UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

THE CHAIRMAN

June 4, 2003

The Honorable Richard H. Baker
Chairman
Subcommittee on Capital Markets, Insurance
and Government Sponsored Enterprises
U.S. House of Representatives
2129 Rayburn House Office Building
Washington, DC 20515

Dear Chairman Baker:

Thank you for your letter, dated April 10, 2003, that follows up on the Subcommittee's recent credit rating agency hearing, and asks a series of questions concerning the Commission's oversight of rating agencies that have been recognized for regulatory purposes. I appreciate your concerns regarding, among other things, the level of competition in the credit rating industry, the existence of potential conflicts of interest, and the recent performance of rating agencies.

I have asked Annette Nazareth, the Director of the Commission's Division of Market Regulation, to prepare a memorandum responding in detail to each of the questions you asked. A copy of that memorandum is enclosed.

As you know, the Commission and its staff have been working diligently to review these and other issues relating to the role and function of credit rating agencies in the operation of the securities markets. Our January 2003 report to Congress identified a number of important substantive issues relating to credit rating agencies that the Commission would be exploring in more depth, including the following: (1) improved information flow in the credit rating process; (2) potential conflicts of interest; (3) alleged anticompetitive or unfair practices by recognized rating agencies; (4) potential regulatory barriers to entry into the credit rating business; and (5) ongoing regulatory oversight of credit rating agencies.

I appreciate your interest in this important area. Please do not hesitate to contact me if I can provide further information on these issues.

Sincerely,

William H. Donaldson

Enclosure

MEMORANDUM

TO: Chairman Donaldson

FROM: Annette L. Nazareth, Director
Division of Market Regulation

SUBJECT: Letter from Chairman Baker on Issues Relating to Rating Agencies

DATE: June 4, 2003

In a letter to you dated April 10, 2003, Chairman Baker asked that you respond to a number of questions relating to credit rating agencies. As you requested, this memorandum responds to those questions.

I. Background

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[1] – Moody's Investors Service, Inc.; Fitch, Inc.; Standard & Poor's, a division of The McGraw-Hill Companies, Inc.; and Dominion Bond Rating Service Limited. 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 Securities Exchange Act of 1934 (the "Net Capital Rule").[2] 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

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[1] 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.

[2] *See* Adoption of Amendments to Rule 15c3-1 and Adoption of Alternative Net Capital Requirement for Certain Brokers and Dealers, Release No. 34-11497 (June 26, 1975), 40 FR 29795 (July 16, 1975).

procedures for recognizing and monitoring the activities of NRSROs.[3] 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.[4] 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 these issues.

On January 24, 2003, the Commission submitted to Congress a 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.[5] 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. 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 you know, the Commission has just approved a concept release ("Concept Release") seeking public comment on a wide range of questions regarding possible approaches the Commission could develop to address various concerns regarding credit rating agencies. We hope the Concept Release elicits extensive comments on these issues, from market participants, other regulators, and the public at large.

II. Response to Questions

1) Do you believe the NRSROs have adequately served the public, in light of this recent history: continuing to rate Enron "investment grade" four days before bankruptcy; California utilities "A-" two weeks before defaulting; Worldcom "investment grade" three months before bankruptcy; and Global Crossing "investment grade" four months before defaulting on loans? We understand that other rating firms, which have not received NRSRO status from the SEC staff,

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

[4] *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) (the "1997 Proposing Release").

[5] *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"].

provided investors with more timely warnings of the financial problems of those issuers. Would greater competition in the credit rating agency business improve the reliability of ratings?

Many have criticized the performance of the NRSROs in connection with a number of recent corporate failures, including those mentioned above. In addition to the hearings on credit rating agencies recently held by the House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, last year the Senate Committee on Governmental Affairs held hearings to evaluate the performance of the rating agencies in connection with the Enron matter. A related report issued by staff of the Senate Committee recommended that the Commission, among other things, require recognized rating agencies to comply with specified performance and training standards and regularly monitor their compliance with those standards. For their part, the rating agencies generally take the position that they rely on issuers and other sources to provide them with accurate and complete information, and typically do not audit the accuracy or integrity of issuer information. They also argue that reputational concerns are sufficient to ensure that they exercise appropriate levels of diligence in the ratings process, and that their track record in predicting the repayment of debt securities reflects the reliability of their ratings.

The Commission has been evaluating the merits of the criticisms of the NRSROs' performance in its study of credit rating agencies, and this issue was discussed in some detail in the Commission's January 2003 Report to Congress. The Commission's Concept Release, among other things, explores this matter in more depth – particularly, whether rating agencies should incorporate general standards of diligence in performing their ratings analysis, and with respect to the training and qualifications of credit rating analysts. The Commission's Report also addressed ways to promote competition and reduce regulatory barriers to entry into the credit rating business. The Commission's Concept Release explores these issues in more depth.

2) I understand that Rule 436(g) under the Securities Exchange Act of 1933 shields NRSROs – but not rating agencies without the designation – from prospectus liability. Therefore, isn't it true that NRSROs are not subject to checks that either competition or the threat of legal accountability would provide?

Rule 436(g) under the Securities Act of 1933 (the "Securities Act") provides that credit rating agencies that are NRSROs: (1) are not required to provide consents when their ratings are disclosed in a registration statement; and (2) will not be subject to civil liability as experts for purposes of Section 11 of the Securities Act. While Rule 436(g) shields NRSROs from potential Section 11 liability, NRSROs remain subject to substantial liability under the antifraud provisions of the federal securities laws, such as Section 17(a) of the Securities Act and Section 10(b), and Rule 10b-5 thereunder, of the Securities Exchange Act of 1934 (the "Exchange Act"). In the proposing and adopting releases for Rule 436(g), the Commission noted the substantial liability to which rating agencies are subject under the antifraud provisions of the federal securities laws, and that

Rule 436(g) would not impact that liability. The Commission also emphasized that, NRSROs, as registered investment advisers under the Investment Advisers Act of 1940 (the "Advisers Act"), have a special duty to base their opinions upon current and adequate information. Thus, the antifraud provisions in the Securities Act, Exchange Act, and the Advisers Act impose legal accountability on NRSROs.[6]

As to competitive concerns, the adopting release for Rule 436(g) states that issuers may include a rating assigned by a non-NRSRO in a Securities Act registration statement; however, such rating would require the filing of the rating agency's written consent under Section 7 and would subject the rating agency to potential Section 11 civil liability. While issuers may choose to include a non-NRSRO security rating in a registration statement, the non-NRSRO would have to assume Section 11 liability whereas a NRSRO would not. As noted above, the Commission's Report discussed, and the Concept Release explores more generally, ways to promote competition and reduce regulatory barriers to entry into the credit rating business.

3) What alternative mechanisms to NRSROs exist to enable investors and regulators to evaluate credit risk? How do market participants and regulators evaluate the creditworthiness of issuers of unrated securities and loan applicants?

NRSROs are only a few of many sources of credit risk information. As discussed in the Commission's Report, the predominant users of securities ratings, such as broker-dealers, banks, mutual funds, pension funds, and insurance companies, conduct their own independent credit analysis, where NRSRO credit ratings are only one of several important inputs to their internal credit assessments and investment analyses. Some of these institutions make their credit analysis available to their clients. In addition, in recent years, we have observed an increase in the number of credit opinions available from non-NRSRO credit rating agencies, as well as from research firms that focus their

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6 To place Rule 436(g) in context, it is necessary to consider the circumstances around which it was created. Prior to 1981, the policy of the Commission staff was to discourage the disclosure of security ratings in Commission filings. In 1977, the Commission issued a concept release that announced that it was considering whether it should encourage or require the disclosure of security ratings in Commission filings and requested comment on a number of issues related to any such action. In 1981, the Commission announced that it would permit the disclosure of security ratings assigned by rating agencies in registration statements and proposed Rule 436(g). The change in Commission policy resulted from the recognition that security ratings are useful to investors and the market, and that investors could benefit from disclosure of security ratings in registration statements. The Commission recognized that a major barrier to the disclosure of security ratings in registration statements had been the issue of whether a rating agency is an "expert" whose consent must be filed under Section 7 and who may be subject to civil liability under Section 11 of the Securities Act. A number of comments received on the 1977 release expressed concern with respect to the applicability of Sections 7 and 11 to disclosure of a security rating. All three existing NRSROs indicated in their comments that they would not provide the requisite consents.

business on evaluating the creditworthiness of issuers of securities. It is our understanding that market participants use internal credit analysis, and, in some cases, independent research firms, to evaluate the creditworthiness of issuers of unrated securities and loan applicants. The Commission does not independently evaluate the creditworthiness of these issuers. The Commission's Concept Release explores possible alternatives to the NRSRO concept in Commission rules.

4) Professor Lawrence White testified at our hearing that in order to achieve the public policy goal of improving competition and increasing the potential for innovation in the ratings business, "the SEC and other financial regulators should cease delegating their safety judgments to a handful of protected bond raters." He argued that regulators should make the same safety and soundness judgments about bonds that they currently make about loans and other financial assets. One way to do this, he asserted, would be for the SEC to withdraw the NRSRO designation. Should the SEC discontinue the concept of NRSROs? If it were to do so, how should federal regulators, Congress, and the states change regulations and laws related to NRSROs so as to minimize disruption to the marketplace?

The Commission's Report explored, and the Concept Release examines in more depth, whether credit ratings should continue to be used for regulatory purposes, and, if not, alternatives capable of achieving the same regulatory objectives currently served by the NRSRO concept. The staff is mindful that the term "NRSRO" is now used on a widespread basis in federal, state, and foreign laws and regulations, as well as in private contracts. Accordingly, in the Concept Release, the Commission seeks comment from market participants, other regulators, and the public at large as to the collateral impact of eliminating the NRSRO concept from Commission rules.

5) Alternatively, how might the Commission eliminate the barriers to entry that it has created and foster a competitive environment for this industry? Would competition be adequate to protect the public interest or should regulatory oversight of the agencies' activities be imposed?

For many years, market participants have voiced concerns about the concentration of credit rating agencies in the U.S. securities markets, and whether inordinate barriers to entry exist. There also has been substantial debate regarding the extent to which any natural barriers to entry are augmented by the regulatory use of the NRSRO concept, and the process of Commission recognition of NRSROs. The Commission's Report discussed in some depth the barriers to entry into the business of acting as a credit rating agency, and the measures needed to remove such barriers.

While there has been a steady growth in the number of firms operating as credit rating agencies in the U.S. and internationally, and new entrants have been able to develop a following for their credit judgments, concerns have been raised that new

entrants are unable to evolve into a substantial presence in the ratings industry. Some believe this is due primarily to the longstanding dominance of the credit rating business by a few firms, as well as the fact that the marketplace may not demand ratings from more than two or three rating agencies. Others have commented that natural barriers to entry into the credit rating business are exacerbated by the regulatory use of credit ratings.

As noted above, the Commission's Concept Release addresses whether credit ratings should continue to be used for regulatory purposes. If the NRSRO concept is not retained by the Commission, then any such regulatory barriers to competition should be eliminated. The Concept Release explores ways to reduce potential regulatory barriers to entry, and the scope of appropriate regulatory oversight, in the event the NRSRO concept is retained by the Commission.

6) Commentators have observed that "ratings triggers" in debentures, which can accelerate a debt obligation, may cause rating agencies to be reluctant to downgrade an issuer's rating, for fear the downgrade will trigger a default. Some have advocated barring such ratings triggers. What is the utility of credit ratings if the rating agencies are loathe to provide accurate ratings if those ratings would trigger a default? This reminds us of the Wall Street securities analysts who were reluctant to downgrade a rating on a company that was an investment banking client. What is the Commission's view of the potential impact of such ratings triggers on ratings?

The Commission's Report explored concerns regarding "ratings triggers" in some depth. As we have seen in some high-profile recent examples, contractual ratings triggers can seriously escalate liquidity problems at firms faced with a deteriorating financial outlook. To date, in its study of credit rating agencies, Commission staff has been unable to confirm allegations of rating agency reluctance to downgrade an issuer subject to a ratings trigger, for fear the downgrade would trigger a default. In fact, such behavior could seriously undermine the credibility on which the business of a rating agency is based.

However, the Commission's Concept Release explores whether issuers should be required to provide more extensive public disclosure regarding ratings triggers. In addition, credit rating agencies and others have been conducting intensive studies to better understand the nature and extent of the use of credit ratings in financial contracts, and their potential impact on a company's liquidity and creditworthiness.

7) How does the development of XBRL, which is expected to facilitate comparison of financial statements, affect the Commission's analysis of the need for the NRSRO designation?

The development of XBRL – short for "eXtensible Business Reporting Language" – may facilitate the comparison of financial statements. If so, credit analysts

may utilize XBRL when developing their opinion of an issuer's creditworthiness, as their analysis often involves a comparison of an issuer's financial statements over time, as well as a comparison with the financial statements of companies in the issuer's industry. While XBRL may be a useful tool for credit analysts, it is not clear whether or how that technology would have a material impact on the Commission's analysis of whether or not there is a need for the NRSRO designation.

8) Absent the "NRSRO" status, from a regulatory standpoint, why should the government regulate credit rating agencies' analyses any differently from how they regulate the work of equity analysts?

Given the importance of credit ratings to investors and the influence such ratings can have on the securities markets, the Commission's Concept Release explores the scope of appropriate regulatory oversight of NRSROs.

There will be some parallels between the issues to be explored relating to NRSROs and those relating to equity analyst oversight, such as how to control potential conflicts of interest. It is important to recognize, however, that there are fundamental differences between the work of equity analysts, whose recommendations are often directed at specific groups of investors to influence their judgment on effecting a securities transaction, and credit rating analysts, who do not make recommendations to specific investors, but rather publish their opinion on the creditworthiness of a particular company, security, or obligation, as of a specific date. In this regard, some believe credit rating activities are journalistic in nature, and consequently are afforded a high level of First Amendment protections. Accordingly, in their view, the Commission and Congress are more constrained in their ability to regulate credit rating agencies than equity analysts.

9) Since the Commission staff has granted NRSRO designation to only four existing firms, two of which control 80% of the market share, it is readily apparent that the normal checks and balances provided by marketplace competition are not present in this industry. In the case of other monopolies regulated by the SEC, statues or regulations typically impose public-interest obligations and limit the exercise of monopoly pricing power. Isn't it true that the SEC does not exercise any oversight of the fees charged by the rating agencies to distribute the ratings to the public? In the absence of SEC oversight, what prevents the rating agencies from exercising monopoly power over pricing for ratings distribution?

The Commission does not oversee the fees charged by NRSROs, whether to distribute their ratings to the public, to issuers to issue a rating, or otherwise. In fact, each of the firms currently recognized as an NRSRO typically make their credit ratings publicly available at no cost. As described more fully in the Commission's Report, when issuing a rating, the NRSROs typically make their ratings, as well as the basic rationale underlying their ratings, publicly available through a broad-based dissemination of press

releases to a number of widely used business newswires. The NRSROs also generally make their current credit ratings available free of charge on their internet websites. More extensive rating information, however, generally is made available to paying subscribers. To date, in its study of credit rating agencies, Commission staff has heard virtually no complaints about the fees charged by the NRSROs either to subscribers or issuers.

10) We have heard concerns that at least one rating agency is attempting to more than triple the price it charges to provide its rating to the public, without any changes to the product itself. What could justify tripling the price of access to ratings information without any change in the information provided? Does this not suggest that the rating agencies exercise monopoly power?

As is noted in the response to Question (9), each firm currently recognized as an NRSRO typically makes its credit ratings publicly available at no cost and, accordingly, the staff is uncertain as to the scenario you pose. Some users of credit ratings do pay for direct electronic access to a "feed" of a rating agency's latest ratings information, but the Commission does not oversee those fees. The staff would be happy to discuss this situation with you or your staff in more detail, however, at your convenience.

11) We have heard concerns regarding "notching" and other monopolistic practices by the rating agencies. Do you share these concerns? What is being done to address these practices?

The Commission's Report discussed allegations that the largest rating agencies have abused their dominant position by engaging in certain aggressive competitive practices, such as "notching" (*i.e.*, lowering their ratings on, or refusing to rate, securities issued by certain asset pools, unless a substantial portion of the assets within those pools was also rated by them). The Commission's Concept Release takes steps to explore the extent to which allegations of anticompetitive or unfair practices, such as these, by large credit rating agencies have merit and, if so, possible Commission action to address them.

12) In 1998, the U.S. Department of Justice filed a comment letter to the Commission's proposed rule relating to NRSROs. The Justice Department expressed several concerns with the Commission's proposal which, in certain respects, would have formalized the NRSRO recognition process. DOJ stated that the Commission's "recognition" requirement – i.e., to receive NRSRO designation, a rating organization would have to be nationally recognized as an issuer of credible and reliable ratings – is "likely to create a nearly insurmountable barrier to de novo entry into the market for NRSRO services." Accordingly, DOJ urged the Commission to revise this language to "minimize this potential anticompetitive effect." We understand that, although this rule was never adopted by the Commission, the "recognition" rule was and continues to be an informal requirement established by Commission staff. Why has the

Commission not heeded the recommendation from the Department of Justice?

As noted in the response to Question (5), there has been substantial debate regarding the extent to which any natural barriers to entry into the credit rating business are exacerbated by the regulatory use of the NRSRO concept, and the process of Commission recognition of NRSROs. Many commenters – such as the DOJ – criticized the regulatory use of the NRSRO concept, and particularly the "national recognition" requirement – as creating a substantial barrier to entry. This criticism was discussed in some detail in the Commission's Report. Further, as noted above, the Commission's Concept Release explores ways to reduce potential regulatory barriers to entry, as well as the possibility of eliminating the NRSRO concept from Commission rules.

13) Regulation FD gives NRSROs preferential treatment, permitting these firms to gain access to non-public information and, therefore, to provide that information to their clients. Doesn't this circumvent the purpose of Regulation FD? Has NRSROs' special access to this information improved the accuracy of their ratings? Why should NRSROs, and not other evaluators of credit risk, receive this special regulatory treatment?

Regulation FD does not give NRSROs preferential treatment that permits them access to information not otherwise available to other credit rating agencies. Generally, Regulation FD prohibits an issuer of securities, or persons acting on behalf of the issuer, from communicating nonpublic information to certain enumerated persons – in general, securities market professionals or others who may use the information for trading – unless the information is publicly disclosed. When Regulation FD was adopted, the Commission exempted all rating agencies – not just NRSROs – from Regulation FD, so long as (a) any nonpublic information is communicated to the rating agency solely for the purpose of developing a credit rating, and (b) the rating is publicly available. The Commission believed this exclusion from the coverage of Regulation FD was appropriate because, so long as the ratings process results in a widely available publication of the rating, the impact of nonpublic information on the creditworthiness of an issuer can be publicly disseminated without disclosing the nonpublic information itself. In addition, rating agencies may be able to avail themselves of the general exemption from Regulation FD for "persons who expressly agree to maintain the disclosed information in confidence."

You also ask whether a rating agency's special access to information under Regulation FD improves the accuracy of its ratings. While Commission staff has not conducted independent research in this area, a number of market participants have told us that a rating agency's access to nonpublic information improves the rating process and results in a more informed and complete credit rating.

14) What are the requirements for obtaining NRSRO status? Where are these requirements published? Is the public granted an opportunity

to comment upon applications for this status or upon SEC action relating to that status? If not, why?

The criteria used by the Commission staff in determining whether to recognize a rating agency as an NRSRO are set forth in a number of publicly-available no-action letters and Commission releases.[7] The single most important criterion is that the rating agency is nationally recognized, which means the rating agency is widely accepted in the United States as an issuer of credible and reliable ratings by the predominant users of securities ratings. Thus, the designation is intended largely to reflect the view of the marketplace as to the credibility of the ratings, rather than represent a "seal of approval" of a federal regulatory agency. The staff also reviews the operational capability and reliability of each rating agency. Included within this assessment are: (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 accurate ratings); and (6) whether the rating agency has internal procedures to prevent the misuse of non-public information and whether those procedures are followed. The staff also recommends that the rating agency become registered as an investment adviser under the Advisers Act. Though the staff does not solicit public comment on NRSRO applications, we do conduct telephone interviews with a number of the rating agency's references and substantial users of credit ratings in order to assess the rating agency's recognition and credibility in the marketplace.

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

The Commission's Report discussed, and the Concept Release explores in more detail, a wide range of issues relating to the Commission's process of recognizing rating agencies as NRSROs. Issues discussed in the Concept Release include whether the current regulatory recognition criteria for rating agencies should be clarified, the

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[7] *See, e.g.*, the 1994 Concept Release, *supra* note 3; the 1997 Proposing Release, *supra* note 4; and Letter from Annette L. Nazareth, Director, Division of Market Regulation, Securities and Exchange Commission, to Mari-Anne Pisarri, Pickard and Djinis LLP (on behalf of Dominion Bond Rating Service Limited) (February 24, 2003). *See also* Letters from Annette L. Nazareth, Director, Division of Market Regulation, Securities and Exchange Commission, to Dr. Barron H. Putnam, LACE Financial Corp. (April 14, 2000, and October 16, 2000).

substance of those criteria, and whether public comment should be sought in connection with applications for NRSRO recognition.

15) Does the Commission vote upon NRSRO designations? What is the Commission's role in granting this status?

The Commission does not vote on whether or not to recognize a rating agency as an NRSRO. However, the staff informs the Commission of its intended action prior to acting on a rating agency's request for NRSRO recognition.

The Commission's Report discussed, and the Concept Release explores in more detail, whether recognition of NRSROs should occur through formal Commission action, rather than through staff no-action letters.

16) Has the Commission ever revoked a rating agency's NRSRO status? Upon what basis would such a determination be made? Does the Commission evaluate NRSRO performance at all?

To date, Commission staff has not revoked a rating agency's NRSRO status. Commission staff has taken the position that they could do so, however, if an NRSRO failed to continue to meet the NRSRO recognition standards. While Commission staff do not formally evaluate the ongoing performance of NRSROs, they do have regular informal meetings with each NRSRO to discuss business, industry and regulatory developments. In addition, as registered investment advisers, the NRSROs are examined periodically by Commission inspections staff.

The Commission's Report discussed, and the Concept Release explores in more detail, whether more direct, ongoing Commission oversight of rating agencies is warranted and, if so, the appropriate method and substance thereof.

17) Conflicts of interest in the form of payments from issuers are a major problem in the equity research area. Prior to 1970, rating firms did not receive much compensation from issuers of debt. In light of this development over the past 30 years, have you tried to wean the rating firms away from issuer compensation, or at least strongly consider recognizing those firms that have succeeded in warning investors and are not subject to the conflicts of interest created by issuer compensation?

Commission staff has not attempted to influence how rating agencies are paid for their ratings, leaving such decisions to the rating agencies and the marketplace. However, the Commission's Report discussed, and the Concept Release explores in more detail, whether rating agencies should implement procedures to manage the potential conflicts of interest that arise both from the issuer-fee and subscriber-fee models.

18) We understand that NRSROs derive the bulk of their revenues from fees charged to the companies they rate. For instance, last year Moody's Investors Service collected approximately $800 million of its $900 million in revenues from such fees. Doesn't this present an obvious conflict of interest? Why shouldn't regulators and the public be just as concerned about this conflict as we have been about the conflicts created by equity analysts' being compensated based on the investment banking business they bring in?

As discussed in depth in the Commission's Report, the practice of issuers paying for their ratings does create the potential for a conflict of interest, and for this reason justifies scrutiny from regulators and the marketplace. Arguably, the dependence of rating agencies on revenues from the companies they rate could induce them to rate issuers more liberally, and temper their diligence in probing for negative information. While most agree that the issuer-fee model creates the potential for a conflict of interest, many believe the rating agencies historically have demonstrated an ability to effectively manage that potential conflict. In this regard, however, many stress the importance of rating agencies implementing and maintaining stringent firewalls, independent compensation, and other related procedures. The fees received from individual issuers tend to be a very small percentage of a rating agency's total revenues, so that arguably no single issuer has material economic influence over a rating agency. As you indicate, analogies can be drawn between the potential conflicts faced by credit rating analysts and those faced by equity research analysts. However, the potential conflicts associated with equity research analysts currently are being addressed through SRO rulemaking.

As noted above, the Concept Release explores in detail whether the Commission should condition NRSRO recognition on rating agencies implementing procedures to manage potential conflicts of interest that arise when issuers pay for ratings.

19) How can an NRSRO accurately be called "independent" if it obtains the majority of its compensation from issuers? Isn't this misleading to investors?

See the response to Question 18 regarding the potential conflicts of interest posed by the issuer-fee model, and the Commission's review of these issues in the context of the Concept Release. The Concept Release explores whether NRSRO recognition should be conditioned on a rating agency having specified financial resources, or less than a certain percentage of its revenues from a single source, to help assure that it operates independently of economic pressures from individual customers.

20) What requirement, if any, does the Commission impose prior to granting NRSRO status to guard against firms' potentially rewarding high ratings or resisting downgrading in order to retain or increase fee income?

Several of the NRSRO recognition criteria are designed to guard against firms' potentially rewarding high ratings or resisting downgrading in order to retain or increase fee income. For example, the staff specifically assesses a rating agency's financial resources and independence to determine whether the rating agency is able to operate free of economic pressures or control from the companies it rates. In addition, the requirement that a credit rating agency be "nationally recognized" is designed to ensure that a firm's ratings are not subject to influence by others, but are credible and reasonably relied upon by the marketplace. As noted in the responses to Questions 18 and 19, the Commission's Concept Release explores additional steps the Commission might take to assure the potential conflicts of interest inherent in the issuer-fee model are appropriately managed.

21) Does the provision of consulting and other services by rating agencies to the companies they rate create conflicts of interest that could call into question the reliability of their ratings?

As discussed in depth in the Commission's Report, the development of ancillary businesses by credit rating agencies does create the potential for a conflict of interest, and for this reason justifies scrutiny from regulators and the marketplace. In recent years, the larger rating agencies have begun developing ancillary businesses to complement their core ratings business. These businesses include ratings assessment services where, for an additional fee, issuers present hypothetical scenarios to the rating agencies to determine how their ratings would be affected by a proposed corporation action (*e.g.*, a merger, asset sale, or stock repurchase). They also include risk management and consulting services.

Among other things, concerns have been expressed that credit rating decisions might be impacted by whether or not an issuer purchases additional services offered by the credit rating agency. In addition, some believe that, whether or not the purchase of ancillary services actually impacts the credit rating decision, issuers may be pressured into using them out of fear that their failure to do so could adversely impact their credit rating. The rating agencies that offer ancillary services point out that they have established extensive policies and procedures to manage potential conflicts in this area, including substantial firewalls that separate the ratings business from the influence of ancillary businesses and prohibiting rating analysts from participating in the marketing of ancillary services.

The Concept Release explores in more detail whether the Commission should require rating agencies to implement procedures to manage potential conflicts of interest that arise when rating agencies develop ancillary fee-based businesses.