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Rating Agencies and the Use of Credit Ratings Under the Federal Securities Laws; Notice

SECURITIES AND EXCHANGE COMMISSION

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RIN 3235–AH28

Rating Agencies and the Use of Credit Ratings Under the Federal Securities Laws

AGENCY: Securities and Exchange Commission (''Commission'').

ACTION: Concept release; request for comments.

SUMMARY: As part of the Commission's review of the role of credit rating agencies in the operation of the securities markets, the Commission is seeking comment on various issues relating to credit rating agencies, including whether credit ratings should continue to be used for regulatory purposes under the Federal securities laws, and, if so, the process of determining whose credit ratings should be used, and the level of oversight to apply to such credit rating agencies.

DATES: Comments should be received on or before July 28, 2003.

ADDRESSES: To help us process and review your comments more efficiently, comments should be sent by hard copy or e-mail, but not by both methods. Comments sent by hard copy should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0609. Comments also may be submitted electronically at the following electronic mail address: *rule-comments@sec.gov.* All comment letters should refer to File No. S7–12–03. This file number should be included in the subject line if electronic mail is used. Comment letters will be available for public inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, NW., Washington, DC 20549. Electronically submitted comment letters will be posted on the Commission's Internet Web site (*http://www.sec.gov*).[1]

FOR FURTHER INFORMATION CONTACT: Michael A. Macchiaroli, Associate Director, at (202) 942–0132; Thomas K. McGowan, Assistant Director, at (202) 942–4886; Mark M. Attar, Special Counsel, at (202) 942–0766; or Mandy B. Sturmfelz, Attorney, at (202) 942–0085.

SUPPLEMENTARY INFORMATION:

I. Introduction[2]

Since 1975, the Commission has relied on credit ratings from market-recognized credible rating agencies for distinguishing among grades of creditworthiness in various regulations under the Federal securities laws. These credit rating agencies, known as ''nationally recognized statistical rating organizations,'' or ''NRSROs,'' are recognized as such by Commission staff through the no-action letter process. There currently are four NRSROs[3]—Moody's Investors Service, Inc.; Fitch, Inc.; Standard & Poor's, a division of the McGraw-Hill Companies, Inc.; and Dominion Bond Rating Service Limited (''DBRS'').[4] Although the Commission originated the use of the term ''NRSRO'' for a narrow purpose in its own regulations, ratings by NRSROs today are widely used as benchmarks in Federal and State legislation, rules issued by financial and other regulators, foreign regulatory schemes, and private financial contracts. The Commission's initial regulatory use of the term ''NRSRO'' was solely to provide a method for determining capital charges on different grades of debt securities under the Commission's net capital rule for broker-dealers, rule 15c3–1 under the Exchange Act (the ''Net Capital rule''). Over time, as the reliance on credit rating agency ratings increased, so too did the use of the NRSRO concept.

In recent years, the Commission and Congress have reviewed a number of issues regarding credit rating agencies and, in particular, the subject of regulatory oversight of them. In 1994, the Commission solicited public comment on the appropriate role of credit ratings in rules under the Federal securities laws, and the need to establish formal procedures for recognizing and monitoring the activities of NRSROs.[5] Comments received by the Commission led to a rule proposal in 1997 which, among other things, would have defined the term ''NRSRO'' in the Net Capital rule.[6] However, the Commission has not acted upon that rule proposal. More recently, the initiation of broad-based Commission and Congressional reviews of credit rating agencies following the collapse of Enron has resulted in the need for a fresh look at the issue.

On January 24, 2003, the Commission submitted to Congress its Report on the role and function of credit rating agencies in the operation of the securities markets in response to the Congressional directive contained in section 702 of the Sarbanes-Oxley Act of 2002 (the ''Sarbanes-Oxley Act'').[7] The Report was designed to address each of the topics identified for Commission study in section 702, including the role of credit rating agencies and their importance to the securities markets, impediments faced by credit rating agencies in performing that role, measures to improve information flow to the market from credit rating agencies, barriers to entry into the credit rating business, and conflicts of interest faced by credit rating agencies.[8] The Report also addresses certain issues regarding credit rating agencies, such as allegations of anticompetitive or unfair practices, the level of due diligence performed by credit rating agencies when taking rating actions, and the extent and manner of Commission oversight of credit rating agencies, that go beyond those specifically identified in the Sarbanes-Oxley Act.

As the Commission enters the next phase of its review, a fundamental threshold matter is the appropriate degree of regulatory oversight that should be applied to credit rating agencies. At one end of the spectrum, the Commission could cease using the NRSRO designation, exit the business of rating agency oversight, and devise alternative means to fulfill its regulatory objectives. At the other, the Commission

[1] We do not edit personal identifying information, such as names or electronic mail addresses, from electronic submissions. You should submit only information that you wish to make publicly available.

[2] For a detailed discussion on credit rating agencies and the Commission's use of credit ratings under the Federal securities laws, *see* the *Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets, As Required by Section 702(b) of the Sarbanes-Oxley Act of 2002,* U.S. Securities and Exchange Commission, January 2003 (hereinafter, the ''Report''). The Report is available on the Commission's Web site at *http://www.sec.gov/news/studies/credratingreport0103.pdf.*

[3] Since 1975, four additional rating agencies have been recognized as NRSROs. However, each of these firms has since merged with or been acquired by other NRSROs. These four additional rating agencies were Duff and Phelps, Inc., McCarthy, Crisanti & Maffei, Inc., IBCA Limited and its subsidiary, IBCA, Inc., and Thomson BankWatch, Inc.

[4] On February 24, 2003, the Commission's Division of Market Regulation (the ''Division'') responded to a request by DBRS that the Division will not recommend enforcement action against broker-dealers that consider ratings by DBRS as NRSRO ratings when computing net capital pursuant to rule 15c3–1 under the Securities Exchange Act of 1934 (''Exchange Act''). *See* letter from Annette L. Nazareth, Director, Division, Commission, to Mari-Anne Pisarri, Pickard and Djinis LLP (February 24, 2003). This letter is available on the Commission's Internet Web site at *http://www.sec.gov/divisions/marketreg/mr-noaction/dominionbond022403-out.pdf.*

[5] *See* Nationally Recognized Statistical Rating Organizations, Release No. 34–34616 (August 31, 1994), 59 FR 46314 (September 7, 1994).

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

[7] *See* the Report, *supra* note 2.

[8] Sarbanes-Oxley Act of 2002, Pub. L. 107–204, § 702(b), 116 Stat. 745 (2002).

could implement, perhaps with additional legislative authority, a much more pervasive regulatory scheme for credit rating agencies that addresses the full range of issues raised in the Report.

Discussed below are broad issues that have been raised during the Commission's ongoing review of credit rating agencies. Following the discussion of each issue is a possible approach the Commission could develop to address that issue, as well as a series of questions, the answers to which would assist the Commission in its review. The Commission wishes to encourage comments from market participants, other regulators, and the public at large.

II. Discussion

A. Alternatives to the NRSRO Designation

Some commenters [9] believe that the NRSRO designation acts as a barrier to entry into the credit rating business. Others have raised concerns about the extent of the Commission's legal authority to regulate or impose requirements on NRSROs. Commenters argue that the Commission does not have explicit regulatory authority over NRSROs, and that it would be inappropriate for the Commission to impose a more comprehensive regulatory framework on rating agencies absent legislation. Others have argued that NRSRO rating activities are journalistic and are consequently afforded a high level of protection under the First Amendment. According to these commenters, suggestions that the Commission inspect or otherwise impose regulatory burdens on NRSROs would implicate the NRSROs' First Amendment rights. They further believe that new legislation providing the Commission with additional authority over NRSROs would face the same First Amendment challenges.

In light of these concerns, some commenters have recommended that the Commission consider ceasing its use of the NRSRO designation. Before doing so, however, the Commission would need to identify alternatives capable of achieving the regulatory objectives currently served by use of the NRSRO designation in certain Commission rules.[10] (Other regulatory or legislative bodies would need to determine appropriate substitutes for that designation in any non-Commission rules or legislation.) To further that discussion, the Commission staff has identified possible alternatives to the NRSRO designation for significant Commission rules that utilize that concept. For example:

- *Rule 15c3–1 under the Exchange Act.* The Commission could allow broker-dealers to use internally-developed credit ratings for purposes of determining the capital charges on different grades of debt securities under the Net Capital rule. Strict firewalls could be required between the broker-dealer employees who develop internal credit ratings and those responsible for revenue production. In addition, a broker-dealer could be required to obtain regulatory approval of its credit rating procedures and rating categories before it could use internal credit ratings for calculating capital charges. The Commission also could allow broker-dealers to calculate capital charges using model-based statistical scoring systems and/or market-based alternatives, such as credit spreads. Finally, the Commission could require the securities industry self-regulatory organizations (''SROs'') to set appropriate standards for broker-dealers to use in determining rating categories for net capital purposes.
- *Rule 2a–7 under the Investment Company Act of 1940.* Rule 2a–7 limits money market funds to investing in ''high quality'' securities. The rule contains minimum quality standards based on an objective test—ratings issued by NRSROs—and on a subjective test—the credit analysis performed by the adviser to the money market fund. The Commission could eliminate the objective test from rule 2a–7, and rely solely on the subjective test.
- *Form S–3 under the Securities Act of 1933.* The Commission could allow a registrant to use Form S–3 for offerings of certain nonconvertible securities and asset-backed securities where specified investor sophistication or large size denomination criteria are met. With regard to asset-backed securities, the Commission also could permit Form S–3 to be used where specified asset and structure experience criteria are met.

The Commission seeks commenters' views in evaluating the advisability and feasibility of eliminating the NRSRO designation from Commission rules, the possible alternatives identified above, and/or any other possible alternatives to the NRSRO designation. In particular, the Commission seeks commenters' views in response to the following questions:

Question 1: Should the Commission eliminate the NRSRO designation from Commission rules?

Question 2: If so, what alternatives could be adopted to meet the regulatory objectives of the Commission rules that currently incorporate the NRSRO designation? What are their respective strengths and weaknesses?

Question 3: Specifically, what are the advantages and disadvantages of allowing broker-dealers to use internally-developed credit ratings to determine capital charges under the Net Capital rule? Is it appropriate to require strict firewalls between the broker-dealer employees who develop internal credit ratings and those responsible for revenue production? Should a broker-dealer be required to obtain regulatory approval of its credit rating procedures and rating categories before it could use internal credit ratings for calculating capital charges? If so, what factors should the Commission review in determining whether to grant such approval? If the Commission substitutes internal credit ratings for the NRSRO designation in the Net Capital rule, what would be the impact on broker-dealers, including small broker-dealers, and what costs would be associated with this change? If there would be an inordinate financial impact on small broker-dealers, are there market-based solutions that could reduce the compliance costs for them? For example, should the Commission permit large broker-dealers to sell their internal credit ratings to small broker-dealers for these purposes? If so, would this help to provide a more competitive marketplace for credit ratings? To what extent should the Commission exercise additional regulatory oversight of this activity (*e.g.*, to control potential conflicts of interest)?

Question 4: What are the advantages and disadvantages of allowing broker-dealers to use credit spreads to determine capital charges under the Net Capital rule and/or other Commission rules? How could capital charges be determined using credit spreads? For example, could the Commission base capital charges on the yield differential between particular debt securities and U.S. Treasury securities of comparable maturity, such that a larger differential results in a larger haircut? How could credit spreads be determined for newly-issued, thinly-traded, or privately-issued securities? Or for variable rate and other short-term synthetic securities

[9] The term ''commenters'' includes those who formally submitted comments in response to the Commission's 1994 concept release and 1997 rule proposal, as well as those contributing to the Commission's recent review of credit rating agencies, including participants at the Commission's November 2002 hearings.

[10] The NRSRO concept is currently utilized in the following Commission rules: 17 CFR 228.10(e), 229.10(c), 230.134(a)(14), 230.436(g), 239.13, 239.32, 239.33, 240.3a1–1(b)(3), 240.10b–10(a)(8), 240.15c3–1(c)(2)(vi)(E), (F), and (H), 240.15c3–1a(b)(1)(i)(C), 240.15c3–1f(d), 242.101(c)(2), 242.102(d), 242.300(k)(3) and (l)(3), 270.2a–7(a)(10), 270.3a–7(a)(2), 270.5b–3(c), and 270.10f–3(a)(3).

held by money market funds? Are there readily available public sources of information sufficient to calculate credit spreads on domestic and foreign debt securities? Are there other model-based statistical scoring systems and/or market-based alternatives that would be viable alternatives to NRSRO ratings?

Question 5: What are the advantages and disadvantages of requiring the SROs to set appropriate standards for broker-dealers to use in determining rating categories for net capital purposes? What form might these standards take?

Question 6: What are the advantages and disadvantages of eliminating the ''objective test'' from rule 2a–7, and relying solely on the ''subjective test''—the credit analysis performed by the adviser to the money market fund—for the purposes of determining asset quality?

Question 7: What are the advantages and disadvantages of relying upon specified investor sophistication, large size denomination, or asset and structure experience criteria for purposes of determining Form S–3 eligibility? Should the Commission explore these possibilities in more depth? If so, what specific criteria should be considered?

Question 8: Are there alternatives other than those discussed above that might be better substitutes for the NRSRO designation in particular Commission rules?

Question 9: If the Commission discontinued using the NRSRO designation, should an entity other than the Commission recognize NRSROs for uses other than Commission rules? If another entity, which entity? How would the transition from the Commission to that entity take place?

Question 10: If, on the other hand, the Commission should continue to use the NRSRO designation in some Commission rules, could that designation be eliminated from other rules? If so, which rules?

B. Recognition Criteria

Since the Commission adopted the NRSRO designation, Commission staff has developed a number of criteria for assessing the credit rating agencies whose ratings can be used for regulatory purposes. Before recognizing a credit rating agency as an NRSRO, the Commission staff first determines that the rating agency satisfies certain established criteria. The single most important criterion is that the rating agency is widely accepted in the U.S. as an issuer of credible and reliable ratings by the predominant users of securities ratings. The staff also reviews the operational capability and reliability of the rating agency, including: (1) The organizational structure of the rating agency; (2) the rating agency's financial resources (to determine, among other things, whether it is able to operate independently of economic pressures or control from the companies it rates); (3) the size and experience and training of the rating agency's staff (to determine if the entity is capable of thoroughly and competently evaluating an issuer's credit); (4) the rating agency's independence from the companies it rates; (5) the rating agency's rating procedures (to determine whether it has systematic procedures designed to produce credible and reliable ratings); and (6) whether the rating agency has internal procedures to prevent the misuse of non-public information and to minimize possible conflicts of interest, and whether those procedures are followed. These criteria are intended to reflect the view of the marketplace as to the credibility of the credit rating agency, and were developed, in part, after evaluating public comments received by the Commission on the NRSRO designation.

While some commenters believe that the current NRSRO recognition criteria are appropriate given the objectives of the NRSRO designation, others have commented that the criteria impose barriers to entry into the business of acting as a credit rating agency. Commenters have also indicated that the current NRSRO recognition process is not sufficiently transparent.

In addition, in light of recent corporate failures, some have criticized the performance of the credit rating agencies. Concerns also have been raised regarding the training and qualifications of credit rating agency analysts.

If the Commission retains the NRSRO designation, the Commission could seek to improve the transparency of the NRSRO recognition process by developing the following approach:

- The Commission could specify in more detail the types of information applicants need to provide to demonstrate, and that could be reviewed in evaluating, satisfaction of the various NRSRO criteria. For example, in reviewing the general acceptance of a rating agency as an issuer of credible and reliable ratings, the Commission could clarify that the review would consider evidence such as: (1) Attestations from authorized officers of users of securities ratings representing a substantial percentage of the relevant market that the applicant's ratings are credible and actually relied on by the user; (2) interviews with representatives of such users regarding the same; and (3) statistical data demonstrating market reliance on the applicant's ratings (*e.g.*, market movements in response to the applicant's rating changes).
- A rating agency that confines its activity to a limited sector of the debt market could be recognized as an NRSRO. The appropriateness of recognizing as an NRSRO a rating agency that confines its activity to a limited, or largely non-U.S., geographic area also could be considered.
- Recognition of NRSROs could occur through Commission action (rather than through staff no-action letters).
- Applications for NRSRO recognition could be publicized by the Commission, and public comment sought on the credibility and reliability of the applicant's ratings.
- The Commission could develop supplemental criteria that would be used to evaluate ratings quality applicable to both rating agencies performing traditional fundamental credit analysis and those primarily reliant on statistical models.
- A rating agency could be required to follow generally accepted industry standards of diligence, to be developed in consultation with a broad-based committee of market participants, in performing its ratings analysis.
- The Commission could establish a time period (*e.g.*, 90 days from receipt of all required information) to serve as a goal for action on NRSRO applications.

To assist the Commission in determining whether to modify the criteria currently used to recognize NRSROs (assuming the Commission continues to utilize the NRSRO concept), we seek commenters' views in response to the following questions:

Existing Substantive Criteria

Question 11: Are the criteria currently used by Commission staff to determine whether a credit rating agency qualifies as an NRSRO appropriate? If not, what are the appropriate criteria? How should a determination be made as to whether a credit rating agency has met each criterion?

Question 12: Is it appropriate to condition NRSRO recognition on a rating agency being widely accepted as an issuer of credible and reliable ratings by the predominant users of securities ratings in the United States (*e.g.*, underwriters, dealers, banks, insurance companies, mutual funds, issuers)? Would this general acceptance be verifiable through the examples set forth above (*e.g.*, requiring verification through attestations from, and interviews with, authorized officers of

users of securities ratings, as well as using statistical data to demonstrate market reliance on an applicant's ratings)? As a more objective way of evidencing market reliance and credibility, should NRSRO recognition be conditioned on a credit rating agency documenting that it has been retained to rate securities issued by a broad group of well-capitalized firms?

Question 13: Should the Commission condition NRSRO recognition on a rating agency developing and implementing procedures reasonably designed to ensure credible, reliable, and current ratings? At a minimum, should each NRSRO have rating procedures designed to ensure that a similar analysis is conducted for similarly situated issuers and that current information is used in the rating agency's analysis? What minimum standards should the Commission use to determine whether the agency's ratings are current? Should each NRSRO use uniform rating symbols, as a means of reducing the risk of marketplace confusion? When reviewing a rating agency's procedures for obtaining information on which to base a rating action, should the Commission establish minimum due diligence requirements for rating agencies? How could these minimum requirements be developed? By the Commission? By the industry, with Commission oversight?

Question 14: Should the extent of contacts with the management of issuers (including access to senior level management of issuers) be a criterion used to determine NRSRO status? Should the Commission limit the credit ratings that can be used for regulatory purposes to credit ratings that include access to senior management of an issuer? If so, why?

Question 15: To the extent a credit rating agency uses computerized statistical models, what factors should be used to review the models? Could a credit rating agency that solely uses a computerized statistical model and no other qualitative inputs qualify as an NRSRO?

Question 16: Should the size and quality of the credit rating agency's staff be considered when determining NRSRO status? Should the Commission condition NRSRO recognition on a rating agency adopting minimum standards for the training and qualifications of its credit analysts? If so, what entity should be responsible for oversight of qualifications and training? How could the Commission verify whether a member of a rating agency's staff is or was previously subject to disciplinary action by a financial (or other) regulatory authority?

Question 17: Should the Commission condition NRSRO recognition on an entity's meeting standards for a minimum number of rating analysts or a maximum average number of issues covered per analyst? For example, should the Commission question whether a single analyst can credibly and reliably issue and keep current credit ratings on securities issued by hundreds of different issuers? Or would this level of scrutiny involve the Commission too deeply in the business practices of rating agencies?

Question 18: Is a credit rating agency's organizational structure an appropriate factor to consider when evaluating a request for NRSRO status? Should the agency that seeks recognition consent to limiting its business to issuing credit ratings or could it conduct other activities, such as rating advisory services?

Question 19: Should the Commission consider a credit rating agency's financial resources as a factor in determining NRSRO status? If so, how? Should NRSRO recognition be conditioned on a rating agency meeting minimum capital or revenue requirements?

Other Factors To Be Considered

Question 20: Should a rating agency that confines its activity to a limited sector of the debt market be considered for NRSRO recognition? Should a rating agency that confines its activity to a limited (or largely non-U.S.) geographic area also be considered?

Question 21: Should the Commission consider a provisional NRSRO status for rating agencies that comply with NRSRO recognition criteria but lack national recognition?

Question 22: Should the Commission develop supplemental criteria to evaluate ratings quality that would be applicable to both rating agencies performing traditional fundamental credit analysis and those primarily reliant on statistical models?

Question 23: Should the Commission consider other criteria in making the NRSRO determination, such as the existence of effective procedures reasonably designed to prevent conflicts of interest and alleged anticompetitive, abusive, and unfair practices, and improve information flow surrounding the ratings process?[11]

Question 24: Should the Commission expect NRSROs to follow generally accepted industry standards of diligence? If so, should the Commission encourage the establishment of a committee of market participants to develop those standards? Or should they be devised through other means?

Recognition Process

Question 25: Should recognition of NRSROs occur through Commission action (rather than through staff no-action letters)? Should the Commission establish an appeal process if the staff remains responsible for the recognition of NRSROs?

Question 26: Should the Commission publicize applications for NRSRO recognition, and seek public comment on the credibility and reliability of the applicant's ratings?

Question 27: Should the Commission establish a time period to serve as a goal for action on applications for NRSRO recognition? If so, would an appropriate time period be 90 days after all required information has been received, or a shorter or longer period?

C. Examination and Oversight of NRSROs

Each of the current NRSROs is registered as an investment adviser under the Investment Advisers Act of 1940 (''Advisers Act''). The Commission's 1997 NRSRO rule proposal would have required this registration. Commenters disagree on whether NRSROs should or could be subject to this amount of regulatory oversight, or even greater regulatory oversight. Some indicate that greater regulation is essential given the importance of their credit ratings to investors, and the influence such ratings can have on the securities markets. Others question the authority and the feasibility of the Commission to impose greater oversight. Some also question whether additional regulatory oversight—particularly the burdens associated with the possibility of a regulatory assessment of the quality of ratings analysis—is justified in light of the performance of credit rating agencies over the past decades.

Assuming the Commission can and should increase its ongoing oversight of NRSROs, the Commission could develop the following approach:

- The Commission could condition NRSRO recognition on a rating agency's agreeing to file annual certifications with the Commission that it continues to comply with all of the NRSRO criteria.
- The Commission also could solicit public comment annually on the performance of each NRSRO, including whether the NRSRO's ratings continue to be viewed as credible and reliable.
- The Commission could condition NRSRO recognition on a rating agency's

[11] *See* sections D, E, and F *infra* for additional discussion of these issues.

agreeing to maintain specified records relating to its ratings business, including those relating to ratings decisions.

• The Commission could condition NRSRO recognition on a rating agency's agreeing to submit to regular Commission inspections and examinations to determine compliance with the appropriate regulatory regime for NRSROs.

• The Commission could condition NRSRO recognition on a rating agency's agreeing to provide Commission staff with access to all personnel and books and records.

• The Commission could condition NRSRO recognition on a rating agency's agreeing to cooperate with the Commission in relevant investigations, including providing access to records and personnel.

To seek commenters' views on whether credit rating agencies should be subject to ongoing oversight, the Commission requests responses to the following questions:

Question 28: Should NRSRO recognition be conditioned on an NRSRO's meeting the original qualification criteria on a continuing basis? If so, should a failure to meet the original qualification criteria lead to revocation of NRSRO recognition? Should some other standard of revocation apply?

Question 29: What would be the appropriate frequency and intensity of any ongoing Commission review of an NRSRO's continuing compliance with the original qualification criteria?

Question 30: Should NRSRO recognition be conditioned on a rating agency's filing annual certifications with the Commission that it continues to comply with all of the NRSRO criteria?

Question 31: Should the Commission solicit public comment on the performance of each NRSRO, including whether the NRSRO's ratings continue to be viewed as credible and reliable? If so, how frequently should public comment be solicited (*e.g.*, annually)?

Question 32: Should NRSROs be subject to greater regulatory oversight? If so, what form should this additional oversight take? If necessary, should the Commission seek additional jurisdictional authority from Congress?

Question 33: Should NRSRO recognition be conditioned on a rating agency's registering as an investment adviser under the Advisers Act? If so, how should the various sections of the Advisers Act apply to NRSROs? Could the Advisers Act rules be amended to make them more relevant to the businesses of NRSROs? Alternatively, would it be more appropriate for the Commission to adopt a separate registration and regulatory regime for NRSROs?

Question 34: Should NRSRO recognition be conditioned on recordkeeping requirements specifically tailored to the ratings business? Should NRSRO recognition be conditioned on a rating agency's maintaining records relating to the ratings business, including those relating to rating decisions?

Question 35: Are there minimum standards or best practices to which NRSROs should adhere? If so, how should these be established? By the Commission? By the industry, with Commission oversight? Should they be incorporated into the conditions for NRSRO recognition? Would it, or would it not, be a productive use of Commission resources to develop the expertise to review, *e.g.*, issues related to the quality and diligence of the ratings analysis?

Question 36: If a currently recognized NRSRO gave up its NRSRO recognition because of concerns regarding the regulatory and liability environment, what effect, if any, would that action have on the market?

D. Conflicts of Interest

Conflicts of interest may arise in several areas within a credit rating agency. As registered investment advisers, the current NRSROs have a legal obligation to avoid conflicts of interest or disclose them fully to subscribers. Reliance by credit rating agencies on issuer fees could lead to a conflict of interest and the potential for rating inflation. While many commenters believe that NRSROs have effectively managed this conflict, they stress the importance of NRSROs implementing stringent firewalls, independent compensation, and other related procedures. The NRSROs have represented that they have implemented a number of policies and procedures designed to assure the independence and objectivity of the ratings process, such as requiring ratings decisions to be made by a ratings committee, imposing investment restrictions, and adhering to fixed fee schedules. In addition, they assert that rating analyst compensation is merit-based (*e.g.*, based on the demonstrated reliability of their ratings), and is not dependent on the level of fees paid by issuers the analyst rates. Further, the NRSROs take the position that their reputation for issuing objective and credible ratings is of paramount importance and that they would not jeopardize their reputation by attempting to appease an issuer.

Some also believe that conflicts of interest can arise when credit rating agencies offer consulting or other advisory services to the entities they rate. The NRSROs generally represent that they have established extensive guidelines to manage conflicts in this area, including firewalls to separate their ratings services from other ancillary businesses. They also indicate that advisory services presently represent a very small portion of their total revenues. Commenters have also expressed concern that conflicts in this area could become much greater if these ancillary services were to become a substantial portion of an NRSRO's business, and suggestions were made that their percentage contribution to the total revenues of an NRSRO be capped. Others were concerned that issuers could be unduly pressured to purchase advisory services, particularly in cases where they were solicited by a rating analyst at an NRSRO.

Finally, some have expressed concern that subscribers, as a practical matter, have preferential access to rating analysts and, as a result, inappropriately may learn of potential rating actions or other nonpublic information.

To manage these potential conflicts of interest, the Commission could develop the following approach:

• NRSRO recognition could be conditioned on a rating agency's developing and implementing procedures to address issuer influence (*e.g.*, prohibiting ratings employees from participating in the solicitation of new business or fee negotiations, and basing their compensation on factors other than business maintenance or development).

• NRSRO recognition could be conditioned on a rating agency's developing and implementing procedures to address subscriber influence (*e.g.*, restricting private contacts between ratings employees and subscribers, to help prevent intentional or inadvertent disclosure of confidential issuer information and information regarding forthcoming rating changes).

• NRSRO recognition could be conditioned on a rating agency's developing and implementing procedures to address issues regarding ancillary fee-based services (*e.g.*, establishing strict firewalls between ratings employees and ancillary business development, and prohibiting compensation of ratings employees from being impacted by revenues from these services).

• NRSRO recognition could be conditioned on a rating agency's having adequate financial resources (*e.g.*, net assets of at least $100,000, or annual gross revenues of at least $1,000,000) to

reduce dependence on individual issuers or subscribers.

• NRSRO recognition could be conditioned on a rating agency's deriving less than a certain percentage of its revenues (*e.g.*, 3%) from a single source to help assure that the NRSRO operates independently of economic pressures from individual customers.

To address the concerns raised with regard to conflicts of interest, the Commission requests commenters' views in response to the following questions:

Question 37: Should the Commission condition NRSRO recognition on an NRSRO's agreeing to document its procedures that address potential conflicts of interest in its business including, but not limited to, potential issuer and subscriber influence? If so, what other potential conflicts should these procedures address?

Question 38: To what extent could concerns regarding potential conflicts of interest be addressed through the disclosure of existing and potential conflicts of interest when an NRSRO publishes ratings?

Question 39: Should NRSRO recognition be conditioned on an NRSRO prohibiting employees involved in the ratings process (*e.g.*, rating analysts and rating committee members) from participating in the solicitation of new business and from fee negotiations? Would conditioning NRSRO recognition on a rating agency's establishing strict firewalls between employees in these areas and credit analysts address potential conflicts? Should the Commission also address the credit analyst compensation structure to minimize potential conflicts of interest?

Question 40: Should NRSRO recognition be conditioned on an agreement by a rating agency not to offer consulting or other advisory services to entities it rates? Could concerns regarding conflicts of interest be addressed by limiting or restricting consulting or advisory services offered by rating agencies?

Question 41: Should NRSRO recognition be conditioned on a prohibition on credit rating analysts employed by NRSROs from discussing rating actions with subscribers? If not prohibited, should the Commission adopt limits on contacts between analysts and subscribers? Or are existing remedies—antifraud, contractual, or otherwise—sufficient to deter inappropriate disclosures to subscribers?

Question 42: Should NRSRO recognition be conditioned on a rating agency having adequate financial resources (*e.g.*, net assets of at least $100,000, or annual gross revenues of at least $1,000,000) to reduce dependence on individual issuers or subscribers?

Question 43: Should NRSRO recognition be conditioned on a rating agency not deriving more than a certain percentage of its revenues (*e.g.*, 3%) from a single source to help assure that the NRSRO operates independently of economic pressures from individual customers?

Question 44: Are there other ways to address potential conflicts of interest in the credit rating business or to minimize their consequences?

E. Alleged Anticompetitive, Abusive, and Unfair Practices

Some have alleged that certain of the larger credit rating agencies abused their dominant market position by engaging in certain aggressive competitive practices. Fitch complained that S&P and Moody's were attempting to squeeze it out of certain structured finance markets by engaging in the practice of ''notching''—lowering their ratings on, or refusing to rate, securities issued by certain asset pools (*e.g.*, collateralized debt obligations), unless a substantial portion of the assets within those pools were also rated by them.

With respect to unsolicited ratings, some commenters have questioned the appropriateness of a rating agency's attempting to induce an issuer to pay for a rating the issuer did not request (*e.g.*, sending a bill for an unsolicited rating, or sending a fee schedule and ''encouraging'' payment).

To address these issues, the Commission could develop the following approach:

• NRSRO recognition could be conditioned on a rating agency's implementing adequate procedures to prevent anticompetitive and other unfair practices, including prohibitions on: (1) Requiring a ratings client to purchase an ancillary service as a precondition for performance of the ratings service and, perhaps, other anticompetitive practices (even those that would not violate the antitrust laws); and (2) engaging in specified ''strong-arm'' tactics with respect to unsolicited ratings.

The Commission invites commenters' views concerning the existence of these practices and requests commenters' views on the following questions:

Question 45: Should the Commission identify specific anti-competitive practices that NRSROs would agree to prohibit as a condition to NRSRO recognition? If so, what are those practices?

Question 46: Would it be sufficient to condition NRSRO recognition on the adoption of procedures intended to prevent anticompetitive, abusive, and unfair practices from occurring?

Question 47: Should NRSRO recognition specifically be conditioned on an NRSRO's agreeing to forbear from requiring issuers to purchase ancillary services as a precondition for performance of the ratings service?

Question 48: Should NRSRO recognition specifically be conditioned on an NRSRO's not engaging in specified practices with respect to unsolicited ratings (*e.g.*, sending a bill for an unsolicited rating, sending a fee schedule and ''encouraging'' payment, indicating a rating might be improved with the cooperation of the issuer)?

F. Information Flow

Several commenters have stressed the importance of transparency in the ratings process. Among other things, they assert that fluctuations in security prices in response to rating actions could often be less pronounced if credit rating agencies disclosed more information about the assumptions underlying their ratings (*e.g.*, specific events that might prompt a rating change), as well as the information and documents reviewed by them in reaching a ratings decision (*e.g.*, whether the issuer participated in the rating process).

To address issues that have been raised with regard to information flow from credit rating agencies, the Commission could develop the following approach:

• NRSRO recognition could be conditioned on a rating agency's implementing procedures to assure appropriate disclosure of key information about its ratings and rating processes, including: (1) Widespread public dissemination of its ratings; (2) identifying an unsolicited rating as such; (3) annual disclosure of specified ratings performance information; and (4) public disclosure of the key bases of, and assumptions underlying, the ratings decision (pursuant to generally accepted industry standards to be developed by a broad-based committee of market participants).

• NRSRO recognition could be conditioned on a rating agency's implementing procedures to assure appropriate public notification when it ceases rating/following an issuer.

To explore ways to improve the quality of information available to users of credit ratings, the Commission requests commenters' views on the following questions:

Question 49: Should the Commission address concerns about information flow from rating agencies? If so, should

the Commission condition NRSRO recognition on a rating agency's agreeing to establish procedures to assure certain disclosures relating to its ratings business, such as those described above? Are there other disclosures that could be appropriate?

Question 50: Specifically, should NRSRO recognition be conditioned on a rating agency disclosing the key bases of, and assumptions underlying its rating decisions? If so, should these disclosures be made pursuant to standards developed by the industry, or otherwise?

Question 51: Would it be advisable for the Commission to condition NRSRO recognition on a rating agency's agreeing to disclose performance information periodically? If so, what type of performance information would be most useful? How often should it be disclosed?

Question 52: Should NRSRO recognition be conditioned on a rating agency's disclosing whether or not an issuer participated in the rating process? Or, could issuers be required to make such disclosures?

Question 53: Concerns have been raised that certain credit rating agencies make their credit ratings available only to paid subscribers, and that it would be inappropriate to require users of credit ratings to subscribe for a fee to an NRSRO's services to obtain credit ratings for regulatory purposes. What steps, if any, should the Commission take to address these concerns? For example, should NRSRO recognition be conditioned on a rating agency's agreeing to public dissemination of its ratings on a widespread basis at no cost, as is currently the case?

Question 54: Should NRSRO recognition be conditioned on a rating agency's implementing procedures to assure public notification when it ceases rating/following an issuer. If so, what form of public notification would be appropriate?

G. Other

During the Commission's review of credit rating agencies, certain issues were raised that do not directly relate to the topics discussed above, but on which the Commission is interested in receiving comment. First, the Commission is interested in exploring whether there are types of information that, if disclosed by an issuer, or disclosed in a more meaningful way, would be useful to rating agencies in making their credit assessments. In addition, concerns were raised that a ''ratings cliff'' exists in the commercial paper market, such that a slight downgrade of an issuer's commercial paper rating can dramatically restrict its access to the U.S. money markets.

In this regard, the Commission solicits commenters' answers to the following questions:

Question 55: What steps, if any, can the Commission take to improve the extent and quality of disclosure by issuers to rating agencies or to the public generally, and in particular, regarding: (a) Ratings triggers in financial covenants tied to downgrades; (b) conditional elements of material financial contracts; (c) short-term credit facilities; (d) special purpose entities; and (e) material future liabilities.

Question 56: Is it appropriate for the Commission to take steps to minimize the ratings ''cliff'' that has been represented to be particularly pronounced in the commercial paper market? If so, what steps should the Commission take?

III. Solicitation of Additional Comments

In addition to the areas for comment identified above, we are interested in any other issues that commenters may wish to address relating to credit rating agencies. Please be as specific as possible in your discussion and analysis of any additional issues.

By the Commission.

Dated: June 4, 2003.

Jill M. Peterson,

Assistant Secretary.

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