TESTIMONY CONCERNING CREDIT RATING AGENCIES

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Chairman Baker, Ranking Member Kanjorski and Members of the Subcommittee:

Thank you for the opportunity to testify before you today on behalf of the Securities and Exchange Commission ("SEC" or "Commission"). Today I plan to provide you with an overview of the SEC's recent work concerning credit rating agencies. I'll begin with a brief history of the SEC's involvement in this area, and then I'll discuss recent SEC initiatives regarding credit rating agencies.

Background

Since 1975, the SEC has relied on credit ratings by market-recognized rating agencies for distinguishing among grades of creditworthiness in various rules under the federal securities laws. These "nationally recognized statistical rating organizations," or "NRSROs," have received no-action letters from the SEC staff. To date, nine firms have received such no-action letters. However, during the 1990s, several NRSROs consolidated so that there are currently five such NRSROs: A.M. Best Company, Inc.; Dominion Bond Rating Service Limited; Fitch, Inc; Moody's Investors Service, Inc.; and the Standard & Poor's Division of the McGraw Hill Companies, Inc.

The term "NRSRO" was originally adopted by the Commission solely for determining capital charges on different grades of debt securities under the Commission's net capital rule for broker-dealers. Over time, however, the NRSRO concept has been incorporated into a number of additional SEC rules and regulations, including rules issued under the Securities Act of 1933, the Securities Exchange Act of 1934, and the

Investment Company Act of 1940. Congress, too, has used the NRSRO concept in legislation, as have other regulatory bodies, including banking regulators both at home and abroad.

Recent Commission Initiatives Relating to Rating Agencies

During the past few years, the Commission has pursued several approaches, on its own and at the direction of Congress, to conduct a thorough and meaningful study of credit rating agencies and the use of credit ratings under the federal securities laws. For example, approximately two years ago the SEC responded to a Congressional directive under the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley") by issuing a report on the role of credit rating agencies in the securities markets. To assist in preparing the report, the SEC held two full days of public hearings. Hearing participants included representatives from credit rating agencies, broker-dealers, buy-side firms, issuers, and the academic community.

The Sarbanes-Oxley report identified a number of substantive issues that the Commission planned to explore in more depth, including (1) improved information flow in the credit rating process; (2) potential conflicts of interest; (3) alleged anticompetitive or unfair practices; (4) potential regulatory barriers to entry into the credit rating business, and (5) ongoing regulatory oversight of credit rating agencies.

On June 4, 2003, the SEC issued a concept release (the "2003 Concept Release") seeking public comment on the issues raised in the Sarbanes-Oxley report. Generally, the SEC sought comment on 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. The Commission also sought comment on the appropriate level of oversight that should be applied to credit rating agencies. Forty-six commenters responded to the concept release.

Most of the 46 commenters supported retention of the NRSRO concept. Many represented that eliminating the concept would be disruptive to the capital markets and would be costly and complicated to replace. Only four commenters supported elimination of the concept, and there was a very limited discussion of regulatory alternatives.

Generally, commenters supported improving the clarity of the process for identifying NRSROs to the extent credit ratings continue to be relied upon in Commission rules and regulations. Specifically, commenters generally supported the Commission's suggestions to specify in more detail what credit rating agencies need to provide to obtain an NRSRO no-action letter. With respect to ongoing oversight, a number of commenters recommended that the Commission enhance the staff's ability to verify whether an NRSRO continues to meet the minimum standards that led to its designation. However, a number of commenters, including each of the current NRSROs, also raised concerns about the extent of the Commission's authority to impose requirements on NRSROs. These commenters argued that the SEC does not have explicit regulatory authority over NRSROs and that NRSRO rating activities are journalistic and are afforded a high level of protection under the First Amendment.

Proposal to Define the Term "NRSRO"

More recently, the Commission, on March 3, 2005, voted to issue a rule proposal that would define the term "NRSRO" for purposes of Commission rules. The proposal builds on earlier Commission work relating to credit rating agencies. The goal of the proposal is to provide greater clarity and transparency to the process of determining whether a credit rating agency's ratings should be relied on as NRSRO ratings for purposes of Commission rules. The proposed definition and the interpretations thereof are intended to provide credit rating agencies with a better understanding of whether they qualify as an NRSRO.

The proposed definition of the term "NRSRO" is composed of three components, which the Commission believes to be the most important criteria in determining whether an entity's ratings should be relied upon for purposes of Commission rules and regulations. Specifically, the Commission is proposing to define the term "NRSRO" as an entity: (1) that issues publicly available credit ratings that are current assessments of the creditworthiness of obligors with respect to specific securities or money market instruments; (2) 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 (3) uses systematic procedures designed to ensure credible and reliable ratings, manage potential conflicts of interest, and prevent the

misuse of nonpublic information, and has sufficient financial resources to ensure compliance with those procedures.

The First Component of the Proposed NRSRO Definition

Under the first component of the proposed definition, to be an NRSRO an entity would have to issue publicly available credit ratings that are current assessments of the creditworthiness of obligors with respect to specific securities or money market instruments. The proposed requirement that an NRSRO make its credit ratings publicly available is consistent with the views of the majority of commenters to the 2003 Concept Release. Most commenters believed that it would be inappropriate to require regulated entities to pay for ratings through subscription services in order to satisfy regulatory requirements.

If adopted, the first component of the proposed definition would also require a credit rating agency to issue credit ratings that are "current assessments" of the creditworthiness of specific securities or money market instruments. The proposal states the belief that this component is necessary so that anyone relying on a rating for regulatory purposes in Commission rules and regulations would have confidence, at any given time, that the rating reflects the credit rating agency's current view. Under the proposed definition, the Commission would interpret "current assessments" to mean that a credit rating agency's published credit ratings should not only reflect its opinion as to the creditworthiness of a security or money market instrument as of the time the rating was issued, but that, until the rating is changed or withdrawn, it continues to represent the rating agency's view as to the creditworthiness of such security or money market instrument.

Because the Commission's regulatory use of the term "NRSRO" primarily relates to credit ratings on specific securities or obligations, the Commission, in its proposed definition, would limit the availability of the NRSRO concept to entities that issue such ratings. The Commission clarifies this element in the proposed NRSRO definition because credit rating agencies that do not issue credit ratings on specific securities, but instead issue credit ratings on the general creditworthiness of specific entities, have requested NRSRO no-action relief. The risk of loss on different debt instruments of the same issuer can vary considerably depending on the terms written into a security's legal

documentation. Therefore, applying a single "issuer" rating to all of an issuer's outstanding debt instruments could be misleading, in the context of the regulatory use of NRSRO ratings, and have adverse regulatory implications.

The Second Component of the Proposed NRSRO Definition

As discussed above, the notion that a credit rating agency be "nationally recognized" for purposes of the NRSRO concept was designed to ensure that credit ratings used for regulatory purposes are credible and reliable, and are reasonably relied upon by the marketplace. Responding to most commenters to the 2003 Concept Release that NRSRO status should be based primarily on a credit rating agency's wide acceptance in the marketplace, the second proposed component of the "NRSRO" definition focuses on whether a credit rating agency is generally accepted in the financial markets as an issuer of credible and reliable ratings by the predominant users of securities ratings.

The second component of the NRSRO definition requires a credit rating agency to be generally accepted in the financial markets. The proposal states the belief that such acceptance would reflect the markets' belief in the credibility and reliability of the ratings provided by the credit rating agency and should provide some level of assurance to those relying on ratings with regard to the dependability and consistency of the ratings for a variety of regulatory purposes. Further, the proposal states the belief that linking the evaluation of a credit rating agency's ratings to the views of the predominant users of securities ratings is helpful. Predominant users generally include financial market participants who hold large inventories of proprietary debt securities, preferred stock, and commercial paper, such as broker-dealers, mutual funds, pension funds, and insurance companies. Given the importance of credit ratings to the business of these market participants, and to the stability of the financial markets as a whole, the proposal notes that incorporating market participant views into the definition of NRSRO provides a certain level of credibility and reliability to NRSRO ratings.

Commenters at the Commission's credit rating agency hearings and to the 2003 Concept Release generally supported the idea that the definition of the term "NRSRO" could include credit rating agencies that confine their activities to limited sectors of the debt market or to limited (or largely non-U.S.) geographic areas. Based on these comments, and the staff's experience in issuing no-action letters to credit rating agencies,

the Commission has proposed that a credit rating agency that has developed a general acceptance in the financial markets for a limited sector of the debt market or a limited geographic area could meet the NRSRO definition. I note that NRSRO no-action letters have been provided to such firms in the past. In these instances, even though the credit rating agencies were generally accepted in the financial markets for a limited sector of the debt market or a limited geographic area, their market acceptance was based on the credibility and reliably of their ratings. Accordingly, the regulatory use of those ratings in Commission rules and regulations is appropriate and consistent with the purposes underlying the NRSRO concept.

The Third Component of the Proposed NRSRO Definition

The third component of the proposed NRSRO definition is designed to ensure that, to meet the definition of the term "NRSRO," a credit rating agency uses systematic procedures designed to ensure credible and reliable ratings, manage conflicts of interest, and prevent the misuse of nonpublic information. It also addresses the need for credit rating agencies to have sufficient financial resources to ensure compliance with such procedures, if they are to meet the definition. This type of analysis should, in turn, assist the credit rating agency in producing credible and reliable ratings, which as discussed above, would further the purposes underlying the regulatory uses of NRSRO ratings.

The proposal solicits comment on whether the following would be important for assessing whether a credit rating agency meets the third component of the proposed definition:

(1) The experience and training of a firm's rating analysts (pertaining to the analysts' ability to understand and analyze relevant information);

(2) The average number of issues covered by analysts (relevant to whether analysts are capable of continuously monitoring and assessing relevant developments relating to their ratings);

(3) The information sources reviewed and relied upon by the credit rating agency and how the integrity of information utilized in the ratings process is verified (relating to the extent and quality of information upon which a firm's ratings are based);

(4) The extent of contacts with the management of issuers, including access to senior level management and other appropriate parties (pertaining to, among other things, the quality and credibility of an issuer's management and to attempt to better understand the issuer's financial and operational condition);

(5) The organizational structure of the credit rating agency (to demonstrate, among other things, the firm's independence from the companies it rates and from potential conflicts of interest that may result from related businesses or those of an affiliate);

(6) How the credit rating agency identifies and manages or proscribes conflicts of interest affecting its ratings business;

(7) How the credit rating agency monitors and enforces compliance with its procedures designed to prohibit the misuse of material, nonpublic information; and

(8) The financial resources of the credit rating agency (regarding whether, among other things, a credit rating agency has sufficient financial resources to ensure that it maintains appropriate staffing levels to continuously monitor the issuers whose securities it rates and to operate independently of economic pressures or control from the companies it rates and from subscribers).

No-Action Letter Process

The proposal states the belief that while adopting a definition of NRSRO would help address commenters' concerns regarding transparency, credit rating agencies might desire to continue to seek staff no-action letters in order to clarify the ability of third parties to rely on their ratings for regulatory purposes. As such, and in light of the long-standing reliance by broker-dealers, issuers, investors and others on the existing staff no-action process, the Commission states in the proposal that, if it were to adopt a definition of NRSRO, it plans to continue to make Commission staff available to provide no-action letters as appropriate to those entities that choose to seek it. No-action letters would be granted for a specific period of time after which the relief would need to be reconsidered.

Commission Authority over NRSROs

As I mentioned previously, a number of commenters to the 2003 Concept Release recommended that the Commission enhance the staff's ability to verify whether an NRSRO continues to meet the minimum standards that led to its designation. Due to apparent limits on the Commission's authority in this area, the Commission staff has worked with the current NRSROs during the past six months to craft a framework for voluntary oversight by the Commission. At this time, our dialogue with the industry has not resulted in an agreed-upon voluntary oversight framework. Nonetheless, I believe a strong and effective industry-led regime could prove to be a constructive and reasonable approach to address a number of concerns involving the credit rating industry that have been raised in recent years by Congress, the Commission, and others, such as the International Organization of Securities Commissions.

That said, the Commission believes that to conduct a rigorous program of NRSRO oversight, more explicit regulatory authority from Congress is necessary. The Commission has not taken a formal position on whether additional legislation should be forthcoming, but it does believe that Congressional hearings on this issue are useful to ensure that this important question is properly vetted. A well-thought out regulatory regime could provide significant benefits in such cases as record-keeping and addressing conflicts of interest in the industry. As Chairman Donaldson said last month before the Senate Committee on Banking, Housing, and Urban Affairs – the Commission welcomes Congressional attention and, of course, would stand ready to work with Congress on crafting appropriate legislation if Congress determines such legislation is necessary.

Thank you again for inviting me to testify. I would be happy to answer any questions you may have.