 95 percent of all assets of US mutual funds); these funds serve approximately 87.7 million shareholders in more than 51.2 million households.

1401 H STREET, NW ■ WASHINGTON, DC 20005-2148 ■ 202/326-5901 ■ FAX 202/326-5806 ■ EMAIL: paul.stevens@ici.org

THE CHAIRMAN

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

June 6, 2005

The Honorable Paul E. Kanjorski
Ranking Member
Subcommittee on Capital Markets, Insurance
and Government Sponsored Enterprises
U.S. House of Representatives
2188 Rayburn House Office Building
Washington, DC 20515

Dear Congressman Kanjorski:

I write in response to your April 12, 2005 letter, in which you request technical assistance in providing greater detail about the statutory authority the Commission may need if Congress determines that it is appropriate to create a comprehensive oversight regime for credit rating agencies.

In response to your request, I am enclosing an outline prepared by Commission staff that sets forth key authority issues that potentially would need to be addressed if Congress were to enact a legislative framework for the oversight and regulation of credit rating agencies. As you know, the Commission has not taken a formal position on the need for legislation.

Please let me know if we may be of further assistance.

Sincerely,

William H. Donaldson

Enclosure

STAFF OUTLINE OF KEY ISSUES FOR A LEGISLATIVE FRAMEWORK FOR THE OVERSIGHT AND REGULATION OF CREDIT RATING AGENCIES

I. Overview of Legislation. Credit rating agencies play an important role in the securities markets, but Congress has not expressly provided for any formal regulation of their activities. Longstanding concerns regarding the lack of a regulatory framework for credit rating agencies were heightened during the financial collapse of several large public companies. The purpose of any proposed legislation would be to provide the legal authority necessary to establish an effective oversight and examination regime to assure that credit rating agencies operate in a transparent manner, with adequate policies and procedures designed to ensure the credibility and reliability of the rating process, and full disclosure of, or restrictions on, conflicts of interest and anti-competitive practices.

To achieve these objectives, legislation could require nationally recognized statistical rating organizations ("NRSROs") and certain other credit rating agencies to register and become regulated by the Securities and Exchange Commission. The Commission, which has for several decades evaluated credit rating agencies through a staff no-action process, could be authorized to adopt substantive rules governing rating agency activities and would have examination, inspection, and enforcement authority. The Commission would *not* be expected to regulate the substantive decision-making of rating agencies or the content of the ratings they assign, issues that can best be addressed through the operation of a free and competitive marketplace.

II. Registration Requirements. Registration with the Commission typically is a key element in the Commission's oversight and regulation of securities market participants. Accordingly, a legislative approach could require certain credit rating agencies to register with the Commission. The Commission historically has been concerned primarily with those credit rating agencies that have the greatest market impact – those who by widespread dissemination of their ratings have become "nationally recognized." Accordingly, the legislation could require any credit rating agency that is designated as an NRSRO by the Commission (on its own motion or by application) to register with the Commission. For this purpose, an NRSRO could be defined, as recently proposed by the Commission, as a credit rating agency (i) that issues publicly available credit ratings that are current assessments of the creditworthiness of obligors with respect to specific securities or money market instruments and (ii) that is generally accepted in the financial markets as an issuer of credible and reliable securities ratings, including ratings for a particular industry or geographic segment, by the predominant users of securities ratings in the United States. In addition, the Commission could be given rulemaking authority to require a credit rating agency that does not meet the definition of NRSRO to register with the Commission and become subject to regulation, if the activities of the credit rating agency have a significant impact on the securities markets or pose a risk to investors, or otherwise as may be necessary or appropriate in the public interest.

III. Rulemaking Authority. Consistent with the Commission's statutory authority over other regulated entities, any legislation proposed could provide the Commission with broad authority to adopt rules in each of the key areas of concern. This approach may be preferable to trying to embed rigid prohibitions and requirements in statutory

language that could not be easily amended. Thus, the legislation could provide the Commission with authority to adopt rules in the following areas with respect to registered credit rating agencies:

- *Conflict of Interests.* The Commission could be given authority to adopt rules prohibiting or requiring the disclosure of conflicts of interest, such as conflicts arising from the payment scheme for credit ratings, financial arrangements with rated issuers, and relationships between the credit rating agency and the underwriter for securities issued by the rated issuer.

- *Competitive Issues.* The Commission could be given authority to adopt rules prohibiting or requiring the disclosure of potentially anticompetitive practices, such as tying arrangements, solicitation of payment for unsolicited ratings, and threats to modify ratings based on payment for related services.

- *Systematic Procedures Designed to Ensure Credible and Reliable Ratings.* To ensure the integrity of the ratings process, the legislation could require a credit rating agency registered with the Commission to adopt and implement systematic procedures designed to ensure credible and reliable ratings, in accordance with Commission rules. The legislation should not, however, regulate the substantive decision-making of rating agencies or the content of the ratings they assign.

- *Market Assessments of the Quality of Credit Ratings.* The legislation could authorize the Commission to adopt rules to define and establish minimum standards for determining whether a credit rating agency is generally accepted in the financial markets as an issuer of credible and reliable securities ratings. Market acceptance historically has been a crucial element in assessing whether a credit rating agency should qualify as an NRSRO or otherwise should be relied upon for regulatory purposes.

- *Misuse of Nonpublic Information.* The legislation could require a registered credit rating agency to adopt and implement written compliance policies and procedures designed to ensure compliance with the federal securities laws, manage conflicts of interest, and prevent the misuse of nonpublic information. In this regard, the Commission could be given authority to adopt rules requiring specific policies and procedures.

In addition to the specific rulemaking authority outlined above, the Commission could be given general rulemaking authority to carry out the purposes of the legislation and to classify persons, applications, reports, and other matters and prescribe greater, lesser, or different requirements for different classes. This general authority would permit the Commission to tailor its rules as may be appropriate in light of continuing cooperation with international regulatory bodies.

IV. Books and Records, Reporting, and Examinations. To the extent the Commission is granted rulemaking authority in the areas described above, it would be essential for the Commission to be able to enforce the substantive regulations through examination and

inspection tools, presumably modeled on the Securities Exchange Act of 1934 ("Exchange Act"). In this regard, the legislation could give the Commission authority to require a registered credit rating agency to make and keep such records, and make and disseminate such reports, as the Commission, by rule, prescribes as necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Exchange Act. The Commission also could be given the authority to examine all records of a registered credit rating agency.

- *Non-Waiver of Privileges*. For an examination program to be effective, it is critical that the legislation permit a registered credit rating agency, as well as other regulated entities, to produce or disclose to the Commission any document or information that is subject to any Federal or State law privilege, or to the protection provided by the work product doctrine, without waiving the privilege or protection as to any other person. This provision would address a significant policy concern of regulated entities and greatly assist the Commission's examination program.

V. Enforcement Authority. Effective implementation of any regulatory framework would require that the Commission be granted administrative and civil enforcement authority comparable to that applicable to other entities registered under the Exchange Act. This would enable the Commission to bring an administrative action or civil injunctive action to enforce compliance by a registered credit rating agency, or any person associated with such credit rating agency, with the provisions of the Exchange Act and the rules thereunder, including those provisions specifically applicable to registered credit rating agencies.

VI. Statutory Framework. The legislation could be incorporated into the Exchange Act. If so, the general provisions in that Act, including those relating to investigations, enforcement procedures, exemptive authority, and general rulemaking authority, would apply to the regulation of registered credit rating agencies, with such conforming changes as may be appropriate.

1399 New York Avenue, NW
Washington, DC 20005-4711
Telephone 202.434.8400
Fax 202.434.8456
www.bondmarkets.com

360 Madison Avenue
New York, NY 10017-7111
Telephone 646.637.9200
Fax 646.637.9126

St. Michael's House
1 George Yard
London EC3V 9DH
Telephone 44.20.77 43 93 00
Fax 44.20.77 43 93 01

June 29, 2005

Statement of
The Bond Market Association

Testimony Submitted to
The Committee on Financial Services
Subcommittee on Capital Markets, Insurance and Government-Sponsored Enterprises
United States House of Representatives

Hearing on Legislative Solutions for the Rating Agency Duopoly

The Bond Market Association appreciates the opportunity to provide this statement for the record on competition in the credit rating industry. As you know, the Association represents securities firms and banks that underwrite, distribute and trade debt securities in the United States and internationally—a global market estimated at $44 trillion today. The Association speaks for the bond industry worldwide, advocating its positions and representing its interests in New York, Washington, London and elsewhere. The Association also works with bond issuers—companies, governments and others who borrow in the capital markets—and investors in fixed-income products from across the globe.

Our members account for approximately 95 percent of U.S. municipal bond underwriting and trading activity, all primary dealers in U.S. government securities as recognized by the Federal Reserve Bank of New York, and all major dealers in U.S. agency securities, mortgage- and asset-backed securities and corporate bonds, as well as money market and funding instruments. In recent years, the Association has sponsored both the American and the European Securitization Forums. These are affiliated organizations that focus on the rapidly growing securitization markets in the United States and Europe. Another Association-sponsored organization, the Asset Managers Forum, brings together institutions that are active in the bond market as investors to address major operational, accounting, public policy and market practice initiatives. The comments here reflect the collective views of the Association and our forums.

We welcome the opportunity to present this statement on the role of credit rating agencies in the capital markets and competition in the credit rating industry. We are also pleased to offer our comments on the Credit Rating Agency Duopoly Act (H.R. 2990), legislation that is clearly intended to change the competitive landscape in the

credit rating industry. For several reasons which we articulate below, however, as currently drafted, H.R. 2990 could ultimately dilute the important role credit rating agencies play in the capital markets.

The past 15 years have seen dramatic growth in the number of issuers and the range and complexity of fixed-income securities. The importance of credit ratings to investors and other securities market participants has increased proportionally. The role of rating agencies is critical to the efficient functioning of the fixed-income markets. It is both important and useful for this committee to focus on an industry that plays such a vital role in the capital markets.

Credit Rating Agencies and the Fixed-Income Markets

All investments involve risk. One important type of risk associated with certain bonds and other fixed-income investments is credit risk—the chance that a bond will default, or the issuer will fail to make all interest and principal payments under the bond's terms. A credit rating is essentially an opinion offered by a rating agency on the credit risk of a bond. An investor can determine objective factors such as a security's coupon, maturity, call features and covenants from the issuer's public disclosures. Analysis of an issuer's credit quality, however, involves individual judgments about a variety of complex financial and other information. A credit rating is a valuable complement to an investor's own credit analysis precisely because it is both expert and independent. Credit ratings also guide the market's pricing decisions. Bonds with lower ratings are viewed as riskier than higher-rated bonds by investors who demand a yield premium as compensation for this risk. Conversely, higher-rated bonds will offer a relatively lower yield as a reflection of their stronger credit standing. In addition, ratings play an important role in market regulation.

To better appreciate the relationship between ratings and yields it is important to consider how the market prices bonds. With few exceptions, prices for fixed-income products are quoted as a number of basis points[1] over a benchmark such as U.S. Treasury securities of a comparable maturity, the London Interbank Offered Rate (LIBOR), the rate on interest rate swaps of comparable duration or some other benchmark that represents an investment perceived to be free of credit risk. The amount that the return on a given investment exceeds the return on the benchmark—a bond's "credit spread"—represents the risk premium investors receive as a result of the degree of risk, principally credit risk, the investment carries. Higher rated bonds have a smaller spread than lower rated bonds of the same maturity.

Why the Quality of the Rating Process Matters

Credit ratings have numerous market and regulatory implications for many market participants. Ratings determine borrowing costs for issuers of securities. They determine permitted investments for many types of investors, including insurance companies, mutual funds and banks. They also are used in determining the regulatory capital charges for different types of financial institutions, including broker-dealers

[1] One basis point equals 1/100th of a percentage point.

and banks. All of these uses for ratings have important regulatory implications. It is important that issuers, investors and financial institutions that use credit ratings for such regulatory purposes use only ratings issued by credit rating agencies that have demonstrated the ability to issue credible and reliable ratings. Otherwise, credit will not be properly allocated and priced, regulated investors with similar investment parameters will be able to invest in more risky securities without violating their investment restrictions, and banks and broker-dealers with similar risk profiles will maintain different capital levels. For this reason The Bond Market Association supports the NRSRO designation.

It is common for some institutional investors to have in-house rules limiting investment in any fixed-income security that does not have at least an investment grade rating.[2] Similarly, most states have laws dictating the permitted investments of insurance companies on the basis of credit rating. Some states require two ratings. The National Association of Insurance Commissioners (NAIC) maintains a list of rating agencies whose ratings are acceptable for this purpose.

Broker-dealers use credit ratings to supplement proprietary credit analysis. They also advise issuers of the effect of ratings on the cost of capital. Credit ratings, of course, are also important to investors with whom broker-dealers interact in the market place. In September 2004, the Corporate Debt Market Panel sponsored by the National Association of Securities Dealers (NASD) released a report recommending the disclosure of credit ratings immediately prior to an investor's decision to buy or sell a bond as well as upon confirmation of a trade.[3] This was followed in April 2005 by a proposal to require disclosure of credit ratings on retail bond confirmations.[4]

Credit ratings are also used in the regulation of broker-dealers and different types of institutional investors. One notable example is the Securities and Exchange Commission's net capital rule, which requires broker-dealers to maintain specified minimum capital levels to support their assets or customer liabilities. Since 1975, the net capital rule has imposed different capital charges for assets depending upon whether (and at what level) the assets are rated by what the SEC defined as a "Nationally Recognized Statistical Rating Organization" or NRSRO. Higher-rated securities receive a lower capital charge than lower-rated securities. Similarly, SEC-registered money market funds are permitted to invest in short-term debt securities

---

[2] An investment grade rating is defined as at least a BBB rating offered by Fitch Ratings or Standard and Poor's or a Baa rating offered by Moody's. A sub-investment grade rating, also known as high-yield or speculative grade, is defined as any rating below investment grade. Some institutional investors purchase a mix of investment grade and sub-investment grade bonds and some specialize in sub-investment grade exclusively.

[3] See Report of the Corporate Debt Market Panel (September 2004), available at http://www.nasd.com/web/groups/reg_systems/documents/regulatory_systems/nasdw_011445.pdf.

[4] See NASD Notice to Members 05-21 (March 2005)(Proposed Rule to Enhance Confirmation Disclosure in Corporate Debt Securities Transactions), available at http://www.nasd.com/web/groups/rules_regs/documents/notice_to_members/nasdw_013616.pdf.

that receive one of the two highest NRSRO ratings. Investment grade ratings can also provide an issuer with the option of short-form SEC registration in some cases.

The Bank for International Settlement's Committee on Banking Regulation stipulates the use of credit ratings in assessing the capital charges for banks under the new Basel Capital Accord, Basel II. Basel II articulates a set of criteria a firm must satisfy in order to qualify as an External Credit Assessment Institution (ECAI) which allow its ratings to be used in this calculation.[5]

The NRSRO designation serves a unique purpose in SEC regulations for which a substitute is either not available or not practical. Using credit spreads or internal credit ratings as alternatives to NRSRO ratings for computing net capital requirements is possible, for example, but would add significant costs. In addition, in the case of internal ratings or ratings issued by rating agencies that have not been determined to produce credible, reliable ratings could result in the non-uniform treatment of the same assets by different firms.

The U.S. and European Regulatory Proposals

Recently, regulators in the U.S. and Europe have stepped up their focus on rating agencies and raised the prospect of changes in the current approach to regulatory oversight. In the U.S., the SEC recently published for comment proposed Rule 3b-10, which for the first time defines the term "nationally recognized statistical rating organization", sets forth some interpretations of the definition, and provides more clarity to the process by which a particular rating agency may apply for a no-action letter confirming that regulated entities may use its ratings as being provided by an NRSRO.[6] The Bond Market Association generally approves of the SEC's proposal and has provided technical comments (attached) on a number of the questions it poses.[7]

In response to queries from Members of Congress, the Commission has stated that it does not have the authority to regulate the activities of rating agencies.[8]

---

[5] *International Convergence of Capital Measurement and Capital Standards*, Basel Committee on Banking Supervision, June 2004. Page 35. The six criteria include objectivity, independence, transparency, disclosure, resources and credibility.

[6] See Definition of Nationally Recognized Statistical Rating Organization, Release No. 33-8570, 70 Fed. Register 21306 (April 25, 2005).

[7] See Comment Letter, dated June 9, 2005 from Marjorie E. Gross, SVP of The Bond Market Association, and Frank A. Fernandez, Senior Vice President of the Securities Industry Association, available at http://www.sec.gov/rules/proposed/s70405/bondmarket-sia060905.pdf.

[8] See, e.g. Testimony of Annette L. Nazareth, Director, Division of Market Regulation, U.S. Securities and Exchange Commission, before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Committee on Financial Services, April 12, 2005.

In 2004, the International Organization of Securities Commissions (IOSCO), of which the SEC is a member, proposed principles (called "fundamentals") for codes of conduct for rating agencies.[9] The code principles are results-based rather than prescriptive. Publication of the IOSCO principles was followed by a request from the European Commission for public input on how the code of conduct principles should be implemented and a consultative paper issued by the Committee of European Securities Regulators (CESR) suggesting a range of regulatory approaches based on the IOSCO principles. In our comments to CESR, the Association stressed the need to avoid the creation of a detailed set of regulatory requirements after the initial certification.

TBMA Response to U.S. and European Regulatory Proposals

The Association's view on the regulation of credit rating agencies is simple:

- We believe that the criteria adopted by regulators for approving NRSRO's or ECAI's should be flexible enough to allow increased competition between a larger number of entities, while ensuring that designated rating agencies have the expertise to produce accurate ratings. In the U.S., this means eliminating the current requirement that a rating agency be widely recognized, rather than accepted in a defined sector of the market.

- We believe credit rating agencies should have policies and procedures to ensure the independence of the credit rating process. Some conflicts of interest should be prohibited. For example, rating agencies should have policies and procedures to prohibit the rating agency and analysts who rate the securities of particular companies from having an interest in the securities of such companies. Rating agencies should also have a policy that analyst compensation may not be related to the amount of revenue the rating agency derives from issuers that the analyst rates. However, many potential conflicts can be managed with disclosure and carefully crafted and enforced policies and procedures, and the regulators must be sensitive to the benefits of certain relationships that create potential conflicts of interest, including the funding sources and ancillary businesses of the rating agency.

- We believe credit rating agencies should publish their rating methodologies for various types of securities, so that both issuers and users will understand the agencies' requirements and standards, and so that different rating analysts in the same agency will produce consistent ratings.

- We believe rating agencies should make public, free of charge, ratings that are required by the rules of the SEC or self-regulatory organizations or used for regulatory purposes such as calculation of regulatory capital, and that rating agencies should have clear policies regarding permitted free use of their

[9]See the Technical Committee of the International Organization of Securities Commissions, Code of Conduct Fundamentals for Credit Ratings Agencies (December 2004), available at http://www.iosco.org/pubdocs/pdf/IOSCOPD180.pdf.

ratings and uses that constitute commercial use of the rating agency's intellectual property rights for which the rating agency may justifiably impose licensing fees.

- We do not believe that regulation of the credit rating process is necessary or desirable, since government regulation would tend to result in less diversity of opinion and would be less responsive to new product developments. Nevertheless, we do believe that to be designated an NRSRO, a rating agency should not use solely quantitative models and should request that an issuer's senior management participate in the rating process free of charge. There is substantial volatility in ratings based solely on quantitative models, and such ratings often give false positive results regarding credit problems. This causes us to conclude that ratings based solely on such models are not "credible, reliable" ratings.

- We believe issuers should be given an opportunity to correct factual misstatements in rating agency reports, but not to appeal rating designations outside the rating agency.

- We believe rating agencies should publish information on the historical accuracy of their rating assessments.

As the capital markets develop and mature globally, the need for a measured approach by regulators toward the conduct of rating agencies grows in importance. The Association does support those actions by regulators—such as modifying the criteria for NRSRO designation—that we believe will help enhance competition among rating agencies. We do not support steps that would limit the independence of rating agencies to determine their opinions of the creditworthiness of issuers. Furthermore, we do not support steps that would undermine the credibility and reliability of ratings.

The Association's position on the regulatory proposals dealing with the credit rating process in the U.S. and Europe is centered on the fundamental issues of competition and market conduct.

Competition

Some observers have questioned whether the credit rating industry is as competitive as it should or could be and have suggested that inappropriate barriers to entry exist. In the U.S., the nature of the NRSRO designation is often brought up as a factor in this debate. The Association supports the retention of this designation. We have also called for greater clarity in the SEC's approval policy and the elimination of the requirement that a rating agency be "widely accepted" in order to gain the designation. The Association certainly welcomes additional entrants to the marketplace from any part of the globe. Increasing competition among qualified rating agencies could only benefit issuers, investors and the market generally.

The SEC's proposed Rule 3b-10 does a number of things that should help to increase

competition in the market for credit rating agencies. First, the increased transparency that will result from the adoption of the SEC's proposed Rule 3b-10 will aid public understanding of the process and improve the ability of other rating agencies to gain the NRSRO designation leading to enhanced competition in the industry. Rule 3b-10 specifically states that the SEC's test for "generally accepted in the financial markets as an issuer of credible and reliable ratings" includes acceptance for ratings in a particular industry or geographic segment. This will make it easier for new rating agencies to overcome barriers to entry by limiting the scope of their business to a particular industry or geographical area. Niche credit raters—after gaining experience and market acceptance—may then expand to cover a broader range of industries and securities.

At present, the SEC primarily considers whether an agency is "widely accepted" when deciding whether to grant NRSRO status. Proposed Rule 3b-10 characterizes the standard as being "generally accepted in the financial markets as an issuer of credible and reliable ratings ... by the predominant users of securities ratings." We understand that this standard has been criticized as creating a "Catch 22": a firm may have difficultly in being recognized as an issuer of credible and reliable ratings by the predominant users unless the SEC recognizes it by granting NRSRO status. The SEC's definition of NRSRO, however, defers to the market to identify the issuers of credible, reliable ratings, rather than assigning responsibility to the SEC to determine those ratings that are credible and reliable. Given the important regulatory uses of ratings, we believe that this "market acceptance" standard, although a high one, is warranted, and we urge Congress not to substitute its own judgment for the SEC's or the market's.

In Europe, CESR has listed barriers to entry that exist in the credit rating field and asked how regulators should address them. CESR recognized that much of the value the market assigns to credit ratings is based on reputation and track record, something new entrants necessarily lack. This dynamic, however, is not unique to the rating industry. CESR itself has described the barriers as "natural," and concluded that the barriers had not created a market failure or a condition in which a segment of issuers goes without service.

Rules of Conduct

The day-to-day operations of rating agencies should never be controlled by regulation. Specific rating methodologies and standards of due diligence should not be mandated by regulators. It is true that rating agencies in general tend to approach the rating process in similar ways – *e.g.* they group rating analysts by market, such as corporate, asset-backed or municipal bonds, and also industry or sector, such as financial services or transportation, and they make rating decisions by committee. As part of the process of gathering information, rating agency personnel attempt to maintain regular contact with issuers and rely on regulatory filings, news and industry reports. They also make use of nonpublic information, such as proprietary business

forecasts.[10] However, it is important that no regulator mandate a particular methodology, as long as the rating agency can demonstrate that its own methodology produces credible and reliable ratings.

Similarly, while conflicts of interest between rating agencies, issuers and subscribers may exist, it would not be appropriate for regulators to prescribe specific methods for dealing with the issue. A more favorable approach—and one the IOSCO code now requires—would be for rating agencies to adopt policies and procedures to address and disclose potential conflicts of interest, such as issuer and subscriber influence and the potential misuse of public information.

The Credit Rating Agency Duopoly Relief Act

The recently introduced Credit Rating Agency Duopoly Relief Act, is clearly an attempt to eliminate barriers to competition in the credit rating industry. In pursuing the worthwhile goal of changing the competitive landscape, however, H.R. 2990 reflects some inaccurate assumptions about the industry and could ultimately dilute the important role credit rating agencies play in the capital markets. The following are our specific concerns with H.R. 2990:

Competition

- The question of competition is an important one. As noted above, the SEC did not create the barriers to entry for new participants. The industry is difficult to penetrate for new firms because much of the value the market assigns to particular credit ratings is based on reputation and track record, something new entrants necessarily lack. Unfortunately, in attempting to increase competition, H.R. 2990 makes it more likely that the quality of credit ratings will become less uniform.

Universal Registration

- H.R. 2990 creates a new category of "statistical rating organization," which is an entity whose primary business for the last three years has been the issuance of publicly available ratings. It also requires these rating agencies to register with the SEC. This is problematic for at least three reasons:
    - It is not clear why universal registration is desirable if a rating agency produces ratings on companies or securities that are not used for regulatory purposes.
    - An organization whose primary business is the issuance of publicly available ratings that are used for regulatory purposes but that has been in existence less than three years would not be required to register. The reason for this exclusion is not evident.

[10] This information is provided under a promise of confidentiality and under an exemption from the Securities and Exchange Commission's (SEC) Regulation FD. The Association strongly supports maintaining this exemption.

- The definition of publicly available ratings is both too narrow and too broad. It is too narrow because a rating would only be deemed to be public if disseminated on the internet. There is no reason that the definition should be so limited. Public ratings used for regulatory purposes could be published using other means (e.g. in newspapers). It is too broad because it would require registration of certain companies that produce credit research for no apparent reason. For example, a rating disseminated to a small group of institutional investors over the internet for a fee on a password-protected basis would be considered to be "public", even if not used for regulatory purposes. Similarly, the definition could be read to include research firms that produce investment research reports with "buy-sell-hold" recommendations. There is no obvious reason for registration of issuers of such ratings.

- Today, rating agencies are not required to register unless their customers want to use the ratings for regulatory purposes. Some firms that provide credit reports with ratings have chosen not to apply for NRSRO status, because their ratings are provided only to institutional investors who want them for their analysis and not for regulatory purposes. H.R. 2990 requires these firms to register, although it would allow the SEC to exempt them from the registration requirements. This turns the current regulatory system on its head. Instead of only a few firms applying to be NRSRO's, many firms that provide credit analysis would have to register or apply for an exemption.

- It is not clear who would have to register under H.R. 2990 because the term "ratings" is not defined. Since ratings may include ratings on either companies or securities, credit research firms who publish buy-sell-hold ratings would all be required to register as NRSROs.

Ratings of securities versus ratings of companies

- Under H.R. 2990, a rating would include a rating on either companies or specific securities. Many companies issue a variety of securities with different terms, subordination, covenants and collateral. A rating of a company is not necessarily meaningful with respect to particular securities issued by the company.

Ratings based solely on quantitative methodology

- Under H.R. 2990, the definition of "statistical rating organization" includes an organization that employs either a quantitative or qualitative model, or both, to determine ratings. As noted above, the Association does not favor granting the NRSRO designation to firms that use solely quantitative models and do not request that an issuer's senior management participate in the rating process free of charge. There is substantial volatility in ratings based solely on quantitative models and such ratings often give false positive results regarding credit problems. This causes us to conclude that ratings based solely on such models are not "credible, reliable" ratings.

Public availability of ratings

- The SEC and IOSCO rules[11] with respect to NRSROs mandate that ratings used for regulatory purposes must be disseminated to the public free of charge. (The report that provides the rationale for the rating need not be disseminated free of charge. The rating agency may thus profit from selling subscriptions to its rating reports.) H.R. 2990 states that a rating will be considered to be "publicly available" if it is disseminated either for free or for a fee. It does not even require that any fee be reasonable. As noted above, The Bond Market Association believes that credit rating agencies should make public, free of charge, ratings that are required by the rules of the SEC or self-regulatory organizations or used for regulatory purposes such as calculation of regulatory capital, and that rating agencies should have clear policies regarding permitted free use of their ratings and uses that constitute commercial use of the rating agency's intellectual property rights for which the rating agency may justifiably impose licensing fees.

Registration versus recognition

- H.R. 2990 involves registration, but not "recognition" of rating agencies. Under the bill, rating agencies would be required to provide information concerning the rating agency and its associated persons, conflicts of interest, rating methodologies, ratings performance measurement statistics, and procedures to prevent the misuse of nonpublic information. However, the bill contains no "merit-based" criteria for granting or denying an application. Rather, the Commission is instructed to grant the registration if it finds that "the requirements of this section" are satisfied, *i.e.,* if the rating agency has filed the necessary disclosures. As noted above, we believe that the regulatory purposes of "recognition" of rating agencies is crucially important. Consequently, we believe the decision to grant or deny "recognition" or "registration" should be merit-based. In addition, because the SEC does not have the same level of expertise in judging the credibility and reliability of ratings, we do not think it unreasonable for the SEC to have determined to use as its benchmark whether the principal users of ratings recognize the value of such ratings by subscribing to them. Finally, because we believe in the importance for regulatory purposes of a merit-based selection process, as noted above, we disagree with the proposal in H.R. 2990 to eliminate the designation.

Investment Advisers Act registration

- H.R. 2990 requires rating agencies that are registered under Section 203 of the Investment Advisers Act to withdraw from registration. Congress could certainly conclude that rating reports are credit opinions and not investment advice and that registration under the Investment Advisers Act is not required. It is not clear, however, why rating agencies should not be able voluntarily to register as

[11] See the SEC's website. http://www.sec.gov/rules/proposed/33-8570.pdf

investment advisers should they choose such a designation, especially if the market perceives that registration under the Investment Advisers Act confers additional benefits to users of ratings.

Anti-competitive practices

- H.R. 2990 requires the SEC to adopt rules "to prohibit specific anti-competitive practices common to the statistical rating organization industry." The purpose of granting anti-trust jurisdiction to the SEC is unclear. Other federal agencies, including the Department of Justice and the Federal Trade Commission, already have jurisdiction over anti-competitive practices and possess expertise in the enforcement of the anti-trust laws. If the SEC is to be given anti-trust jurisdiction, it should be to prohibit anti-competitive practices. The SEC should not have to prove that such practices are "common to the statistical rating organization industry."

- The Association supports the concept advanced in H.R. 2990 of requiring the SEC to adopt provisions regarding conflicts of interest, a firm's ratings methodology, and the publication of ratings performance measures and procedures.

Conclusion

The Association is pleased to offer the above comments on credit rating agencies and H.R. 2990. As we have noted, the credit rating industry plays an important and unique role in the capital markets. Regulators can best ensure the twin goals of increased competition and credible, reliable ratings by (1) retaining the NRSRO designation for rating agencies whose ratings are used for securities regulatory purposes, (2) adopting clear requirements for the designation of NRSROs, (3) encouraging all rating agencies to adhere to the principles enunciated in the IOSCO Code Fundamentals for Rating Agencies, and (4) ensuring that the SEC has the authority to examine NRSROs to ensure that they continue to meet the requirements for designation as NRSROs and adhere to a code of conduct that complies with the IOSCO code principles but does not dictate specific methodologies for determining ratings.

The Bond Market Association
360 Madison Avenue
New York, NY 10017

Securities Industry Association
1425 K Street, NW
Washington, DC 20005

U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549
Attn: Jonathan G. Katz, Secretary

June 9, 2005

Re: Definition of Nationally Recognized Statistical Rating Organization; File No. S7-04-05

Ladies and Gentlemen:

The Bond Market Association (the "BMA")[1] and the Securities Industry Association (the "SIA"[2] and, together with the BMA, the "Associations") welcome the opportunity to comment on the proposed new rule published by the Securities and Exchange Commission (the "Commission" or the "SEC") under the Securities Exchange Act of 1934, which would define the term "nationally recognized statistical rating organization" ("NRSRO").

The Associations have been and continue to be active participants in the debate concerning credit ratings agencies. The BMA has written a number of comment letters

[1] The Bond Market Association is an international trade association representing approximately 200 securities firms and banks that underwrite, distribute and trade in fixed income securities in the U.S. and internationally. More information about the BMA and its members and activities is available on its website www.bondmarkets.com.

[2] The Securities Industry Association brings together the shared interests of nearly 600 securities firms to accomplish common goals. SIA members, including investment banks, broker-dealers and mutual fund companies, are active in U.S. and foreign markets and in all phases of corporate and public finance. More information about the SIA and its members and activities is available on its website www.sia.com.

on the U.S. and European proposals regarding credit rating agencies.[3] The Associations applaud the Commission for its thoughtful approach to bringing more clarity and transparency with regard to the NRSRO concept. This letter will give our views on some of the issues raised by the Commission in the proposing release (the "Release"), specifically:

1. **Public Availability**. The Commission has asked how it should be determined whether an NRSRO is making its credit ratings readily available on a widespread basis. We do not believe the commission should limit the means by which rating agencies disseminate their ratings, since there are undoubtedly many ways in which such disseminations could be effected. Nevertheless, we believe it would be appropriate for the Commission to state that internet posting alone would be sufficient, since the vast majority of investors in rated securities have access to the internet.

The Release also mentions the issue of whether a credit rating agency should be required to disclose ratings to the public when the rating agency has prescribed conditions for not publishing the issuer's ratings (e.g. in the case of "private" ratings provided only to the issuer). The Release contains an interpretation that "publicly available" means that ratings used for regulatory purposes must be disseminated on a widespread basis. We support this interpretation, as it applies to the use of ratings for SEC regulatory purposes. However, we understand that investors often request private ratings of unrated securities or obtain a credit enhancement for a rated security and then obtain a private higher rating. If another regulator (e.g. the NAIC) is willing to allow an investor (e.g. an insurance company) to use such a rating for regulatory (e.g. permitted investment) purposes, even if the rating is not made public, we do not believe the rule should make the issuer of such a private rating ineligible for NRSRO status merely because it provides a private rating.[4]

---

[3] See, e.g. Comment letter, dated January 28, 2005, from the BMA to the Committee of European Securities Regulators ("CESR") on CESR's technical advice to the European Commission on possible measures concerning credit rating agencies (Consultation Paper of November 2004), available at http://www.bondmarkets.com/assets/files/CESR%20CP%2030%20Nov%2004%20-%20Final.pdf; Letter, dated November 6, 2004, from the BMA on the Report of the Chairmen's Task Force of the Technical Committee of the International Organisation of Securities Commissions regarding a Code of Conduct Fundamentals for Credit Rating Agencies, available at http://www.bondmarkets.com/assets/files/Response%20to%20IOSCO%20Final%20-%20Clean.doc; Letter, dated August 5, 2004, from the BMA to the Committee of European Securities Regulators, responding to CESR's call for evidence on Possible Measures Concerning Credit Rating Agencies, available at http://www.bondmarkets.com/assets/files/CESR%20Call%20-%20BMA%20comment%20letter.pdf ; Letter dated July 28, 2003 from John M. Ramsey to Jonathan G. Katz on Credit Rating Agency Concept Release (see Release footnote 48).

[4] See, for example, Technical Committee of the International Organization of Securities Commissions, Code of Conduct Fundamentals for Credit Rating Agencies (December 2004)(hereinafter "IOSCO Code Fundamentals", Section 3.4 which states "Except for 'private ratings' provided only to the issuer, the CRA should disclose to the public, on a non-selective basis and free of charge, any rating regarding publicly issued securities . . . if the rating action is based in whole or in part on material non-public information."

2. **Requirement to rate specific securities**. We agree with the requirement that an NRSRO rate specific securities and not provide solely entity ratings. Many bond issuers have several different classes or issues of outstanding debt obligations with varying maturities and structures. Those issues often have different rights, depending on the terms under which they were issued, including different call features, covenant packages, seniority or subordination in the corporate capital structure, collateral, guaranties and other economic attributes. Consequently, publication of a single issuer rating could be misleading. It should be made clear that an NRSRO may also issue company specific assessments, such as "default predictors."

3. **Current Assessment Requirement**. The proposed definition requires a rating to be a "current" assessment." This, in turn, would require the rating agency to have and follow procedures designed to ensure that its ratings are reviewed and, if necessary, updated on the occurrence of material events. We agree that this requirement is desirable. We also agree, however, that the Commission should not prescribe a specific time period within which an NRSRO's ratings would need to be updated, since the appropriate time will vary from security to security. We believe that some NRSROs have begun to publish lists of securities ratings, along with the date of the most recent rating/rating report. We believe this should be encouraged. We also believe the Commission should address the update requirement with respect to private ratings. We understand that at least one rating agencies does not update private ratings, and that some ratings are designed for a particular purpose and would not need updating.[5]

4. **Nationally recognized**. In determining whether to issue a no action letter, the Staff has considered the single most important factor to be whether the credit rating agency is "nationally recognized" in the United States by the predominant users of securities ratings as an issuer of credible and reliable ratings. The Proposed Rule's standard is whether a credit rating agency is "generally accepted in the financial markets as an issuer of credible and reliable ratings by the predominant users of securities ratings." The staff believes that this "recognition" or "acceptance" is a proxy for whether ratings are credible and reliable and can reasonably be relied upon in the marketplace.

The Release proposes two ways that a rating agency could meet this component of the NRSRO definition: (1) statistical data that demonstrates market reliance on the credit agency's ratings such as, market movements in response to ratings changes, and (2) attestations by authorized officers of users representing a "substantial percentage of the relevant market" that the credit rating agency's ratings are credible and actually relied upon by them. It also asks whether other types of information would be appropriate, such as the fact that a rating agency has many subscribers, or the views of issues.

We believe it is very difficult to measure "reliance" on ratings. Many ratings do not involve upgrades and downgrades and therefore may not produce market movements.

[5] See IOSCO Code Fundamentals, Section 1.9, which states "Except for ratings that clearly indicate they do not entail ongoing surveillance, once a rating is published the CRA should monitor on an ongoing basis and update the rating . . . ." (emphasis supplied).

Moreover, market movements in response to ratings changes may be difficult to attribute solely to a particular rating change, if the change is made in response to issuer developments and is made at the same time as the public announcement or the same time other rating agencies are taking similar action. Either attestations by authorized officers of users or the number of subscribers willing to pay for the rating agency's research reports would be a much more objective measure.

We believe the requirement of attestations from users representing a "substantial percentage of the relevant market" needs further clarification. For example, clarification is required with regard to how to determine what is the relevant market for a particular security, e.g., whether that market is defined geographically or by common characteristics of investors or dealers. Additional clarification is needed with regard to what percentage is considered substantial, e.g. 10%? 20%?, and what metric should be used to calculate that percentage, e.g., the number of users or the amount of assets they own or manage.

Finally, we believe that, if the purpose of this test is as a proxy for whether ratings are credible and reliable and whether they can reasonably be relied upon in the marketplace, then the views of issuers may not be meaningful and may be subject to conflicts of interest.

5. **Limited Sector/Geography Recognition.** We applaud the Commission's decision to recognize that the definition of NRSRO should include credit rating agencies that confine their activities to limited product or geographic sectors. We believe that there are valid arguments that, once an agency is recognized for issuing credible and reliable ratings within a limited sector or geographic area, it should meet the NRSRO definition without product or geographic limitation ("broad recognition"). There are also valid arguments on the other side ("narrow recognition"). However, we believe the balance favors broad recognition. First, this will enable relatively new entrants to build out their businesses, and will help to lower what has been a barrier to new entrants into the market. Second, once a firm has demonstrated the ability to publish credible, reliable ratings in one area, it has proved its expertise in credit risk assessment, and, thus, its ability to produce credible ratings in other areas. Third, using broad recognition avoid the problem of distinguishing ratings that are considered to be issued by an NRSRO from those that are not, particular when the Commission prohibits NRSROs from disclosing that they are NRSROs. Finally, it levels the playing field with existing NRSROs, which do not have to obtain Commission permission before beginning to rate new types of securities. The argument for narrow recognition, of course, is that the Commission's test for "nationally recognized" is that the rating agency is generally accepted in the financial markets as an issuer of credible and reliable ratings by the predominant users of securities ratings. General recognition for a particular expertise does not necessarily equate to acceptance in other areas. On balance, however, we believe this should be a matter for determination when the NRSRO's designation is being reviewed.

6. **Analyst Experience and Training**. The ability to identify, understand and analyze data from and about issuers is clearly crucial to credit rating agencies. The Proposal contains a number of recommendations with respect to workload and training of "analysts" and other staff, but does not define the term "analyst." Consequently, it is not clear whether the proposal is limited to persons who are responsible for recommending ratings, or would apply to all rating agency staff who perform any kind of financial or credit analysis. We believe a definition of "analysts" would be helpful, and that the definition of Research Analyst in Regulation AC, which depends on the definition of a Research Report and focuses on those primarily responsible for the preparation of reports could be used as a model. Such a definition would recognize that the ratings process is a team and committee process. Consequently, every person on the team may not have the same level of competence. What is important is that the rating agency has procedures for ensuring that the persons actually responsible for the report have the required experience and competence and are responsible for delegated work.[6] We also believe that an NRSRO should have policies and procedures in place to ensure compliance with requirements for the qualifications, experience, workload and performance of its ratings staff.

7. **Number of Ratings Per Analyst**. We do not support a Commission-imposed limitation on the number of ratings per analyst. The right number of ratings will depend on the nature of the securities being rating, the complexity of the issuers, and the resources available to the analysts, among other things. We believe, however, that disclosure by an NRSRO of the number of credit analysts they employ and the average number of issues rated or otherwise followed would be salutary.

8. **Ratings Relying Primarily on Quantitative Models**. We do not believe that a rating agency that uses solely quantitative models and does not request that an issuer's senior management participate in the rating process free of charge should be designated an NRSRO. There is substantial volatility in these ratings and they often give false positive results regarding credit rating problems. However, ratings based solely on quantitative information may have their place and be useful for investors and others. For example, Moody's KMV RiskCalc Model is based solely on quantitative factors. It does not actually assign a rating, but rather an expected default frequency, which can then be easily correlated to a certain rating level. Nevertheless, we believe there is a substantial difference between ratings that rely primarily on quantitative models and those that include extensive contacts with the issuer's management, and that the former should not be the only ratings relied upon for regulatory purposes. If the Commission determines not to exclude firms relying primarily on quantitative models from NRSRO designation, we believe a rating agency that relies primarily on such models should provide clear disclosure that its ratings are based solely on quantitative factors.

---

[6] Compare IOSCO, Code Fundamentals, Section 1.4 ("the CRA should use people who, individually or collectively have appropriate knowledge and experience in developing a rating opinion for the type of credit being applied.")

9. **Conflicts of Interest**. The Release states that the examination of NRSROs or comment letters on the Commission's 2003 concept release on rating agencies (the "Concept Release")[7] revealed a concern with potential conflicts of interest, including (1) potential conflicts created when issuers pay for their ratings; (2) conflicts due to the marketing by NRSROs of ancillary services to issuers, such as pre-rating assessments and corporate consulting; (3) giving subscribers preferential access to rating analysts; and, (4) unsolicited ratings.

We agree that ratings should not be unduly influenced by a person with a vested interest in the level of the rating. For that reason, we believe rating agencies should have policies and procedures to prohibit the rating agency and analysts who rate particular companies from owning securities in those companies.[8] However, we believe it is important to determine whether potential conflicts are likely to have an adverse effect on the independent judgment of analysts. Moreover, we do not agree that all the listed potential conflicts are actual conflicts that should be eliminated rather than managed. We also believe it is salutary for rating agencies to have a policy that analyst compensation will be unrelated to the amount of revenue the rating agency derives from issuers that the analyst rates.[9] Similarly, we believe rating agencies should prohibit an employee from participating in the rating process for an issuer if the employee has had recent employment or another significant business relationship with the rated entity or has an immediate relation (e.g. a spouse, partner, parent, child or sibling) who currently works for the rated entity. We understand that the Commission believes that its authority to regulate the practices of NRSROs is limited. However, the topic of analyst conflicts seems no less important than the ratio of companies covered.

We agree that unsolicited ratings raise sufficient concerns that credit rating agencies should have procedures designed to avoid employing improper practices with respect to unsolicited ratings and to verify compliance with those procedures. We do not believe, however, that unsolicited ratings are per se manipulative or that they should be banned.

We do not believe that the fact that issuers often pay for ratings creates a per se conflict of interest. Rating agencies must please a number of different constituencies, including not only issuers, but also investors and investment bankers. In addition, we believe rating agencies value their reputations for accuracy and trenchant analysis. Consequently, we believe the disclosure of the source of any payments for the rating is sufficient to put users on notice of any potential conflict.

---

[8] See, e.g. IOSCO Code Fundamentals, Section 2.9 (The CRA and its employees should not engage in any securities or derivatives trading presenting conflicts of interest with the CRA's rating activities).

[9] See IOSCO Code Fundamentals, Section 2.11, which proposes that the CRA's code of conduct should state that a CRA analyst will not be compensated or evaluated on the basis of the amount of revenue that the CRA derives from issuers that the analyst rates or with which the analyst regularly interacts.

The question of ancillary services is one that should be closely evaluated. Credit rating agencies do not currently provide the same level of ancillary services that were provided by accountants before such services were limited by law and regulation. In addition, we believe that many services that might be considered "ancillary" to the "ratings" business are actually either an integral part of the ratings business or should be seen as complementary and not conflicting. Consequently, we believe that any risk that performance of such services will have an adverse effect on the independence of the judgment of the ratings analyst may be managed with policies and procedures adopted by the rating agencies. Requiring the complete separation of "rating services" from so-called ancillary services may have a substantial negative effect on the cost of implementing Rule 3b-10. In this regard, we note that the IOSCO Code Fundamentals only require that a rating agency separate its credit rating business and analysts from other businesses of the rating agency *that may present a conflict of interest.*[10]

For example, we believe that rating assessments or evaluation services ("RAS/RES") are not ancillary services or consulting services, but are core rating products. They involve communicating to issuers that a proposed structure of a hypothetical security would receive a designated rating. Nothing about provision of the rating assessment should affect the judgment of the analyst in recommending an actual rating. Consequently, any requirement to separate the staff advising issuers as to a proposed rating from the rating analysts who actually rate such products would needlessly produce increased cost for both issuers and rating analysts. Potential conflicts of interest can be adequately controlled if rating analysts are not allowed to market the rating agency's services and are not informed whether a prospective rating customer was solicited for other types of business.

Similarly, Moody's KMV RiskCalc model is probably not a rating product within the meaning of the Release, since it is not security-specific and does not produce ratings within a specific number of ratings categories, although the expected default frequencies produced by the model can easily be correlated to a certain rating level. Yet we see no reason why the provision of such expected default frequencies should be viewed as inconsistent with the rating business. It is based on the same underlying information and is a complementary service.

Another example of a complementary service is the provision of insurance company payment ratings. They are different from credit ratings, but sufficiently similar that they pose no risk to the judgment of a single rating staff.

Along the same lines, if a credit rating agency were to establish a business to perform continuous due diligence on issuers of debt securities in order to aid underwriters in performing due diligence in connection with underwritings, we believe it would be counterproductive if the Commission's rules required that such business be performed only by employees separated by information walls from the rating analysts. The

[10] See IOSCO Code Fundamentals Section 2.5.

information required by the rating agency to perform these functions would be the same. The expertise required of the rating agency staff would be the same. The engagements would be complementary. As in the case of RAS/RES services, we believe rating analysts should not market such services, but we see no problem with their performing them.

10. **Financial Resources**. We agree that an NRSRO should have the financial resources necessary to ensure that it can comply with its rating procedures and to monitor continuously the financial condition of the issuers of the securities it rates. In our opinion, an NRSRO should make its audited financial statements available to users of its ratings so that they can assess whether the NRSRO meets this requirement. We do not think an NRSRO should be required to provide users of ratings with information relating to the percentage of revenue it receives from all issuers or subscribers, but we would support a requirement for disclosure of issuers or subscribers from whom NRSRO's receive more than a specified proportion of their revenues, e.g. 5%, so that such users can assure themselves that the NRSRO is finally independent of its large subscribers and issuers. We would not favor limiting the percentage of revenues an NRSRO receives from a single issuer or subscriber. We believe that the existence of such concentrations should be considered by the SEC in determining whether to approve or re-approve designation as an NRSRO. However, the effect of such concentrations may vary by market and it will be important for the Commission to apply its own judgment in determining whether such concentrations are likely to affect the NRSRO's independent credit judgment.

11. **Other issues**. Although the Release cites, in footnote 55, the IOSCO Code Fundamentals, it does not state the extent to which other issues addressed in the IOSCO Code Fundamentals, or rating agency codes of conduct that comply with the IOSCO Code Fundamentals, will be treated in determining compliance with the Commission's 3-pronged test for NRSRO designation. For example, the IOSCO Code Fundamentals require (1) that a credit rating agency use rating methodologies that are rigorous, systematic and, where possible, result in ratings that can be subjected to some form of objective validation based on historical experience; (2) that analysts should use methodologies established by the rating agency and should apply a given methodology in a consistent manner; (3) that credit ratings should be assigned by the agency and not by any individual analyst; and (4) that rating agencies have a policy that they not forbear or refrain from taking a rating action based on the potential effect (economic, political or otherwise) of the action on the rating agency, an issuer, an investor, or other market participants. These are all factors that the Commission should consider in determining whether to grant or renew NRSRO status.

12. **The Interpretations**. We believe it would be useful for the final Rule 3b-10 to include the interpretations of the components of the definition discussed in the Release. Although the release is relatively short, it contains much information other than the interpretations, and, over time, the interpretations will be more difficult to find. Given the concerns about barriers to entry into the credit rating agency business, we believe that

the Commission should help potential new entrants by maintaining the relevant interpretations in a readily accessible place, such as in or accompanying the rule.

13. **More Substantive Regulation of Credit Rating Agencies**. The IOSCO Code Fundamentals have only recently been put into place. The major credit rating agencies have adopted Codes of Conduct to meet the IOSCO requirements. We believe the Commission should allow more time to determine whether those Codes of Conduct are working before seeking extensive new regulatory powers over credit rating agencies. As the Release points out, many commenters on the Concept Release supported the concept of regulatory oversight of NRSROs solely to allow the Commission to determine whether a credit rating agency continued to meet the NRSRO criteria on an ongoing basis. We believe the Commission either has or should have the authority to determine whether a rating agency meets or continues to meet the requirements for designation as an NRSRO. We do not, however, believe that more extensive regulation of rating agencies is warranted. We urge the Commission to allow the market to police the rating agencies and not to attempt to impose new regulatory burdens that will attempt to substitute the Commission's judgments for those of the market.

The Associations thank the Commission for this opportunity to comment on the proposed rule and Release. If you have any questions on these comments, please feel free to contact Marjorie Gross of The Bond Market Association at 646.637.9204 or mgross@bondmarkets.com or Frank Fernandez from the Securities Industry Association at 212-618-0517 or ffernandez@sia.com.

Very truly yours,

Marjorie E. Gross
Senior Vice President and Regulatory Counsel

Frank A. Fernandez
Senior Vice President and Chief Economist

○