TESTIMONY

TESTIMONY OF
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CONCERING THE ROLE OF CREDIT RATING AGENCIES IN THE U.S. SECURITIES MARKETS

BEFORE THE COMMITTEE ON GOVERNMENTAL AFFAIRS
UNITED STATES SENATE

March 20, 2002

Chairman Lieberman, Senator Thompson and Members of the Committee:

Thank you for the opportunity to testify before you today on behalf of the Securities and Exchange Commission regarding credit rating agencies and the Commission's experience with the credit rating industry.

Introduction

For almost a century, credit rating agencies have been providing opinions on the creditworthiness of issuers of securities and other financial obligations. During this time, the importance of these opinions to investors and other market participants, and the influence of these opinions on the securities markets, has increased significantly, particularly with the increase in the number of issuers and the advent of new and complex financial products, such as asset-backed securities and credit derivatives. The globalization of the financial markets also has served to expand the role of credit ratings to jurisdictions other than the United States, where the reliance on credit ratings largely was confined for the first half of the twentieth century. Today, credit ratings affect securities markets in a number of important ways, including an issuer's access to and cost of capital, the structure of financial transactions, and the ability of fiduciaries and others to invest in particular investments.

During the past thirty years, regulators such as the Commission have increasingly used credit ratings as a convenient surrogate for the measurement of risk in assessing investments held by regulated entities. Specifically, since 1975, the Commission has referenced the ratings of specified rating agencies in certain of its regulations under the federal securities laws. These rating agencies are often referred to as "Nationally Recognized Statistical Rating Organizations" or "NRSROs."

The Use of Ratings in the Federal Securities Laws

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, Rule 15c3-1 under the Securities Exchange Act of 1934.[1] The net capital rule requires broker-dealers, when computing net capital, to deduct from their net worth certain percentages of the market value ("haircuts") of their proprietary securities positions. A primary purpose of the haircuts is to provide a margin of safety against losses that might be incurred by broker-dealers as a result of market fluctuations in the prices of or lack of liquidity in their proprietary positions. The Commission determined that it was appropriate to apply a lower haircut to securities held by a broker-dealer that were rated investment grade by a credit rating agency of national repute because those securities typically were more liquid and less

volatile in price than those securities that were not so highly rated. The requirement that the credit rating agency be "nationally recognized" was designed to ensure that the firm's ratings were credible and that the ratings were reasonably relied upon by the marketplace.

Over time, as the reliance on credit rating agency ratings increased, so too did the use of the NRSRO concept. Indeed, the concept has been incorporated into several other areas of the federal securities laws. Several regulations issued pursuant to the Securities Act of 1933,[2] the Securities Exchange Act of 1934,[3] and the Investment Company Act of 1940[4] have incorporated the term "NRSRO" as it is used in the net capital rule. For example, Rule 2a-7 under the Investment Company Act of 1940 limits money market funds to investing in only high quality short-term instruments. Under Rule 2a-7, NRSRO ratings provide minimum quality investment standards for money market funds. A money market fund is permitted to invest in securities rated by an NRSRO in the two highest rating categories for short-term debt. Over $2 trillion of investor assets are held in money market funds meeting the standards of Rule 2a-7. In addition, offerings of certain nonconvertible debt and preferred securities that are rated investment grade by at least one NRSRO can be registered on Form S-3 without the issuer satisfying a minimum public float test. Generally, Form S-3 is a short-form registration statement designed for use by issuers that are subject to periodic reporting requirements under the Securities Exchange Act of 1934.

Congress itself employed the term "NRSRO" when it defined the term "mortgage related security" in Section 3(a)(41) of the Securities Exchange Act of 1934.[5] The term "mortgage related security" was added by the Secondary Mortgage Market Enhancement Act of 1984, and it required that such securities must, among other things, be rated in one of the two highest rating categories by at least one NRSRO.

Finally, other regulatory bodies, including banking regulators both at home and abroad, employ the concept of NRSRO in their regulations.

The System for Designating Rating Agencies as NRSROs

Currently, to determine whether a rating organization is an NRSRO, the Commission staff reviews the rating organization's operations, position in the marketplace, and other criteria. If the Commission staff determines that the NRSRO designation is appropriate, the staff sends a no-action letter to the rating organization stating that it will not recommend enforcement action to the Commission against broker-dealers that use ratings issued by the rating agency for purposes of the net capital rule.

To assess whether a rating agency may be considered an NRSRO for purposes of the Commission's rules, the Commission staff consider a number of criteria. The single most important criterion is that the rating agency is nationally recognized, which means the rating organization 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 organization. Included within this assessment are: (1) the organizational structure of the rating organization; (2) the rating organization'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 organization's staff (to determine if the entity is capable of thoroughly and competently evaluating an issuer's credit); (4) the rating organization's independence from the companies it rates; (5) the rating organization's rating procedures (to

determine whether it has systematic procedures designed to produce credible and accurate ratings); and (6) whether the rating organization has internal procedures to prevent the misuse of non-public information and whether those procedures are followed. Because credit ratings entail the conveyance of a form of investment advice, the staff also recommends that the rating agency become registered as an investment adviser under the Investment Advisers Act of 1940.

When the Commission first began using ratings in the net capital rule in 1975, the Commission staff, in consultation with the Commission, determined that the ratings of Standard and Poor's Corporation, Moody's Investors Service, Inc., and Fitch Investors Service, Inc. were used nationally and so these firms should be considered NRSROs for purposes of the net capital rule.[6] Since 1975, the Commission staff has issued no-action letters to Duff and Phelps, Inc.,[7] McCarthy Crisanti & Maffei, Inc.,[8] IBCA Limited and its subsidiary, IBCA, Inc.,[9] and Thomson BankWatch, Inc.[10] These latter firms were subsequently merged or acquired such that presently there are three NRSROs.

Over the course of its history the Commission has considered a number of issues regarding credit rating agencies. Not surprisingly, many of the instances in which either the Commission or Congress reflected on the need for regulation coincided with a large scale credit default such as the Orange County default and the default of the Washington Public Power Supply System ("WPPSS") bonds. Ten years ago the Commission seriously considered the need for oversight authority of credit rating agencies, given their increasing role in the financial and regulatory systems.[11] The Commission at that time did not reach a consensus on the need for regulation.

In 1994, the Commission did, however, issue a concept release soliciting public comment on the appropriate role of ratings in the federal securities laws, and the need to establish formal procedures for designating and monitoring the activities of NRSROs.[12] The Commission specifically solicited comments on: (1) whether it should continue to use the NRSRO concept, and, if so, whether it should define the term "NRSRO"; and (2) whether the current no-action letter process for recognizing NRSROs is satisfactory, and, if not, whether the Commission should establish an alternative procedure. The Commission received 25 comment letters, which generally supported the continued use of the NRSRO concept, but recommended that the Commission adopt a formalized process for approving NRSROs. Commenters generally opposed additional regulatory oversight of NRSROs.

In 1997, the Commission published a rule proposal that would have adopted a definition of the term "NRSRO" that set forth the criteria a rating organization would have to satisfy to be acknowledged as an NRSRO.[13] The proposed amendments would have defined an NRSRO as an entity that (1) issues ratings that are current assessments of the creditworthiness of obligors with respect to specific securities or money market instruments and is registered under the Investment Advisers Act of 1940 and (2) is approved as an NRSRO by the Commission unless such designation is withdrawn. Generally, under the proposed amendments, the Commission would consider the same criteria currently used in the no-action letter process. To a large extent the proposal was designed to bring greater transparency to the existing process and to provide for a formal appeal process.

The process would have included:

- a procedure in which the Commission staff would approve or reject an application for NRSRO status, unless the Commission objected;
- a procedure for rating organizations that are denied NRSRO status to appeal the Commission staff's decision to the Commission, in which case the Commission may designate a hearing officer to preside over any proceeding; and

- a requirement that NRSROs notify the Commission of material changes and permit the Commission to withdraw NRSRO status if changes affect a rating agency's ability to continue to meet any of the requisite criteria. A rating organization could appeal a final decision by the Commission to withdraw its NRSRO status in federal court.

The Commission has not yet acted on the proposal. Given the recent focus on the larger question of rating agency oversight, the Commission is unlikely to act on the proposal until it is satisfied that it has appropriately addressed the relevant issues.

Competition

A number of observers, including the U.S. Department of Justice, have criticized the national recognition requirement as creating a barrier to entry for new credit rating agencies.[14] Generally, this argument is based on the premise that users of securities ratings have a regulatory incentive to use ratings issued by NRSROs, rather than non-NRSROs, and that this makes it quite difficult for non-NRSROs to achieve the national recognition necessary for Commission designation as an NRSRO. Historically, the Commission has not determined that the national recognition requirement creates a substantial barrier to entry into the credit rating business. Growth in the businesses of several credit rating agencies not recognized as NRSROs suggests that there may be a growing appetite among market participants for advice about credit quality from all credible sources, and that this~~which~~ makes it possible for new entrants to develop~~ing~~ a national following for their credit judgments. The Commission has determined to examine the competitive impact of the Commission's use of the NRSRO designation. The Commission also will consider suggestions concerning other market-based alternatives for determining the credibility of credit ratings that might address the competitive concerns associated with the NRSRO framework.

Regulation of Rating Agencies

Each of the current NRSROs is registered with the Commission as an investment adviser under the Investment Advisers Act of 1940.[15] The Advisers Act prohibits fraud, imposes fiduciary duties on advisers with respect to their advice, requires advisers to maintain certain books and records specified by Commission rules, and gives the Commission authority to examine NRSROs registered as investment advisers for compliance with the provisions of the Advisers Act. While the Advisers Act requires these NRSROs to have an adequate basis for their ratings, and prohibits them from having undisclosed conflicts with respect to the ratings, the Advisers Act does not directly address the quality or reliability of NRSROs ratings.

Because of the quasi-public responsibilities of rating agencies, the importance given to ratings by investors and other market participants, and the influence of ratings on the securities markets, a number of observers believe that rating agencies, regardless of whether they are designated as NRSROs, should be subject to greater Commission oversight. The Commission believes that its authority to use NRSRO ratings and the process for designating NRSROs is clear under existing law. If greater supervision of NRSROs is deemed necessary, the NRSRO designation process might provide a basis for increased Commission oversight of NRSROs. In particular, the Commission is exploring whether additional oversight of NRSROs could be applied as a condition to recognition as an NRSRO.

Conclusion

The Commission will engage in a thorough examination, which may include hearings, to ascertain facts, conditions, practices and other matters relating to the role

of rating agencies in the U.S. securities markets. It is our intention to call upon a number of experts for their views, including market professionals who rely on credit ratings and academics, as well as the NRSROs themselves. We believe it is an appropriate time and in the public interest to re-examine the role of rating agencies in the U.S. securities markets and to conduct a public examination of the potential need for greater regulation in this area.

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

[2] See, e.g., Regulation S-K (17 CFR 229.10); Rule 436 (17 CFR 230.436); Form S-3 (17 CFR 239.13); and Forms F-2 and F-3 (17 CFR 239.32, 239.33).

[3] See, e.g., Rule 101 (17 CFR 242.101) and Rule 102 (17 CFR 242.102).

[4] See, e.g., Rule 2a-7(a)(9) (17 CFR 270.2a-7(a)(9)); Rule 10f-3 (17 CFR 270.10f-3); and Rule 3a-7 (17 CFR 270.3a-7).

[5] Pub. L. No. 98-440, § 101, 98 Stat. 1689 (1984). See 15 U.S.C. 78c(a)(41).

[6] See, e.g., Letter from Gregory C. Yadley, Staff Attorney, Division of Market Regulation, SEC, to Ralph L. Gosselin, Treasurer, Coughlin & Co., Inc. (November 24, 1975).

[7] See Letter from Nelson S. Kibler, Assistant Director, Division of Market Regulation, SEC, to John T. Anderson, Esquire, of Lord, Bissell & Brook, on behalf of Duff & Phelps, Inc. (February 24, 1982).

[8] See Letter from Michael A. Macchiaroli, Assistant Director, Division of Market Regulation, SEC, to Paul McCarthy, President, McCarthy, Crisanti & Maffei, Inc. (September 13, 1983).

[9] See Letter from Michael A. Macchiaroli, Assistant Director, Division of Market Regulation, SEC, to Robin Monro-Davies, President, IBCA Limited (November 27, 1990); Letter from Michael A. Macchiaroli, Assistant Director, Division of Market Regulation, SEC, to David L. Lloyd, Jr., Dewey Ballentine, Bushby, Palmer & Wood, on behalf of IBCA (October 1, 1990).

[10] See Letter from Michael A. Macchiaroli to Gregory A. Root, President, Thomson BankWatch, Inc. (August 6, 1991); Letter from Michael A. Macchiaroli to Lee Pickard, Pickard and Djinis LLP (January 25, 1999).

[11] See Letters from Representative John D. Dingell to Richard C. Breeden, Chairman, SEC (April 28, 1992 and July 9, 1992); Letter from Richard C. Breeden, Chairman, SEC, to the Honorable John D. Dingell (July 23, 1992); Letter from J. Carter Beese, Jr., Commissioner, SEC, to the Honorable John D. Dingell (August 12, 1992); Letter from Mary L. Schapiro and Richard Y. Roberts, Commissioners, SEC, to the Honorable John D. Dingell (August 12, 1992).

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

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

[14] See, e.g., Comments of the United States Department of Justice in the Matter of: File No. S7-33-97 Proposed Amendments to Rule 15c3-1 under the Securities Exchange Act of 1934 (March 6, 1998).

[15] Subject to certain exclusions, the Investment Advisers Act defines an "investment adviser" to include any person who, for compensation, is engaged in the business of using reports or analyses regarding securities.

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