Testimony of Frank Partnoy
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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 <u>not</u> 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.

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[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.
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> 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
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