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17 CFR Part 240

**Definition of Nationally Recognized
Statistical Rating Organization; Proposed
Rule**

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 240

[Release Nos. 33–8570; 34–51572; IC–26834; File No. S7–04–05]

RIN 3235–AH28

Definition of Nationally Recognized Statistical Rating Organization

AGENCY: Securities and Exchange Commission (“Commission”).

ACTION: Proposed rule.

SUMMARY: The Commission is publishing for comment a proposed new rule under the Securities Exchange Act of 1934 (“Exchange Act”), which would define the term “nationally recognized statistical rating organization” (“NRSRO”). The proposed definition contains three components that must each be met in order for a credit rating agency to be an NRSRO. The Commission is also providing interpretations of the proposed definition of the term “NRSRO.” Defining the term “NRSRO” and providing interpretations of the definition would increase transparency with regard to the NRSRO concept.

DATES: Comments should be received on or before June 9, 2005.

ADDRESSES: Comments may be submitted by any of the following methods:

Electronic Comments

- Use the Commission’s Internet comment form (<http://www.sec.gov/rules/proposed.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number S7–04–05 on the subject line; or
- Use the Federal eRulemaking Portal (<http://www.regulations.gov>). Follow the instructions for submitting comments.

Paper Comments

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549–0609.

All submissions should refer to File Number S7–04–05. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission’s Internet Web site (<http://www.sec.gov/rules/proposed.shtml>). Comments are also available for public inspection and copying in the Commission’s Public

Reference Room, 450 Fifth Street, NW, Washington, DC 20549. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

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I. Introduction

In June 2003, the Commission issued a concept release (the “2003 Concept Release”) soliciting public comment on various issues regarding credit rating agencies, including whether credit ratings should continue to be used for regulatory purposes under the federal securities laws, and, if so, the process of determining whose credit ratings should be used and the level of oversight to apply to such credit rating agencies.¹ To address certain issues raised in response to the 2003 Concept Release, particularly with regard to the clarity of whether a credit rating agency is an NRSRO, the Commission is proposing to define the term “NRSRO” in new Exchange Act Rule 3b–10, and to provide interpretations of that definition. The Commission notes that this proposal is intended only to address the meaning of the term “NRSRO” as it is used by the Commission; it does not attempt to address many of the broader issues raised in response to the 2003 Concept Release.

II. The Development of the NRSRO Concept

A. Background

Since 1975, the Commission has relied in several significant regulatory areas on credit ratings by rating agencies that the markets have recognized as credible. These “nationally recognized statistical rating organizations,” or “NRSROs,” have typically sought a level of comfort regarding their status as NRSROs through the no-action letter process.² To date, nine firms have been identified as NRSROs by the Commission staff. However, during the 1990s, several credit rating agencies consolidated so that there are currently five such NRSROs: A.M. Best Company, Inc. (“A.M. Best”), Dominion Bond Rating Service Limited (“DBRS”); Fitch,

¹ Securities Act Release No. 33–8236, 68 FR 35258 (June 12, 2003). The 2003 Concept Release was intended to assist the Commission in addressing issues identified in its January 24, 2003 report on credit rating agencies, which was required by Congress under Section 702 of the Arbanes-Oxley Act of 2002. See *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.

² See, e.g., Letter from Annette L. Nazareth, Director, Division of Market Regulation, Commission, to Mari-Anne Pisarri, Pickard and Djinis LLP (February 24, 2003). For a more detailed description of the no-action letter process, see also Section III.E.

Inc. ("Fitch"); Moody's Investors Service Inc. ("Moody's"); and the Standard & Poor's Division of the McGraw Hill Companies, Inc. ("S&P").

Although the Commission originated the use of the term "NRSRO" for use in its rules and regulations, ratings by NRSROs today are used as benchmarks in federal and state legislation, rules issued by financial and other regulators, foreign regulatory schemes, and private financial contracts. Many of these uses specifically refer to the term "NRSRO" as used in the Commission's rules and regulations. However, the Commission has never defined the term "NRSRO."

B. History of the NRSRO Concept

The term "NRSRO" was originally adopted by the Commission in 1975 solely for use in determining capital charges on different grades of debt securities under Exchange Act Rule 15c3-1, the Commission's "net capital rule."³ The use of this term enabled the Commission to distinguish between investment grade and non-investment grade paper in a reasonably objective fashion. The net capital rule requires broker-dealers, when computing net capital, to deduct from their net worth certain percentages of the market value of their proprietary securities positions. These deductions, often referred to as "haircuts," are intended 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 securities that were not so highly rated.⁴

Over time, as marketplace and regulatory reliance on credit ratings increased, the Commission's use of the NRSRO concept as a proxy for regulatory determinations of liquidity and creditworthiness became more widespread.⁵ Several rules and

regulations issued by the Commission pursuant to the Securities Act of 1933,⁶ the Exchange Act,⁷ and the Investment Company Act of 1940,⁸ utilize the term "NRSRO" and cross-reference to 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, and NRSRO ratings can be used as benchmarks for establishing minimum quality investment standards. Under Rule 2a-7, a money market fund is limited to investing in securities rated by an NRSRO in the two highest ratings categories for short-term debt (or unrated securities of similar quality), and there are limitations on the amount of securities the fund can hold that are not rated in the highest rating category (or are not unrated securities of similar quality).⁹ In addition, in regulations adopted by the Commission under the Securities Act of 1933, offerings of certain nonconvertible debt, preferred securities, and asset-backed securities that are rated investment grade by at least one NRSRO can be registered on Form S-3—the Commission's "short-form" registration statement—without the issuer satisfying a minimum public float test.¹⁰

In addition, Congress has incorporated the term "NRSRO" into a wide range of legislation.¹¹ For example, when Congress defined the term "mortgage related security" in

Section 3(a)(41) of the Exchange Act,¹² as part of the Secondary Mortgage Market Enhancement Act of 1984,¹³ it required, among other things, that such securities be rated in one of the two highest rating categories by at least one NRSRO.

Finally, a number of other federal, state, and foreign laws and regulations today use the term "NRSRO." For example, the U.S. Department of Education uses ratings from NRSROs to set standards of financial responsibility for institutions that wish to participate in student financial assistance programs under Title IV of the Higher Education Act of 1965, as amended.¹⁴ In addition, several state insurance codes rely on NRSRO ratings in determining appropriate investments for insurance companies.¹⁵ The term "NRSRO" also has been used in foreign jurisdictions.¹⁶

In 1975, when NRSRO ratings first were incorporated in the net capital rule, the Commission staff determined that the ratings of S&P, Moody's, and Fitch were used nationally, and that the staff would raise no questions if these firms were utilized as NRSROs for purposes of the net capital rule.¹⁷ Since 1975, the Commission staff has issued NRSRO no-action letters¹⁸ to six additional credit rating agencies: (1) Duff and Phelps, Inc.;¹⁹ (2) McCarthy, Crisanti & Maffei, Inc.;²⁰ (3) IBCA Limited and its subsidiary, IBCA, Inc.;²¹

⁶ See Regulation S-B (17 CFR 228.10) and Regulation S-K (17 CFR 229.10); Rule 134 (17 CFR 230.134); Rule 436 (17 CFR 230.436); Form S-3 (17 CFR 239.13); Form F-2 (17 CFR 239.32); and Form F-3 (17 CFR 239.33).

⁷ See Rule 3a1-1 (17 CFR 240.3a1-1); Rule 10b-10 (17 CFR 240.10b-10); Rules 101 and 102 of Regulation M (17 CFR 242.101 and 242.102, respectively); and Rule 300 of Regulation ATS (17 CFR 242.300).

⁸ See Rule 2a-7 (17 CFR 270.2a-7); Rule 3a-7 (17 CFR 270.3a-7); Rule 5b-3 (17 CFR 270.5b-3); and Rule 10f-3 (17 CFR 270.10f-3).

⁹ Under Rule 2a-7 (17 CFR 270.2-7), NRSRO ratings are minimum requirements; fund advisers must also make an independent determination that the security presents "minimal credit risks."

¹⁰ Form S-3 (17 CFR 239.13).

¹¹ See, e.g., 15 U.S.C. 78c(a)(41) (defining the term "mortgage related security"); 15 U.S.C.

78c(a)(53)(A) (defining the term "small business related security"); and 15 U.S.C. 80a-6(a)(5)(A)(iv)(I) (exempting certain companies from the provisions of the Investment Company Act of 1940); Gramm-Leach-Bliley Act, Pub. L. 106-102 (1999); Transportation Equity Act for the 21st Century, Pub. L. 105-178 (1998); Reigle Community Development and Regulatory Improvement Act of 1994, Pub. L. 103-325 (1994); Department of Commerce, Justice, and State, The Judiciary, and Related Agencies Appropriations Act, FY2001, Pub. L. 106-553 (2000); Higher Education Amendments of 1992, Pub. L. 102-325 (1992); Housing and Community Development Act of 1992, Pub. L. 102-550 (1992); Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. 102-242 (1991); and Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. 101-72 (1989).

¹² 15 U.S.C. 78c(a)(41).

¹³ Pub. L. 98-440, 101, 98 Stat. 1689 (1984).

¹⁴ 20 U.S.C. 1070 *et seq.* and 42 U.S.C. 2751 *et seq.*, 34 CFR 668.15(b)(7)(ii) and (8)(ii).

¹⁵ For example, the California Insurance Code relies on NRSRO ratings in allowing California-incorporated insurers to invest excess funds in certain types of investments. See Cal. Ins. Code 1192.10.

¹⁶ See, e.g., National Instrument 71-101, The Multijurisdictional Disclosure System (Oct. 1, 1998) (Can.).

¹⁷ See, e.g., Letter from Gregory C. Yadley, Staff Attorney, Division of Market Regulation, Commission, to Ralph L. Gosselin, Treasurer, Coughlin & Co., Inc. (November 24, 1975).

¹⁸ For a discussion of the no-action letter process, see Section III.E.

¹⁹ See Letter from Nelson S. Kibler, Assistant Director, Division of Market Regulation, Commission, to John T. Anderson, Esquire, Lord, Bissell & Brook, on behalf of Duff & Phelps, Inc. (February 24, 1982).

²⁰ See Letter from Michael A. Macchiaroli, Assistant Director, Division of Market Regulation, Commission, to Paul McCarthy, President, McCarthy, Crisanti & Maffei, Inc. (September 13, 1983).

²¹ See Letter from Michael A. Macchiaroli, Assistant Director, Division of Market Regulation, Commission, to Robin Monro-Davies, President, IBCA Limited (November 27, 1990) and Letter from Michael A. Macchiaroli, Assistant Director, Division of Market Regulation, Commission, to David L. Lloyd, Jr., Dewey Ballentine, Bushby, Palmer & Wood (October 1, 1990).

³ 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).

⁴ See, e.g., 17 CFR 240.15c3-1(c)(2)(vi)(E), (F), and (H).

⁵ The NRSRO concept is currently used in the following Commission rules: 17 CFR 228.10(e), 229.10(c), 230.134(a)(14), 230.436(g), 239.13, 239.32, 239.33, 240.3a1-1(b)(3), 240.10b-10(a)(8), 240.15c3-1(c)(2)(vi)(E), (F) and (H), 240.15c3-3a(b)(1)(i)(C), 240.15c3-1(f)(d), 240.15c3-3a, Item 14, Note G, 242.101(c)(2), 242.102(d), 242.300(k)(3) and (l)(3), 270.2a-7(a)(10), 270.3a-7(a)(2), 270.5b-3(c), and 270.10f-3(a)(3).

(4) Thomson BankWatch, Inc.;²² (5) DBRS;²³ and (6) A.M. Best.²⁴ With the exception of A.M. Best and DBRS, each of these additional firms has since merged with or been acquired by other NRSROs, resulting in five NRSROs at present.

The Commission has not adopted a definition of the term "NRSRO." However, through experience from the no-action process, the Commission staff has developed a number of criteria that it considers when reviewing NRSRO no-action requests. As a result, under current practice, the Commission staff reviews a credit rating agency's operations, position in the marketplace, and other specific factors to determine whether to grant a no-action letter.

In determining whether to issue an NRSRO no-action letter, the Commission staff has considered the single most important factor to be whether the credit rating agency is "nationally recognized" in the United States as an issuer of credible and reliable ratings by the predominant users of securities ratings. The notion of "national recognition" was designed to help ensure that credit ratings used for regulatory purposes under Commission rules are credible and can reasonably be relied upon by the marketplace. Also reviewed in connection with the no-action letter process is a credit rating agency's operational capability and ratings process. Included within this assessment are: (1) The organizational structure of the credit rating agency; (2) the credit rating agency's financial resources; (3) the size and quality of the credit rating agency's staff; (4) the credit rating agency's independence from the companies it rates; (5) the credit rating agency's rating procedures; and (6) whether the credit rating agency has internal procedures to prevent the misuse of nonpublic information and whether those procedures are followed.

C. Commission Reviews of Credit Rating Agencies

1. 1994 Concept Release

Over the years, the Commission has reviewed a number of issues regarding credit rating agencies, including their regulatory oversight. In 1994, the

²² See Letter from Michael A. Macchiaroli, Assistant Director, Division of Market Regulation, Commission, to Gregory A. Root, President, Thomson BankWatch, Inc. (August 6, 1991) and Letter from Michael A. Macchiaroli, Associate Director, Division of Market Regulation, Commission, to Lee Pickard, Pickard and Djinis LLP (January 25, 1999).

²³ See *supra* note 2.

²⁴ See Letter from Mark M. Attar, Special Counsel, Division of Market Regulation, Commission, to Arthur Snyder, President, A.M. Best (March 3, 2005).

Commission issued a concept release soliciting public comment on the Commission's use of NRSRO ratings (the "1994 Concept Release").²⁵ Due to the expanded role played by credit ratings in Commission rules and regulations, a number of domestic and foreign credit rating agencies at that time had sought NRSRO no-action letters. Also, concerns had been expressed that Commission rules and regulations did not define the term "NRSRO," and that there was no formal mechanism for monitoring the activities of NRSROs. As a result, the Commission solicited public comment on the appropriate role of credit ratings in the federal securities laws, and the need to establish formal procedures for identifying NRSROs and monitoring their activities. Most commenters supported the continued use of the NRSRO concept and recommended that the Commission adopt a formalized process for identifying NRSROs.²⁶

2. 1997 Rule Proposal

As a response to the 1994 Concept Release, the Commission, in 1997, proposed to amend the net capital rule to define the term "NRSRO."²⁷ The proposed amendments set forth criteria to be considered by the Commission in recognizing credit rating agencies as NRSROs, and would have established an NRSRO application process for credit rating agencies.

Although commenters generally supported the Commission's attempt to define the requirements necessary for a credit rating agency to be identified as an NRSRO, the Commission did not act upon the 1997 rule proposal described above as a result of, among other things, the initiation of broad-based Commission and Congressional reviews of credit rating agencies.

3. Recent Reviews of Credit Rating Agencies

More recently, the Commission has pursued several approaches to conduct a thorough and meaningful study of the use of credit ratings in the federal securities laws, the process of determining which credit ratings should be used for regulatory purposes, and the level of oversight to apply to credit rating agencies. Commission efforts included discussions with credit rating agencies and market participants,

²⁵ See Nationally Recognized Statistical Rating Organizations, Release No. 34-34616 (August 31, 1994), 59 FR 46314 (September 7, 1994).

²⁶ See, e.g., Letter from Walter J. Schroeder, President, DBRS, to Jonathan G. Katz, Secretary, Commission (December 20, 1994).

²⁷ 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).

including buy-side firms,²⁸ formal examinations of each of the NRSROs, and public hearings that offered a broad cross-section of market participants the opportunity to communicate their views on credit rating agencies and their role in the capital markets.

a. NRSRO Examinations

On March 19, 2002, the Commission issued an Order directing investigation, pursuant to Section 21(a) of the Exchange Act, into the role of credit rating agencies in the U.S. securities markets.²⁹ The purpose of the Order was to ascertain facts, conditions, practices, and other matters relating to the role of credit rating agencies in the U.S. securities markets, and to aid the Commission in assessing whether to continue to use credit ratings in its rules and regulations under the federal securities laws and, if so, the categories of acceptable credit ratings and the appropriate level of regulatory oversight.

The Commission's examination of the NRSROs revealed several concerns, including those relating to: (i) Potential conflicts of interest caused by payment by issuers to NRSROs for their ratings; (ii) exacerbation of those conflicts of interest due to the marketing by the NRSROs of ancillary services to issuers, such as pre-rating assessments and corporate consulting; (iii) the potential for the NRSROs, given their substantial power in the marketplace, to improperly pressure issuers to pay for ratings; (iv) the potential for the NRSROs, given their substantial power in the marketplace, to improperly pressure issuers to purchase ancillary services; (v) the effectiveness of the NRSROs' existing policies and procedures designed to protect confidential information; and (vi) difficulties in the Commission's examinations of NRSROs from, among other things, the lack of recordkeeping requirements tailored to NRSRO activities, the NRSROs' assertions that the document retention and production requirements of the Investment Advisers Act of 1940 are inapplicable to the credit rating business, and their claims that the First Amendment shields the NRSROs from producing certain documents to the Commission.

²⁸ Retail investor participation in the debt markets often takes place indirectly through buy-side firms, such as investment companies.

²⁹ See Order In the Matter of the Role of Rating Agencies in the U.S. Securities Markets Directing Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934, and Designating Officers for Such Designation (March 19, 2002).

b. Credit Rating Agency Hearings

The Commission's broad-based study of credit rating agencies included public hearings held on November 15 and 21, 2002, that addressed credit rating agencies operating in U.S. securities markets.³⁰ Panel participants represented various views, including those of credit rating agencies, broker-dealers, buy-side firms, issuers, and the academic community.

Topics addressed during the hearings included the current role and functioning of credit rating agencies, information flow in the credit rating process, concerns regarding credit rating agencies (e.g., potential conflicts-of-interest), and the regulatory treatment of credit rating agencies (including concerns regarding potential barriers to entry).

Most hearing participants favored the regulatory use of credit ratings issued by NRSROs as a simple, efficient benchmark of credit quality, and suggested that regulatory standards for NRSROs were necessary for this concept to have meaning and reliability.³¹

Many participants expressed concern about the existing NRSRO no-action letter process.³² Suggestions to improve the process included (i) that the Commission should specify the information credit rating agencies should provide when requesting NRSRO no-action letters; and (ii) that the Commission review the staff's work in evaluating satisfaction of the NRSRO criteria.³³ Some suggested that NRSRO no-action requests be completed in a more timely fashion and some noted that the Commission might promote competition in the credit rating industry by explicitly permitting credit rating agencies that specialize in particular sectors to receive NRSRO no-action letters.³⁴

Some ratings users and issuers suggested that the Commission consider

³⁰ The Current Role and Function of Credit Rating Agencies in the Operation of the Securities Markets, Hearings Before the U.S. Securities and Exchange Commission (November 15 and 21, 2002) ("SEC Hearing on Credit Rating Agencies"). Full hearing transcripts are available on the Commission's Web site at <http://www.sec.gov/spotlight/ratingagency.htm> [hereinafter "SEC Hearing Transcript"].

³¹ See, e.g., SEC Hearing Transcript, *supra* note 30 (November 15, 2002) (testimony of Gregory A. Root, Executive Vice President, DBRS).

³² See, e.g., Written Statement of Paul Saltzman, Executive Vice President and General Counsel, The Bond Market Association, SEC Hearing on Credit Rating Agencies, *supra* note 30 (November 21, 2002).

³³ *Id.*

³⁴ See, e.g., Written Statement of Yasuhiro Harada, Senior Executive Managing Director, Rating and Investment Information, Inc., SEC Hearing on Credit Rating Agencies, *supra* note 30 (November 21, 2002).

more substantive regulation of credit rating agencies (e.g., to address potential conflicts of interest), and engage in more active oversight of them (e.g., monitoring compliance with the NRSRO criteria).³⁵

Concerns were raised by hearing participants regarding the special access of subscribers to credit rating agency personnel, particularly given the exclusion from Regulation FD available for disclosures to credit rating agencies.³⁶ While the larger credit rating agencies make ratings and the basic rating rationale available simultaneously to subscribers and non-subscribers, subscribers may also have direct access to credit rating agency analysts.³⁷ Because of this direct access, there is a greater risk that nonpublic material information may be communicated to subscribers.

c. Report Under the Sarbanes-Oxley Act of 2002

Coincident with these Commission initiatives, Congress in Section 702 of the Sarbanes-Oxley Act of 2002, required that the Commission conduct a study of credit rating agencies and submit a report on that study to the President and Congress (the "Report"). The Commission submitted the Report to the President and Congress on January 24, 2003.³⁸ The Report addressed, among other things, 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,

³⁵ See, e.g., Written Statement of Amy Lancellotta, Senior Counsel, Investment Company Institute, SEC Hearing on Credit Rating Agencies, *supra* note 30 (November 21, 2002).

³⁶ See, e.g., SEC Hearing Transcript, *supra* note 30 (November 15, 2002) (testimony of Malcolm S. Macdonald, Vice President—Finance and Treasurer, Ford Motor Company). See also Selective Disclosure and Insider Trading, Release No. 34-43154 (August 15, 2000), 65 FR 51716 (August 24, 2000). Generally, Regulation FD prohibits an issuer of securities, or persons acting on behalf of the issuer, from communicating material 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 credit rating agencies—not just NRSROs—from Regulation FD, on the condition that the material nonpublic information is communicated to a credit rating agency solely for the purpose of developing a credit rating and that the rating is publicly available. In addition to the specific rating agency exemption in Regulation FD, credit rating agencies may be able to avail themselves of the exemption for "persons who expressly agree to maintain the disclosed information in confidence." 17 CFR 243.100(b)(2)(ii).

³⁷ *Id.*

³⁸ See *supra* note 1.

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.³⁹

d. The 2003 NRSRO Concept Release

To further assist the Commission in addressing issues identified in the Report, the Commission published the 2003 Concept Release on June 4, 2003, seeking comment on a number of issues relating to credit rating agencies. These issues included whether credit ratings should continue to be used for regulatory purposes under the federal securities laws, and, if so, the process of determining whose credit ratings should be used, and the level of oversight to apply to such credit rating agencies. Issues discussed during the Commission's two days of public hearings on credit rating agencies were also addressed in the 2003 Concept Release.

Most of the 46 commenters responding to the 2003 Concept Release supported retention of the NRSRO concept. They generally represented that, among other things, eliminating the NRSRO concept would be disruptive to the capital markets,⁴⁰ and would be costly and complicated to replace.⁴¹ Only four commenters supported elimination of the concept,⁴² and there was limited discussion of regulatory alternatives.⁴³

Most commenters supported improving the clarity of the process for identifying NRSROs to the extent credit ratings continue to be relied upon in Commission rules. Specifically, commenters generally supported the Commission's suggestions to specify more detail in what credit rating agencies need to provide to obtain an NRSRO no-action letter.⁴⁴ Some also generally supported greater transparency regarding the NRSRO concept, for example, by identifying

³⁹ Sarbanes-Oxley Act of 2002, Pub. L. 107-204, Section 702(b), 116 Stat. 745 (2002).

⁴⁰ See, e.g., Letter from Leo C. O'Neill, President, Standard & Poor's, to Jonathan G. Katz, Secretary, Commission (July 28, 2003).

⁴¹ See, e.g., Letter from Gregory V. Serio, Superintendent, New York Insurance Department, Chair, NAIC Rating Agency Working Group, National Association of Insurance Commissioners, to Commission (July 28, 2003).

⁴² See, e.g., Letter from Lawrence J. White, Professor of Economics, Stern School of Business, New York University, to Commission (July 25, 2003).

⁴³ See, e.g., Letter from Frank Partnoy, University of San Diego School of Law, to Jonathan G. Katz, Secretary, Commission (July 28, 2003).

⁴⁴ See, e.g., Letter from Barbara Roper, Director of Investor Protection, Consumer Federation of America, to Jonathan G. Katz, Secretary, Commission (July 28, 2003).

NRSROs through Commission action versus the existing no-action letter process.⁴⁵

A few commenters represented that the current NRSRO criteria, as set forth in the 2003 Concept Release, create barriers to entry for new entrants and that the standards for determining NRSRO status should be lowered.⁴⁶ Others disagreed and represented that the current NRSRO criteria should not be diluted.⁴⁷ Most commenters supported NRSRO criteria designed to limit conflicts of interest in the credit rating business.⁴⁸ There was also general support for recognizing credit rating agencies that confine their activities to a limited sector of the debt market⁴⁹ or a limited geographic area.⁵⁰

Most commenters supported the concept of regulatory oversight of NRSROs, at a minimum, to determine whether a credit rating agency continues to meet the NRSRO criteria on an ongoing basis.⁵¹ Commenters also recommended that NRSROs should be subject to periodic Commission examinations.⁵²

D. International Initiatives

In recent years, there have also been several international initiatives involving credit rating agencies. In February 2003, the Technical Committee of the International Organization of Securities Commissions ("IOSCO"),⁵³ of which the Commission is a member, created a task force to study issues concerning credit rating agencies, and in September 2003 IOSCO published "Principles Regarding the

Activities of Credit Rating Agencies,"⁵⁴ a set of high-level objectives for regulators, credit rating agencies, and other market participants. In February 2004, the IOSCO Technical Committee formed a Chairmen's Task Force for the purpose of developing a voluntary code of conduct for credit rating agencies providing guidance on ways credit rating agencies could implement the Principles in practice, leading to the December 2004 publication by IOSCO of a "Code of Conduct Fundamentals for Credit Rating Agencies."⁵⁵ The Code, among other things, addresses how credit rating agencies can protect their analytical independence, eliminate or manage conflicts of interest, and help ensure the confidentiality of nonpublic information shared with them by issuers.

III. Discussion

A. Background

The Commission is proposing to define the term "NRSRO" in new Exchange Act Rule 3b-10. The proposed definition would be composed of three components, which the Commission preliminarily believes to be the most important criteria in determining whether an entity's ratings should be relied upon for purposes of the securities laws and Commission rules and regulations. In addition, the Commission is providing interpretations of the proposed definition.

Specifically, the Commission is proposing to define the term "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 those procedures.

The components of the proposed definition are designed to determine those credit rating agencies whose

ratings are sufficiently reliable to be used for a variety of regulatory purposes, such as for purposes of the net capital rule. For example, the principal purposes of the net capital rule are to protect customers and other market participants from broker-dealer failures and to enable those firms that fall below the minimum net capital requirements to liquidate in an orderly fashion without the need for a formal proceeding or financial assistance from the Securities Investor Protection Corporation. The net capital rule requires different minimum levels of capital based upon the nature of the firm's business and whether the broker-dealer handles customer funds or securities. In relying on credit ratings believed to be sufficiently reliable, the Commission is using those ratings as a means to evaluate the liquidity as well as the creditworthiness of certain securities held by a broker-dealer in establishing a sufficient capital cushion.

B. Proposed Definition of the Term "NRSRO"

1. The First Component

The first component of the proposed NRSRO definition would limit the definition to entities that issue publicly available credit ratings that are current assessments of the creditworthiness of obligors with respect to specific securities or money market instruments.

a. Publicly Available Credit Ratings

In the 2003 Concept Release, the Commission inquired whether it should address concerns that certain credit rating agencies make their ratings available only to paid subscribers and that it would be inappropriate to require users of credit ratings to subscribe for a fee to an NRSRO's services to obtain ratings for regulatory purposes. The majority of commenters agreed that credit rating agencies whose ratings are used for regulatory purposes under the Commission's rules and regulations should agree to make public dissemination of their ratings on a widespread basis at no cost.⁵⁶

Commenters generally represented that the publication of credit ratings (i) enhances the transparency and efficiency of the market, (ii) helps prevent potential selective disclosure of material nonpublic information obtained by a credit rating agency under Regulation FD, and (iii) and allows for

⁴⁵ See, e.g., Letter from Steven C. Nelson, Director of Taxable Money Market Research, Fidelity Investments Money Management, Inc., to Jonathan G. Katz, Secretary, Commission (July 25, 2003).

⁴⁶ See, e.g., Letter from LACE Financial Corp. (July 25, 2003).

⁴⁷ See, e.g., Letter from Grace Hinchman, Senior Vice President, Public Affairs, Financial Executives International, to Jonathan G. Katz, Secretary, Commission (July 25, 2003).

⁴⁸ See, e.g., Letter from John M. Ramsey, Senior Vice President and Regulatory Counsel, The Bond Market Association, to Jonathan G. Katz, Secretary, Commission (July 28, 2003).

⁴⁹ See, e.g., Letter from Jeffrey P. Neubert, President and CEO, The New York Clearing House Association L.L.C., to Jonathan G. Katz, Secretary, Commission (July 31, 2003).

⁵⁰ See, e.g., Letter from Naohiko Matsuo, Director for International Financial Markets, Financial Services Agency, Government of Japan, to Jonathan G. Katz, Secretary, Commission (July 25, 2003).

⁵¹ See, e.g., Letter from Amy B.R. Lancellotta, Senior Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Commission (July 28, 2003).

⁵² See, e.g., *supra* note 41.

⁵³ IOSCO consists of 175 securities market regulators that have agreed to cooperate in order to promote high standards of regulation and to maintain efficient and sound domestic and international securities markets.

⁵⁴ "IOSCO Statement of Principles Regarding the Activities of Credit Rating Agencies," The Technical Committee, IOSCO (September 25, 2003). See also "Report on the Activities of Credit Rating Agencies," The Technical Committee, IOSCO (September 2003).

⁵⁵ See "Code of Conduct Fundamentals for Credit Rating Agencies," The Technical Committee of IOSCO (December 2004).

⁵⁶ See, e.g., Letter from Denise Voigt Crawford, Securities Commissioner, Texas State Securities Board, to Jonathan G. Katz, Secretary, Commission (July 28, 2003).

ratings comparability.⁵⁷ The commenters also said that a credit rating should not be considered to be “publicly disseminated” if access to it is not readily available on a widespread basis.⁵⁸

One commenter noted that a credit rating agency should not be required to disclose ratings to the public when there is a specific prior agreement between the credit rating agency and an issuer as to certain prescribed conditions for not publishing the issuer’s rating (e.g., in the case of “private” ratings, in which a credit rating agency agrees to provide its rating of an issuer only to the issuer).⁵⁹ Another commenter suggested that NRSROs should permit others, such as publishers of financial information, to freely distribute new rating information without limitations.⁶⁰ One commenter also cautioned the Commission against involving itself in the determination of an NRSRO’s pricing models.⁶¹ This commenter represented that NRSROs should be allowed to charge whatever price the market will bear.⁶² Another commenter expressed concern that requiring NRSROs to publish their credit ratings at no cost may result in higher prices for issuers and others who pay for an NRSRO’s services.⁶³

In response to these comments, the Commission is proposing that, in order to meet the definition of the term “NRSRO,” a credit rating agency must issue credit ratings that are publicly available. The Commission is also interpreting “publicly available,” as used in the definition, to mean that credit ratings used for regulatory purposes under Commission rules must be disseminated on a widespread basis at no cost. In this context, the rating could be published in a readily accessible manner on the credit rating agency’s internet Web site. The Commission believes that it is important for credit ratings used for regulatory

purposes to be publicly available, as public availability—at no cost—should assure wide dissemination of ratings and provide the opportunity for the marketplace to judge the credibility and reliability of an entity’s credit ratings.

This approach is consistent with the views of most commenters that it would be inappropriate to require users of credit ratings to subscribe for a fee to an NRSRO’s services to obtain credit ratings for regulatory purposes. The Commission notes that in proposing to define the term “NRSRO” as an entity that makes its credit ratings publicly available, the public availability reference only would apply to the credit rating itself (i.e., the rating symbol), and not to other information otherwise developed by the credit rating agency (e.g., the credit rating agency’s rating rationale). This approach should not result in NRSROs charging higher fees for their services because it would not require a credit rating agency to make available at no cost the analysis underlying its rating.⁶⁴ The Commission notes that this approach is also consistent with the current practices of many credit rating agencies, including each of the current NRSROs, that already publish their credit ratings on a widespread basis at no cost.

Questions: How should it be determined whether an NRSRO is making its credit ratings readily available on a widespread basis? Should our rule specify the manner and methods that must be used to distribute ratings? Should internet posting itself be sufficient?

b. Issue-Specific Credit Opinions

The Commission is aware that credit rating agencies often issue different types of credit ratings that can reflect, among other things, the creditworthiness of specific securities or obligations, or the general creditworthiness of specific entities. 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 of the term “NRSRO,” is limiting the availability of the NRSRO concept to entities that issue such ratings.

The Commission is proposing to clarify this element of 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.

Questions: Should a credit rating agency that does not rate specific securities or money market instruments be included in the definition of NRSRO? If so, under what circumstances?

c. Current Credit Opinions

The proposed definition also attempts to ensure that only “current” credit ratings—meaning that such ratings are actively monitored and updated appropriately on a continuous basis—be used for regulatory purposes under the federal securities laws. The Commission believes that credit ratings used for regulatory purposes should be actively monitored on a continuous basis and confirmed, upgraded, or downgraded, if and when necessary. The Commission’s reliance on credit ratings from a credit rating agency that are not current, and thus, may not even reflect the credit rating agency’s own view as to the creditworthiness of a security, could interfere with the intended regulatory uses of the NRSRO rating.

The first component of the proposed definition would require a credit rating agency to issue credit ratings that are “current assessments” of the creditworthiness of specific securities or money market instruments. This component may help to ensure that persons relying on a rating for regulatory purposes in Commission rules and regulations can 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 reflect its opinion as to the creditworthiness of a security or money

⁵⁷ See, e.g., Letter from Raymond McDaniel, President, Moody’s, to Jonathan G. Katz, Secretary, Commission (July 28, 2003).

⁵⁸ *Id.*

⁵⁹ See, e.g., Letter from Yasuhiro Harada, Executive Vice President, Rating and Investment Information, Inc., to Jonathan G. Katz, Secretary, Commission (July 28, 2003).

⁶⁰ See, e.g., Letter from David Colling, Product Director, ABS Reports (UK) Limited, to Jonathan G. Katz, Secretary, Commission (July 31, 2003).

⁶¹ See, e.g., Letter from James A. Kaitz, President and CEO, Association for Financial Professionals, to Jonathan G. Katz, Secretary, Commission (July 28, 2003).

⁶² *Id.*

⁶³ See, e.g., Letter from Richard Raeburn, Chief Executive, and John Grout, Technical Director, The Association of Corporate Treasurers, United Kingdom, to Jonathan G. Katz, Secretary, Commission (August 8, 2003).

⁶⁴ In connection with the Commission’s review of issues concerning credit rating agencies, commenters have consistently represented that they typically subscribe to a rating agency’s services primarily to understand the analysis underlying the rating agency’s ratings—not solely for the credit rating itself. For example, during the Commission’s 2002 credit rating agency hearings, representatives of users of credit ratings (e.g., from mutual fund companies and broker-dealers) indicated that they review research that is done by credit rating agencies to assess credit risk for the securities they purchase within their portfolios. See, e.g., SEC Hearing Transcript, *supra* note 30 (November 15, 2002) (testimony of Deborah A. Cunningham, Senior Vice President and Senior Portfolio Manager, Federated Investors, Inc., and testimony of Cynthia L. Strauss, Director of Taxable Bond Research, Fidelity Investments Money Management, Inc.).

market instrument as of the time the rating was issued and until the rating is changed or withdrawn. Under this interpretation, a credit rating agency could meet the “current assessments” element of the proposed definition if it has and follows procedures designed to ensure that its ratings are reviewed and, if necessary, updated on the occurrence of material events, including significant sector or issue-specific events. By including in the NRSRO definition that a credit rating agency’s ratings need to be “current assessments,” the Commission is responding to comments received in response to the 2003 Concept Release that a requirement that NRSRO ratings be kept “current” is desirable.⁶⁵

Further, although the Commission is proposing to define the term “NRSRO” to require an NRSRO’s ratings to be current, the Commission is not proposing to prescribe a specific time period within which an NRSRO’s ratings would need to be updated. Specifying a time period within which a credit rating agency must update or affirm a rating might be problematic because the appropriate time period for responding to a material event may vary considerably based on, for example, the complexity of an issuer or the specific security being rated. Accordingly, it may be appropriate for a credit rating agency to have the flexibility to respond to material events relating to its ratings on a case-by-case basis. This approach responds to comments that the Commission should not set detailed standards as to when a rating agency should update its ratings.⁶⁶

Questions: Should the Commission provide additional interpretation regarding what it means for a credit rating agency’s credit ratings to be “current assessments”? Should the Commission specify the time period? Will the proposed rule’s provisions provide sufficient assurance to the markets that ratings are current?

2. The Second Component

a. General Acceptance in the Financial Markets

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 Commission is proposing that the second component of the NRSRO definition require a credit rating agency to be generally accepted in the financial markets. 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. For example, net capital calculations and haircuts that are determined through use of these credit ratings are more likely to be reliable than those determined without the use of such ratings and, thus, could be more likely to protect customers and other market participants from harm in the event of a broker-dealer failure.

Further, linking the evaluation of a credit rating agency’s ratings to the views of the predominant users of securities ratings would be 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. These firms—given their large inventories of rated fixed income securities—generally have developed sophisticated internal credit rating departments which rate issuers and counterparties. However, they also rely on external ratings from credit rating agencies to compare against and test their internal rating and analysis. 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 Commission believes that incorporating their views into the definition of NRSRO provides a certain level of credibility and reliability to NRSRO ratings.

The Commission proposes that a credit rating agency could meet the second component of the NRSRO definition through a variety of objective means. For example, in appropriate circumstances, a credit rating agency could do so through statistical data that demonstrates market reliance on the credit rating agency’s ratings (e.g., market movements in response to ratings changes). A credit rating agency also might be able to satisfy the second

component if authorized officers of users of securities ratings representing a substantial percentage of the relevant market attest that the credit rating agency’s ratings are credible and actually relied on by the users.

Questions: How else could the Commission define the term “NRSRO” in order for users of a credit rating agency’s ratings to determine whether such ratings are credible and are reasonably relied upon by the marketplace? Are the approaches discussed above useful for determining whether a credit rating agency meets the second component of the proposed definition? Are there other types of information that would be appropriate? For example, should the fact that a credit rating agency has many subscribers support a finding that the credit rating agency satisfies the second component? What types of statistical data could be relied on to determine if a credit rating agency’s credit ratings are relied on by the marketplace? What standards should be considered to assess such statistical data? Should the views of issuers be a relevant consideration in determining whether a credit rating agency meets the second component of the NRSRO definition?

b. Limited Coverage NRSROs

Commenters at both the Commission’s credit rating agency hearings and responding 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. While several commenters suggested that the Commission distinguish between full- and limited-coverage NRSROs,⁶⁷ others represented that credit rating agencies should only be able to meet the definition as full-coverage NRSROs because, in their view, it would be difficult for limited coverage NRSROs to provide a full and accurate assessment of credit risks without a broader expertise in credit risk assessment.⁶⁸

Based on the staff’s experience in issuing no-action letters to credit rating agencies, 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. As noted in Section II.B., NRSRO no-action letters have been provided to

⁶⁷ *Id.*

⁶⁸ See, e.g., Letter from Jonathan C. Conley, Federated Investment Management Company, to Jonathan G. Katz, Secretary, Commission (July 28, 2003).

⁶⁵ See, e.g., *supra* note 63.

⁶⁶ See, e.g., *supra* note 59.

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 reliability of their ratings. Accordingly, the regulatory use of those ratings in Commission rules and regulations was appropriate and consistent with the purposes underlying the NRSRO concept.

Questions: Should a credit rating agency that is recognized by the financial marketplace for issuing credible and reliable ratings within a limited sector or geographic area meet the NRSRO definition only for its ratings within such sector or geographic area, or more broadly? If a credit rating agency meets the NRSRO definition only with respect to its ratings within a particular sector or geographic area, would the NRSRO classification interfere with the credit rating agency's ability to expand its business? How should ratings from such an NRSRO be identified so that broker-dealers and other users of NRSRO ratings for regulatory purposes can determine which credit ratings from the NRSRO may be used for regulatory purposes? We noted above that commenters mentioned that it would be difficult for limited coverage NRSROs to provide a full and accurate assessment of credit risks without a broader expertise in credit risk assessment. We request further comment on this view given our proposal to permit limited coverage NRSROs.

3. The Third Component

The third proposed component of the 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.

The Commission preliminarily believes that including in the proposed definition the requirement that an entity use systematic rating procedures in producing credit ratings should help to ensure that NRSRO ratings are based on a thorough credit analysis of issuers and their financial obligations. 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 Commission preliminarily believes that the following would be important for assessing whether a credit rating agency meets the third component of the proposed definition: (i) The experience and training of a firm's rating analysts (pertaining to the analysts' ability to understand and analyze relevant information); (ii) 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); (iii) 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); (iv) 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); (v) 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); (vi) how the credit rating agency identifies and manages or proscribes conflicts of interest affecting its ratings business; (vii) how the credit rating agency monitors and enforces compliance with its procedures designed to prohibit the misuse of material, nonpublic information; and (viii) 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).

a. Analyst Experience and Training

There was no consensus among commenters to the 2003 Concept Release as to whether the experience and training of a credit rating agency's staff should be a factor in determining whether a credit rating agency is an NRSRO. Similarly, there was no consensus as to whether the Commission should include in an NRSRO definition minimum standards for the training and qualifications of the credit rating agency's credit analysts.

Several commenters indicated that the competency of a credit rating agency's staff should be a relevant consideration in connection with being an NRSRO, and that experience and training of a credit rating agency's staff are of particular importance.⁶⁹ Several commenters suggested that, to be an NRSRO, a credit rating agency should develop minimum standards for training and qualification of its analysts, and that compliance with such standards should be verified when assessing whether a credit rating agency is an NRSRO.⁷⁰ There was also support among commenters that an NRSRO should take steps to verify whether members of its staff have been subject to disciplinary action by a financial (or other) regulatory authority.⁷¹

While several commenters were of the view that minimum training standards for NRSROs would be appropriate, a few indicated that oversight of training methods would add little value to the NRSRO concept.⁷² One commenter recommended that NRSROs should be required to disclose staff qualifications and staff size on a periodic basis.⁷³ Several commenters also represented that credit rating agencies with staffing deemed inadequate by the marketplace would quickly be rejected by investors and issuers.⁷⁴

The Commission is not proposing to require that a credit rating agency satisfy specified minimum experience and training requirements to meet the proposed definition of the term "NRSRO." A credit rating agency with an inadequately trained and inexperienced staff would likely encounter difficulties meeting the second and third components of the proposed definition. However, the Commission currently believes that to meet the proposed definition of the term "NRSRO," a credit rating agency should have procedures designed to ensure that its analysts are competent—that is, that they are able to identify, understand, and analyze information relevant to the issuers whose securities they rate. A credit rating agency should also have procedures designed to examine the backgrounds of its analysts and other members of its staff.

⁶⁹ See, e.g., Letter from Mark Roemer, Finance Strategies, Siemens AG, to Commission (July 28, 2003).

⁷⁰ See, e.g., Letter from William M. Wells, Chief Financial Officer, Bunge Limited, to Commission (July 28, 2003).

⁷¹ See, e.g., Letter from Joseph E. Cantwell, President, Cantwell & Company, to Commission (July 22, 2003).

⁷² *Id.*

⁷³ See, e.g., Letter from Cate Long, Multiple-Markets, to Commission (July 28, 2003).

⁷⁴ See, e.g., *supra* note 61.

The Commission believes that analyst experience and training is an important consideration with regard to the NRSRO concept because credit ratings relied upon by the marketplace typically result from thorough and competent credit analysis employed by a credit rating agency's analysts. For example, if a credit rating agency's rating procedures require an analyst to evaluate an issuer's financial statements, the ability of the analyst to understand and analyze those financial statements depends on the analyst's experience and training in financial analysis. If the credit rating agency's rating procedures do not require such experience and training, it follows that the credit rating agency would not have systematic procedures designed to ensure credible and reliable ratings, and that it would be inappropriate to rely on the credit rating agency's ratings for providing limited exemptions or privileges in Commission rules.

While the Commission is not proposing to require NRSROs to disclose staff qualifications and size on a periodic basis, as suggested by commenters, such disclosures on a voluntary basis could assist users of a credit rating agency's ratings in assessing whether the credit rating agency uses systematic procedures designed to ensure credible and reliable ratings.

Questions: The Commission recognizes that the evaluation of an analyst's experience would involve a degree of subjectivity. The Commission requests comment on the appropriate subjective criteria that a credit rating agency should use in assessing the experience and training of an analyst to meet the proposed NRSRO definition. In addition, what objective criteria are relevant? What level of importance should be given to the subjective and objective criteria? How can a credit rating agency in seeking to meet the proposed NRSRO definition demonstrate that it has adequate procedures designed to ensure that its analysts are competent? What factors should a credit rating agency consider in evaluating the background of its analysts and other members of its staff?

b. Number of Ratings Per Analyst

While there was little support for the Commission to condition NRSRO status on an entity's meeting standards for a maximum average number of issues covered per analyst, there was support for requiring NRSROs to disclose the number of credit analysts they employ and the average number of issues rated

or otherwise followed by those analysts.⁷⁵

Commenters generally shared the view that the number of analysts and number of issues rated per analyst are best left to the credit rating agencies.⁷⁶ They also generally agreed that strong incentives exist for credit rating agencies to monitor the quality of their analysis due to the constant scrutiny from both issuers and investors.⁷⁷ Further, they agreed that analysts must maintain reasonable workloads for their analytical quality to remain high.⁷⁸ Concern was also expressed that setting such standards would involve the Commission too deeply into the business practices of credit rating agencies and that they could potentially create barriers to NRSRO status.⁷⁹

Based on the views of commenters, the Commission is not proposing that a credit rating agency must have specific limits on the number of securities rated per analyst to meet the definition of the term "NRSRO." However, as a preliminary matter, the Commission is concerned that a credit rating agency's ratings may become less reliable as the number of issues rated per analyst increases. This appears more significant to the extent an analyst rates securities of issuers with complex business models operating in a variety of industries.

Due to this concern, and the Commission's preliminary belief that credit ratings used for regulatory purposes should be the result of a competent and thorough analysis, a credit rating agency should be able to demonstrate to users of its securities ratings that its analysts are capable of continuously monitoring and assessing relevant developments relating to their ratings. Thus, the number of ratings per analyst could be an important consideration for users of securities ratings in assessing under the third component of the proposed definition whether a credit rating agency uses systematic procedures designed to ensure credible and reliable ratings.

While the Commission is not proposing to require credit rating agencies to disclose the number of credit analysts they employ and the average number of issues rated or otherwise followed by those analysts, as suggested by commenters, it may be that disclosures such as these would assist users of a credit rating agency's ratings in assessing whether the credit rating

agency uses systematic procedures designed to ensure credible and reliable ratings.

Questions: Is the concern that a credit rating agency's ratings may become less reliable as the number of issues rated per analyst increase valid? If so, what type of workload is reasonable for the analytical quality of a credit rating agency's ratings to remain high? Should the Commission specify minimum standards for a credit rating agency's analysts to continuously monitor and assess relevant developments relating to their ratings so that users of the credit rating agency's ratings can determine whether the credit rating agency meets the NRSRO definition? If a credit rating agency relies primarily on quantitative models to develop credit ratings, how can such a firm's ratings reflect a thorough analysis of the specific credit characteristics of a particular security? Should the Commission require credit rating agencies to disclose the number of credit analysts they employ and the average number of issues rated or otherwise followed by those analysts, as suggested by commenters?

c. Information Sources Used in the Ratings Process

The process of rating a particular issuer's securities typically begins with collecting relevant financial information about the issuer. Relevant financial information often includes an issuer's recent past financial performance and current financial condition. This information generally is obtained directly from the issuer in the form of audited and unaudited financial statements. In some instances, credit rating agencies rely on third parties that collect the information and disseminate it through proprietary data feeds. Generally, these vendors download or otherwise obtain public financial information (e.g., from 10-K's and 10-Q's) and repackage such information into data feeds to subscribers.

The reliability of a credit rating agency's ratings depends, in part, on the integrity of the information upon which the credit rating agency bases its ratings. Therefore, the Commission believes that, to meet the third component of the NRSRO definition, credit rating agencies should have controls in place to reasonably assess the integrity of the information sources they rely on in their ratings process.⁸⁰ For example, if a credit rating agency is relying on quantitative financial results, such as an issuer's quarterly earnings, provided by

⁷⁵ See, e.g., *supra* note 73.

⁷⁶ See, e.g., *supra* note 70.

⁷⁷ *Id.*

⁷⁸ See, e.g., *supra* note 71.

⁷⁹ See, e.g., *supra* note 40.

⁸⁰ We do not intend here to suggest that a credit rating agency must audit or otherwise ensure the accuracy of an issuer's financial condition.

a third-party vendor, the credit rating agency should have a process designed to test the integrity of the vendor's information. This could include cross-checking a sample of the earnings reports against other sources such as audit reports, Commission filings (e.g., a 10-K or 10-Q), or by contacting the issuer.

Questions: Should a credit rating agency be required to test in some way the integrity of information provided directly by issuers (both public and nonpublic) and through third party vendors? Are there other appropriate objective methods for determining whether a credit rating agency has reasonably tested the integrity of the information on which it bases its ratings?

d. Contacts With Management

In the 2003 Concept Release, the Commission inquired whether it should limit the credit ratings that can be used for regulatory purposes in Commission rules to credit rating agencies that regularly contact senior management of an issuer. A number of commenters indicated that obtaining senior management's views enhances a credit rating agency's ability to assess the quality and credibility of an issuer's management and to attempt to better understand the issuer's operational and financial condition.⁸¹ Others, however, indicated that it is possible to perform a high quality credit analysis when sufficient publicly available information exists on an issuer.⁸² It was noted by commenters that requiring contact with issuer management could act as a barrier to entry for smaller credit rating agencies that cannot compel issuers to engage in a dialogue.⁸³ Other commenters indicated that issuer management would be less inclined to talk to credit rating agencies issuing lower ratings.⁸⁴

The Commission's proposed definition of the term "NRSRO" does not explicitly limit the definition of the term "NRSRO" to entities that systematically contact an issuer's senior management. Nonetheless, it could be important for a credit rating agency whose credit ratings will be used for regulatory purposes to involve in the rating process, when possible, an issuer's senior management, or, in the

case of issuers of asset-backed securities, other appropriate parties.⁸⁵

Question: In designing and implementing systematic procedures to ensure credible and reliable ratings, should a credit rating agency seeking to meet the definition of NRSRO address how and the extent to which it involves an issuer's senior management in the rating process? To meet the proposed NRSRO definition, should a credit rating agency's procedures require that the credit rating agency request an issuer's senior management to participate in the credit rating agency's rating process without incurring a fee?

e. Organizational Structure

Commenters generally agreed that organizational structure is an appropriate factor to consider when evaluating whether a rating agency is an NRSRO. Commenters indicated that credit rating agencies typically structure their businesses to ensure that their ratings have been thoroughly analyzed, reviewed, and approved by independent and relevant persons within a credit rating agency's organization, and that because of this, it would be appropriate to consider a credit rating agency's organizational structure when evaluating a credit rating agency's status as an NRSRO.⁸⁶ Several commenters also believed that this would enable the Commission to better identify and potentially minimize conflicts of interest issues at NRSROs.⁸⁷

Some commenters believed that NRSROs should consent to limiting their business to issuing credit ratings because it would be useful to prevent NRSROs from engaging in activities that raise conflicts of interest issues.⁸⁸ Others disagreed, however, indicating that it is not necessary or in investors' best interests to preclude an NRSRO from being part of a larger business organization that has the ability to offer financial strength and stability and can support the level of investment necessary to continually enhance their ratings operations.⁸⁹

For the reasons discussed above, the Commission preliminarily believes that a credit rating agency's organizational structure would be relevant to determine whether the credit rating

agency meets the definition of NRSRO. For example, such structure should include a process for ensuring that credit ratings are analyzed, reviewed, and approved at all appropriate levels within the credit rating agency's organizational structure. Further, the organizational structure of a credit rating agency can also be designed to avoid or minimize potential conflicts of interest and prevent the misuse of nonpublic information (e.g., through firewalls separating ratings services and analysts from affiliated businesses).

Though the Commission is not defining the term "NRSRO" to exclude a credit rating agency from being part of a larger business organization, certain affiliated businesses of a credit rating agency could interfere with the credit rating agency's ability to meet the proposed NRSRO definition. For example, a credit rating agency that is affiliated with an entity that underwrites securities rated by the credit rating agency would have a difficult time meeting the third component regarding procedures to manage conflicts of interest.

Questions: Would information on a credit rating agency's organizational structure be useful to users of ratings? If so, what information would be useful?

f. Conflicts of Interest

Conflicts of interest may arise in a number of areas within a credit rating agency. For example, commenters to the 2003 Concept Release indicated that reliance on issuer fees by a credit rating agency could lead to conflicts of interest and the potential for rating inflation.⁹⁰ Commenters also represented that conflicts of interest can arise when credit rating agencies offer consulting or other advisory services to the entities they rate.⁹¹ In addition, during the Commission's 2002 credit rating agency hearings, hearing participants indicated that a credit rating agency's subscribers could be given preferential access to rating analysts and, as a result, inappropriately may learn of potential rating actions or other nonpublic information. The Commission notes that conflicts may arise as well when a person associated with a credit rating agency (e.g., an employee) also is associated with or has an interest in an issuer that is being rated.

As noted above, investors rely on credit ratings directly and through investor protection regulation that uses the NRSRO concept. Given this reliance, an investor could be harmed if a rating is unduly influenced by a person with

⁸⁵ For instance, we would expect ratings on securities issued by asset-backed issuers to involve, as appropriate, the senior personnel of their depositor and servicer.

⁸⁶ See, e.g., *supra* note 41.

⁸⁷ See, e.g., Letter from Olivier Raingard, to Commission (July 27, 2003).

⁸⁸ See, e.g., Letter from Takashi Kanasaki, Managing Director, Japan Credit Rating Agency, Ltd., to Jonathan G. Katz, Secretary, Commission (July 14, 2003).

⁸⁹ See, e.g., *supra* note 40.

⁹⁰ See, e.g., *supra* note 84.

⁹¹ *Id.*

⁸¹ See, e.g., *supra* note 69.

⁸² See, e.g., *supra* note 40.

⁸³ See, e.g., Letter from LACE Financial Corp. (July 25, 2003).

⁸⁴ See, e.g., Letter from Sean J. Egan, Managing Director, Egan-Joens Ratings Co., to Jonathan G. Katz, Secretary, SEC (July 28, 2003).

a vested interest in the level of the rating.

In responding to the 2003 Concept Release, most commenters supported the idea of conditioning NRSRO status on a credit rating agency implementing procedures to address conflicts of interest in its business.⁹² We believe that concerns about conflicts of interest are valid and have therefore proposed, as part of the definition of the term "NRSRO," that an entity must use systematic procedures designed to manage potential conflicts of interest. To satisfy this part of the definition, a credit rating agency should, at a minimum, be able to identify the types of conflicts of interest that arise in its business, its procedures designed to address and minimize or avoid those conflicts of interest, and how the firm monitors and verifies compliance with those procedures. The Commission believes that it is necessary for an NRSRO to take these steps to address conflicts of interest because credit ratings may be unduly influenced by obligors, subscribers, or other interested persons if conflicts of interest are not handled appropriately.

Further, if a credit rating agency has adopted procedures to address conflicts arising, for example, between its ratings business and its affiliated advisory business, then such procedures, if followed, would reduce the risk that obligors will be unduly pressured into purchasing advisory services in order to maintain their credit rating.⁹³

Questions: What specific conflicts of interest should be addressed in a credit rating agency's procedures and how should they be addressed? Should a credit rating agency that engages in activities that present potential or actual conflicts of interest be excluded from the definition of NRSRO? Alternatively, is it sufficient for a credit rating agency

to impose and implement safeguards to prevent potential conflicts of interest from affecting the quality and independence of its credit ratings? Are there other practices that raise concerns similar to those raised by conflicts of interest, for example, those referred to in footnote 93 regarding unsolicited ratings, that should be addressed in a credit rating agency's procedures?

g. Misuse of Information

Some credit rating agencies, as part of their analysis, maintain contact with senior management of the issuers they rate. In the course of these contacts, an issuer may provide an analyst with nonpublic information such as contemplated business transactions or estimated financial information. There is a potential that this information could be used by a credit rating analyst or others for improper purposes. In fact, the Commission recently brought an insider trading action against a former analyst of a credit rating agency.⁹⁴ The Commission, in that case, alleged that the analyst obtained information about two proposed transactions and tipped that information to others.⁹⁵

As this example shows, there is the risk that persons exposed to such material, nonpublic information may trade on it. In fact, the Commission staff, as part of its 2002 NRSRO examinations discussed above in Section II, identified as a potential concern, among other things, the effectiveness of the NRSROs' existing policies and procedures designed to protect confidential information.⁹⁶ In light of this concern, the Commission posed a number of questions in the 2003 Concept Release to solicit comment on the protection of nonpublic information. For example, the Commission asked whether NRSRO recognition should be conditioned on a credit rating agency having internal procedures to prevent the misuse of nonpublic information.⁹⁷ Commenters generally acknowledged the importance of protecting nonpublic information provided by issuers.⁹⁸ They explained that nonpublic information greatly assists credit rating agencies in issuing credible and reliable ratings and pointed out that if credit rating agencies had a track record of failing to protect such

information, issuers would stop providing such information.⁹⁹

The Commission believes that for a credit rating agency to meet the proposed definition of the term "NRSRO," it should have policies and procedures that are designed to effectively protect nonpublic information provided by issuers. Accordingly, under the third component of the proposed NRSRO definition, a credit rating agency would be required to adopt and implement procedures designed to prohibit the misuse of material, nonpublic information obtained during the credit rating process. The Commission believes that to meet this component of the NRSRO definition, a credit rating agency should adopt procedures governing the receipt and use of nonpublic information that applies to all employees.

Question: As discussed above, to meet the third component of the NRSRO definition, should a credit rating agency demonstrate that it has systematic procedures designed to prevent the misuse of material nonpublic information? What types of procedures are reasonable for a credit rating agency to protect material nonpublic information? Should a credit rating agency have personnel dedicated specifically to verifying employees' compliance with such procedures? Should persons performing this function provide ongoing training of employees and act as a resource to answer questions as they arise? Should the procedures provide for a system by which employees can report violations of the controls in place to protect nonpublic information or other inappropriate activities? The Commission encourages commenters to provide information on appropriate procedures for receiving and adequately securing material nonpublic information.

h. Financial Resources

There was no consensus among commenters to the 2003 Concept Release as to whether a credit rating agency's financial resources should be considered by the Commission as a condition for NRSRO recognition. Several commenters supported the evaluation of a credit rating agency's financial resources as a condition, particularly to ensure that NRSROs maintain financial independence from rated issuers and subscribers.¹⁰⁰ One commenter suggested that such a

⁹² See, e.g., Letter from Charles D. Brown, General Counsel, Fitch Ratings, to Jonathan G. Katz, Secretary, SEC (July 28, 2003).

⁹³ A separate area of concern arises when credit rating agencies issue unsolicited ratings. These are ratings that are not initiated at the request of the issuer. Specifically, one concern with unsolicited ratings is that they will be used by a credit rating agency to obtain business from issuers. For example, a credit rating agency could conceivably issue an unsolicited rating and send it to the issuer along with a fee schedule for its rating services. See, e.g., Letter from James I. Kaplan, Associate General Counsel, Northern Trust Corporation, to Jonathan G. Katz, Secretary, Commission (July 28, 2003). Moreover, the rating agency improperly might issue a lower than warranted rating in order to increase the issuer's incentive to purchase the rating service. We believe that unsolicited ratings raise sufficient concerns such that a credit rating agency should have procedures designed to avoid employing improper practices with respect to unsolicited ratings and to monitor and verify compliance with those procedures.

⁹⁴ Commission v. Rick A. Marano, William Marano and Carl Loizzi, Civil Action No. 04 CV 5828 (Judge Kimba Wood) (S.D.N.Y. July 27, 2004), available on the SEC Web site at <http://www.sec.gov/litigation/litrelases/lr18799.htm>.

⁹⁵ *Id.*

⁹⁶ See *supra* note 28.

⁹⁷ See *supra* note 1.

⁹⁸ See, e.g., *supra* note 59.

⁹⁹ See, e.g., *supra* note 40.

¹⁰⁰ See, e.g., Letter from Walter Schroeder, President, Dominion Bond Rating Service Limited, to Jonathan G. Katz, Secretary, Commission (August 5, 2003).

condition be used to ensure that an NRSRO does not receive more than a small portion of revenue from any particular issuer or customer.¹⁰¹ and another suggested that NRSROs be required to disclose information relating to their financial resources.¹⁰² One commenter also stated that it would be prejudicial to investors if securities they purchased, based in part on credit ratings, ceased to be rated because the credit rating agencies that rated them no longer existed.¹⁰³

Commenters that opposed the use of financial resources as an NRSRO criterion generally represented that meeting a mandated level of capital or financial resources does not assure the credibility or reliability of a credit rating agency's ratings and, accordingly, the Commission should instead focus on such credibility and reliability.¹⁰⁴

The Commission is not proposing to specify minimum financial requirements as part of the definition of the term "NRSRO." The Commission anticipates that the financial resources necessary to support an NRSRO would vary based on the size and scope of the credit rating agency's business. The Commission has proposed, however, that in order for a credit rating agency to meet the definition of the term "NRSRO," it would be required to have sufficient financial resources to ensure that it is able to comply with its procedures. For example, to meet the definition, a credit rating agency would need to have sufficient financial resources to ensure that it maintains appropriate staffing levels to continuously monitor the issuers it rates. Further, a credit rating agency with sufficient financial resources is less likely to be subject to conflicts of interest as described above because of its financial independence from subscribers and issuers it rates.

Questions: Should a credit rating agency make its audited financial statements readily available to users of securities ratings in order for such users to assess whether a credit rating agency has sufficient financial resources to satisfy the third component? What other types of financial information could a credit rating agency make available to users of securities ratings for purposes of the third component? Should a credit rating agency provide users of securities ratings with information relating to the percentage of revenue it receives from particular issuers or subscribers as compared to the credit rating agency's

total revenues? Should a credit rating agency establish procedures to limit the percentage of revenues it receives from a single issuer or subscriber? How else can it be determined that a credit rating agency is financially independent of both subscribers and rated issuers?

i. Standardized Rating Symbols

Several commenters responded to the Commission's request on whether NRSROs should use uniform rating symbols to reduce the risk of marketplace confusion. Commenters generally supported the idea of uniform rating symbols by NRSROs, indicating that such standardization would be particularly helpful if the number of NRSROs increase.¹⁰⁵ However, one credit rating agency indicated that mandated uniformity of rating symbols could mislead investors into assuming that all NRSRO credit ratings are comparable and involve the same analytical judgments, ratings criteria, and methodologies.¹⁰⁶ Another commenter suggested that rather than establish uniform rating symbols, the Commission should require each NRSRO to annually disclose the definition and historic default rates for the rating symbols it uses.¹⁰⁷

The Commission is not proposing to standardize the use of rating symbols by NRSROs. While the symbols used by an NRSRO to distinguish securities of varying risks may technically differ both in form and in meaning from those used by other NRSROs (e.g., S&P's lowest investment grade rating category for corporate debt securities is "BBB" and Moody's is "Baa"), the similarities in NRSROs' rating symbols (including the symbols previously used by entities that received NRSRO no-action letters but no longer exist) suggests the existence of a market-based standard.

Similarly, there appears to be an existing market-based standard for credit rating agencies to have a consistent number of rating categories for distinguishing securities of varying risks. This latter standard is important for purposes of the NRSRO concept because a number of Commission rules referencing the term "NRSRO" also reference the NRSRO's levels of rating categories. For example, paragraph (c)(2)(vi)(F) of the net capital rule sets forth regulatory capital charges for proprietary positions of broker-dealers in nonconvertible debt securities rated in "one of the four highest rating categories" by at least two NRSROs.

Questions: Should the Commission continue to rely on existing market-based standards for rating symbols and rating categories, or should specific standards be incorporated into the definition of the term "NRSRO"? If the latter, what standards are appropriate?

C. Statistical Models

In the 2003 Concept Release, the Commission inquired whether credit rating agencies that solely use statistical models and no other qualitative inputs should be able to qualify as NRSROs. There was a general consensus among commenters that computerized statistical models may be helpful in the credit rating process, but that a credit rating agency that solely uses statistical models should not qualify as an NRSRO.¹⁰⁸ Most commenters responding to this question identified limitations with regard to the use of such models for providing in-depth credit analysis.¹⁰⁹ One commenter stated that the Commission staff does not have the expertise to evaluate the types of models used by most credit rating agencies.¹¹⁰

However, one commenter noted that purely quantitative credit models have gained acceptance by credit risk managers in recent years, and that such models should be further considered before restricting NRSRO status to companies who do not solely rely on statistical models.¹¹¹

Although commenters were generally of the view that credit rating agencies that rely solely on statistical models should not qualify as NRSROs, the Commission, in proposing to define the term "NRSRO," is not precluding through this proposed definition the possibility that a credit rating agency with a more quantitative business model than the current NRSROs could meet the definition of NRSRO. Accordingly, the proposed definition of the term "NRSRO" and the interpretations to the definition contained in this release should not be construed as excluding a credit rating agency that significantly relies on quantitative statistical models in developing credit ratings.

Questions: Should a credit rating agency that relies solely or primarily on statistical models be able to meet the proposed NRSRO definition? If so, under what circumstances? The Commission also requests comment on guidelines for assessing the relevance and reliability of statistical models used in the ratings process.

¹⁰¹ See, e.g., *supra* note 63.

¹⁰² See, e.g., *supra* note 73.

¹⁰³ See, e.g., *supra* note 70.

¹⁰⁴ See, e.g., *supra* note 87.

¹⁰⁵ See, e.g., *supra* note 73.

¹⁰⁶ See, e.g., *supra* note 40.

¹⁰⁷ See, e.g., *supra* note 61.

¹⁰⁸ See, e.g., *supra* notes 59, 73, and 92.

¹⁰⁹ See, e.g., *supra* note 88.

¹¹⁰ See, e.g., *supra* note 84.

¹¹¹ See, e.g., *supra* note 41.

D. Provisional NRSRO Status

In the past, a number of observers have criticized the regulatory use of the NRSRO concept—particularly the “national recognition” requirement—as creating a substantial barrier to entry. In essence, these critics contend that important users of securities ratings have a regulatory incentive to obtain ratings issued by NRSROs, and that without NRSRO status new entrants encounter great difficulties achieving the “national recognition” necessary to obtain an NRSRO no-action letter.

For example, the U.S. Department of Justice (“DOJ”), commenting on the Commission’s 1997 rule proposal, opposed the use of the “national recognition” requirement because, in its view, that criterion likely creates a “nearly insurmountable barrier to new entry into the market for NRSRO services.”¹¹² DOJ believed that, while the historical dominance of Moody’s and S&P had eroded in recent years for certain types of securities ratings, the overall level of market power they retained continued to be a competitive concern. To ameliorate entry barriers, DOJ suggested the Commission consider giving “provisional” NRSRO status (for the first 12 to 18 months of existence) to newly-formed credit rating affiliates of established, well-capitalized firms that have reputations for quality financial analysis in the investment community (e.g., investment banks, commercial banks, insurance companies, consulting firms, or accounting firms). DOJ also recommended the Commission consider “provisional” NRSRO status for foreign rating agencies, and indicated they might initially specialize in rating U.S. companies with substantial operations abroad.

In response to these concerns, the Commission, in the 2003 Concept Release, sought comment on whether to consider a “provisional” NRSRO status for credit rating agencies that comply with NRSRO recognition criteria but lack national recognition. Most commenters generally did not support the concept of “provisional” NRSROs.

Commenters supporting provisional NRSROs indicated that permitting them could promote competition among credit rating agencies by facilitating the entry of high-quality but lesser-known credit rating agencies.¹¹³ One commenter stated that credit rating

agencies that provide quality ratings but are not national in nature could be provisional NRSROs,¹¹⁴ while another commenter represented that it would support a time-limited provisional NRSRO status if the Commission retains the “widely accepted” criterion.¹¹⁵

Commenters opposing the idea of provisional NRSROs represented that permitting two classes of NRSROs would likely cause marketplace confusion,¹¹⁶ and that permitting provisional NRSROs would have little, if any, effect on a credit rating agency’s ability to compete with the larger NRSROs.¹¹⁷ Several commenters also indicated that certain investors likely would not use ratings from “provisional” NRSROs for regulatory purposes because securities purchased based on a provisional NRSRO’s ratings would possibly have to be sold if the provisional NRSRO failed to continue to meet the definition.¹¹⁸

The Commission has considered the responses to the 2003 Concept Release and has decided at present against creating a “provisional” NRSRO status. The Commission’s use of the term “NRSRO” is intended to reflect the fact that the marketplace views a credit rating agency’s ratings as credible and reliable. Without such assurance as to the quality of the ratings issued by a credit rating agency, it may be inappropriate to rely upon a credit rating agency’s ratings as a proxy for credit quality in regulation.

The Commission understands that the rationale for permitting provisional NRSROs is to promote competition in the credit rating industry. To this end, defining the term “NRSRO” to 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 may be a more reasonable approach that attempts to address the concerns raised by commenters and preserve the Commission’s intended regulatory objectives. The Commission also notes with respect to the competitive concerns raised by commenters that since the term “NRSRO” was first used in the mid-1970’s, several credit rating agencies have been able to enter the credit rating business and achieve the requisite level of market acceptance to receive NRSRO no-action letters.

Question: Does the Commission’s proposed NRSRO definition and approach for promoting competition

address the competitive concerns raised by commenters’ supporting provisional NRSROs?

E. Staff No-Action Process

In the 2003 Concept Release, the Commission asked a series of procedural questions regarding the NRSRO concept. Across the board, commenters strongly supported Commission action to enhance the clarity of the process. However, a number of commenters also raised concerns about the extent of the Commission’s legal authority to regulate or impose requirements on NRSROs.¹¹⁹ In the absence of Congressional action, we are proposing to adopt a comprehensive definition of the term “NRSRO,” which we believe to be an appropriate balance within the confines of the Commission’s existing legal authority.

As noted above, the Commission has never adopted a definition of the term. The Commission preliminarily believes that the proposed components of the NRSRO definition, discussed in detail above, would be a significant step forward in providing greater clarity in determining whether an entity’s ratings should be relied on as NRSRO ratings for purposes of the securities laws, and Commission rules and regulations. An entity that meets the proposed definition would be an NRSRO.

While we believe that adopting a definition of NRSRO could help address commenters’ concerns regarding transparency, we understand that credit rating agencies might desire to continue to seek staff no-action letters in order to provide some measure of certainty to those entities relying on ratings provided by credit rating agencies. As such, and in light of the long-standing reliance by broker-dealers, issuers, investors and others on the existing staff no-action process, if we were to adopt a definition of NRSRO, we plan to continue to make our staff available to provide no-action letters as appropriate to those entities that choose to seek it. The continued provision of staff no-action letters, where appropriate, is intended to provide more certainty.

Currently, a credit rating agency initiates the no-action letter process by requesting a no-action letter that will state that the Commission staff will not recommend enforcement action against persons who use the firm’s credit ratings for purposes of the Commission’s net capital rule. Upon receipt of such a request, the Commission staff typically sends a letter to the credit rating agency requesting detailed information

¹¹² See 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).

¹¹³ See, e.g., *supra* note 87.

¹¹⁴ See, e.g., *supra* note 41.

¹¹⁵ See, e.g., *supra* note 63.

¹¹⁶ See, e.g., *supra* note 100.

¹¹⁷ See, e.g., *supra* note 61.

¹¹⁸ *Id.*

¹¹⁹ See, e.g., *supra* note 40.

regarding the criteria discussed above. After receiving this detailed information, the Commission staff meet with the credit rating agency for an on-site meeting. During this meeting, the credit rating agency's senior management, analysts, and other persons who are knowledgeable about the firm's policies and procedures are interviewed. The Commission staff also contacts and interviews references provided by the credit rating agency and others to assess, among other things, the references' use of the credit rating agency's ratings, whether they believe the credit rating agency issues credible and reliable ratings, and how the credit rating agency compares to other credit rating agencies.¹²⁰ The Commission staff then determines whether the credit rating agency meets the NRSRO criteria and either issues the requested no-action letter, or informs the credit rating agency of its decision not to so issue a letter.¹²¹

There was strong support in response to the 2003 Concept Release for the Commission to establish a time period to serve as a goal for acting on requests for NRSRO status.¹²² Some commenters addressing this issue thought that the process for seeking NRSRO status should include deadlines once a credit rating agency has submitted all required information, and that such a time period could enhance the market's perception of the NRSRO process and afford greater certainty to a credit rating agency as to when a ruling will be made on its request.¹²³

Some commenters believed that the Commission should act on a request for a no-action letter within 90 to 120 days after an entity has submitted all required information.¹²⁴ Some commenters noted, however, that flexibility should exist if circumstances arise and an additional investigation needs to be conducted.¹²⁵ Several commenters stated that credit rating agencies that do not obtain no-action letters should be notified as to why so

¹²⁰ These interviews have been useful indicators of a credit rating agency's marketplace recognition, and the Commission anticipates that, in connection with the no-action process, the staff will continue to interview references and other predominant users of securities ratings in determining which credit rating agencies should receive a no-action letter.

¹²¹ When issuing an NRSRO no-action letter, the Commission staff has consistently conditioned such letters on credit rating agencies not representing in any of their ratings, marketing, or similar literature that the Commission considers the credit rating agency to be an NRSRO. *See, e.g., supra* note 2.

¹²² *See, e.g.,* Letter from Andrew Fight to Jonathan G. Katz, Secretary, Commission (July 25, 2003).

¹²³ *See, e.g., supra* note 56.

¹²⁴ *See, e.g., supra* note 46.

¹²⁵ *See, e.g., supra* note 61.

that they can improve their operations in the specified areas and increase their chances of submitting a successful request in the future.¹²⁶

In this regard, we would expect that no-action requests would be considered by the staff, and resolved, in a timely fashion.¹²⁷ The Commission believes that, if it were to adopt a definition of the term "NRSRO," the staff should be able to act on NRSRO no-action requests within 90 days after a credit rating agency has submitted all necessary information.¹²⁸

Like any staff no-action position, the staff's views on whether an entity meets the definition of NRSRO would be conditioned on the facts and representations made by the entity.¹²⁹ Of course, if the facts and circumstances upon which the staff relied to provide its guidance change, the staff position may no longer be applicable. In this regard, given the changing market conditions in this context, we understand that the staff will include expiration dates in NRSRO no-action letters that it issues. In addition, the staff's views on issues may change from time-to-time, in light of reexamination,

¹²⁶ *See, e.g., supra* note 100.

¹²⁷ As part of this process, the Commission staff will inform the Commission promptly upon receipt of a request for a no-action letter from a credit rating agency.

¹²⁸ The information provided to the staff by a credit rating agency to obtain a no-action letter will be accorded confidential treatment to the extent permitted by law. However, it is the responsibility of the credit rating agency to request confidentiality under the appropriate Commission rules. *See* 17 CFR 200.83.

¹²⁹ *See generally* 17 CFR 202.2. No-action requests should be directed to an appropriate officer of the Commission's staff. *Id.* The no-action letter process is an informal procedure that permits the public to request the views of the Commission staff on issues or activity that may raise compliance issues under federal securities law. In a no-action letter, the Commission staff states that it will not recommend enforcement action to the Commission with respect to identified rules or statutory provisions if the requesting party acts in accordance with specific facts and representations made in its letter. In some instances, the Commission staff will state that it is not able to give such assurance. The Commission takes the position that no-action letters do not constitute Commission precedent and do not bind subsequent Commission action. Although informal guidance from Commission staff assists the public in understanding how to comply with the Commission's rules and policies, the Commission reserves the right to act contrary to staff advice. *See* Informal Guidance Program for Small Entities, Release No. 33-7407 (March 27, 1997), 62 FR 15604 (April 4, 1997); and Procedures for Rendering Informal Advice, Release No. 33-6253 (October 28, 1980), 45 FR 72644 (November 3, 1980). *See also* 17 CFR 202.1(d) ("In certain instances an informal statement of the views of the Commission may be obtained. The staff, upon request or on its own motion, will generally present questions to the Commission which involve matters of substantial importance and where the issues are novel or highly complex, although the granting of a request for an informal statement by the Commission is entirely within its discretion.").

new considerations, or changing conditions that indicate that its earlier views are not longer in keeping with the objectives of the proposed NRSRO rule or with the regulatory use of NRSRO ratings.

IV. General Request for Comment

The Commission seeks comment generally on all aspects of proposed Exchange Act Rule 3b-10. In addition to the specific requests for comment found throughout this release, the Commission invites general comments on the proposed definition and the interpretations. The Commission also seeks comment on whether to expand the text of the proposed rule to include the interpretations of the components discussed in this release, or other interpretations. Furthermore, the Commission invites interested persons to submit written comments and data on any aspects of the proposed rule.

V. Paperwork Reduction Act

Proposed Rule 3b-10 would not impose a new "collection of information" within the meaning of the Paperwork Reduction Act of 1995.¹³⁰

VI. Consideration of the Costs and Benefits of the Proposed Rule

The Commission is sensitive to the costs and benefits that result from its rules. We have identified certain costs and benefits of the proposed rule and request comment on all aspects of this cost-benefit analysis, including identification and assessment of any costs and benefits not discussed in the analysis. The Commission requests data to quantify the costs and the value of the benefits identified. The Commission seeks estimates and views regarding these costs and benefits from market participants who might be impacted by the proposed rule, including credit rating agencies, independent credit analysts, broker-dealers, mutual fund companies, securities issuers, and investors.

A. Benefits

The proposed rule would define the term "NRSRO" and thereby enhance the use of the NRSRO concept in Commission rules and regulations. Specifically, it would provide greater clarity to determine whether credit rating agencies are NRSROs. This would also assist credit rating agencies that are currently NRSROs in understanding how they can continue to meet the definition. For credit rating agencies that are not currently NRSROs, the definition would provide a better

¹³⁰ 44 U.S.C. 3501 *et seq.*

understanding of the enhancements necessary to meet the definition. This could reduce concerns related to barriers to entry for credit rating agencies seeking to become NRSROs. Moreover, concerns about barriers to entry also could be reduced by the interpretations of the proposed definition that would recognize credit rating agencies with an expertise in a particular industry or geographic region. This component could be particularly beneficial to smaller credit rating agencies in their efforts to meet the proposed definition of NRSRO.

By lowering the barriers to entry identified above, the proposed rule could potentially increase the number of NRSROs. Issuers would be provided with more choices in terms of selecting NRSROs to rate their debt securities, which could lower their costs for this service. The greater competition in the market for credit ratings and analysis could provide for more credible and reliable ratings. Greater competition also could stimulate innovation in the technology and methods of analysis for issuing credit ratings, which could further lower barriers to entry.

As previously noted, the NRSRO concept was first used by the Commission for the purposes of determining capital charges for broker-dealers with respect to their proprietary debt securities. Broker-dealers benefited from this use of the NRSRO concept in that it provided a simple regulatory benchmark. At the same time, the NRSRO concept benefited customers and counterparties of broker-dealers by linking the capital charge (and, consequently, the broker-dealers' capital adequacy) to a rating that is recognized by the marketplace as reliable and credible. These benefits would continue under the proposed rule.

The benefit of the NRSRO concept as a regulatory benchmark and the beneficial impact of the proposed definition is indicated by its use in various other Commission rules and regulations; namely, Regulation S-B,¹³¹ Regulation S-K,¹³² Securities Act Rule 134 ("Communications not deemed a prospectus"),¹³³ Securities Act Rule 436 ("Consents requires in special cases"),¹³⁴ Form S-3,¹³⁵ Form F-2,¹³⁶ Form F-3,¹³⁷ Exchange Act Rule 3a1-1 ("Exemption from the definition of 'Exchange' under the Section 3(a)(1) of

the Act"),¹³⁸ Exchange Act Rule 10b-10 ("Confirmation of transactions"),¹³⁹ Exchange Act Rule 15c3-1 ("Net capital requirements for brokers or dealers"),¹⁴⁰ Exchange Act Rule 15c3-1a ("Options"),¹⁴¹ Exchange Act Rule 15c3-1f ("Optional market and credit risk requirements for OTC derivatives dealers"),¹⁴² Exchange Act Rule 15c3-3a ("Exhibit A—formula for determination reserve requirement of brokers and dealers under § 240.15c3-3"),¹⁴³ Rule 101 of Regulation M under the Exchange Act ("Activities by distribution participants"),¹⁴⁴ Rule 102 of Regulation M under the Exchange Act ("Activities by issuers and selling security holders during a distributions"),¹⁴⁵ Rule 300 of Regulation ATS under the Exchange Act ("Definitions"),¹⁴⁶ Investment Company Act Rule 2a-7 ("Money market funds"),¹⁴⁷ Investment Company Act Rule 3a-7 ("Issuers of asset-backed securities"),¹⁴⁸ Investment Company Act Rule 5b-3 ("Acquisition of repurchase agreement or refunded security treated as acquisition of underlying securities"),¹⁴⁹ and Investment Company Act Rule 10f-3 ("Exemption for the acquisition of securities during the existence of an underwriting or selling syndicate").¹⁵⁰ The concept also has been used in federal statutes, state laws, and foreign laws and regulations.¹⁵¹ The importation of a market assessment of creditworthiness into a regulation benefits the affected entities by linking a regulatory requirement to a market determined benchmark. Thus, the proposed rule would result in the benefits described above by codifying the meaning of the term NRSRO.

B. Costs

The proposed rule would impose some costs on existing NRSROs. They could incur some costs in evaluating themselves against the proposed definition, and in seeking renewal of their no-action letters, should the Commission adopt a definition of NRSRO. However, in this regard, we note that the proposed definition of

"NRSRO" is generally consistent with the criteria historically used by the Commission staff to identify NRSROs for purposes of no-action relief under the Commission's net capital rule.

The proposed definition would not impose direct costs on credit rating agencies that do not currently meet the proposed definition of "NRSRO," since these entities would not be within its scope. A non-NRSRO credit rating agency likely would incur costs if it sought to become an NRSRO, or needed to enhance its activities and operations to meet the NRSRO definition. An entity that is recognized nationally by the predominant users of credit ratings as issuing credible and reliable ratings generally would meet the proposed definition of "NRSRO" or would be able to meet the definition with little incremental cost. Accordingly, a credit rating agency seeking to meet the definition of "NRSRO" would not incur costs beyond those that normally would be expended to gain acceptance in the marketplace, on a national level, as a credit rating agency that is recognized as issuing credible ratings. As such, the Commission does not believe that the proposed definition would increase costs for a rating agency seeking to be an NRSRO.

The Commission also notes that the internet permits credit rating agencies to publish their ratings to a worldwide audience—*i.e.*, make the ratings publicly available—for a minimal cost. Thus, a credit rating agency could meet this component of the proposed definition without incurring substantial costs. Moreover, under the proposed definition, a credit rating agency could become an NRSRO if it is generally accepted in the financial markets as an issuer of credible and reliable ratings for a particular industry or geographic segment. This could make it easier for a smaller entity, with a specific ratings expertise, to become an NRSRO. As such, over time, the proposed definition could reduce costs by making it easier for a credit rating agency that focuses on a particular geographic area or sector to be an NRSRO.

The Commission seeks comment on the costs that would be incurred by a non-NRSRO credit rating agency to meet the proposed definition. As mentioned above, to assist the Commission in evaluating the costs and benefits that may result from the proposed rule, the Commission requests comment on the potential costs and benefits identified in the release, as well as any other costs or benefits that may result from the proposed rule. In particular, the Commission requests comments on the potential costs for any modification to

¹³¹ 17 CFR 228.10.

¹³² 17 CFR 229.10.

¹³³ 17 CFR 230.134.

¹³⁴ 17 CFR 230.436.

¹³⁵ 17 CFR 239.13.

¹³⁶ 17 CFR 239.32.

¹³⁷ 17 CFR 239.33.

¹³⁸ 17 CFR 240.3a1-1.

¹³⁹ 17 CFR 240.10b-10.

¹⁴⁰ 17 CFR 240.15c3-1.

¹⁴¹ 17 CFR 240.15c3-1a.

¹⁴² 17 CFR 240.15c3-1f.

¹⁴³ 17 CFR 240.15c3-3a.

¹⁴⁴ 17 CFR 242.101.

¹⁴⁵ 17 CFR 242.102.

¹⁴⁶ 17 CFR 242.300.

¹⁴⁷ 17 CFR 270.2a-7.

¹⁴⁸ 17 CFR 270.3a-7.

¹⁴⁹ 17 CFR 270.5b-3.

¹⁵⁰ 17 CFR 270.10f-3.

¹⁵¹ See, e.g., *supra* notes 14, 15, and 16.

both computer systems and surveillance mechanisms and for information gathering, management, and recordkeeping systems or procedures, as well as any potential benefits resulting from the proposals for registrants, issuers, investors, brokers or dealers, other securities industry professionals, regulators, and others. The commenters should provide analysis and data to support their views on the costs and benefits.

The Commission has found that opinions differ regarding the critical elements for success in the credit rating business (e.g., staff, experience, capital), and this may lead to varying views on the precise nature and extent of the costs and benefits. The Commission poses the following questions regarding the proposed rule: What are the costs for an entity to operate as a credit rating agency that is recognized on a national level by the predominant users of credit ratings as issuing credible and reliable ratings? What are the costs for an entity to enter into the credit rating business with respect to rating securities within a specific industry or geographic segment? What additional costs would such an entity incur to achieve national recognition?

In answering these questions, commenters should provide detailed information on, or estimates of, the costs associated with maintaining an office, a staff, and the necessary communications and information systems and equipment as well as costs related to publishing credit ratings. We also seek comment on whether costs related to technology have significantly increased in recent years.

VII. Consideration on Burden and Promotion of Efficiency, Competition, and Capital Formation

Section 3(f) of the Exchange Act requires the Commission, whenever it engages in rulemaking and must consider or determine if an action is necessary or appropriate in the public interest, to consider whether the action would promote efficiency, competition, and capital formation.¹⁵² In addition, Section 23(a)(2) of the Exchange Act requires the Commission, when making rules under the Exchange Act, to consider the impact that such rules would have on competition.¹⁵³ Exchange Act Section 23(a)(2) prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or

appropriate in furtherance of the purposes of the Exchange Act.

The Commission preliminarily believes that the proposed definition of "NRSRO" would not impose any burdens on efficiency, capital formation and competition and would, in fact, promote these interests. The proposed definition would provide greater clarity to the process by which credit rating agencies become NRSROs. This would also assist credit rating agencies that are currently NRSROs in understanding how they could meet the proposed definition. For credit rating agencies that are not currently NRSROs, the definition would provide a better understanding of the enhancements necessary to meet the proposed definition. This could reduce concerns regarding barriers to entry for credit rating agencies seeking to become NRSROs. Moreover, concerns about barriers to entry also could be reduced by the component of the proposed definition that would recognize credit rating agencies with an expertise in a particular industry or geographic region. This component could be particularly beneficial to smaller credit rating agencies in their efforts to meet the proposed NRSRO definition.

By lowering any barriers to entry discussed above, the proposed rule could potentially increase the number of NRSROs. Issuers could be provided with more choices in terms of selecting NRSROs to rate their debt securities, which would lower their costs for this service. The greater competition in the market for credit ratings and analysis could provide for more credible and reliable ratings. Greater competition also could stimulate innovation in the technology and methods of analysis for issuing credit ratings, which could further lower barriers to entry.

The Commission believes the resulting increased clarity from the proposed definition could have some positive impact on capital formation. As noted in the Benefits Section in Section VI., a number of Commission rules and regulations use the NRSRO concept. For example, certain regulations provide safe harbors to small businesses issuing securities and to all issuers in making non-financial statements in securities registrations.¹⁵⁴ The NRSRO concept also is used in defining which debt securities can be held by a money market fund.¹⁵⁵ In addition, as noted throughout, the NRSRO concept is used in the broker-dealer capital rule. Finally, states, foreign governments, and private entities use the NRSRO concept as well.

The proposed definition, by codifying a component of the NRSRO concept, would provide clarity to its use in these rules and regulations which all relate in some respects to the issuance of debt securities. Accordingly, the proposed definition could assist in the underwriting and making of markets in corporate debt.

While we believe the proposed definition could lower any barriers to entry and promote competition, we recognize that some market participants have argued that the NRSRO concept impedes competition by creating unreasonable barriers to entry. There is a widespread view that one of the most significant natural barriers into the credit rating business is the current dominance of a few highly-regarded, well-capitalized rating agencies that pioneered the industry many decades ago. This view may, in part, be a consequence of the fact that, until the mid-1970s, only a handful of firms (primarily three of the five current NRSROs) issued credit ratings on securities. These firms developed substantial brand names during the period when they were the only entities issuing securities ratings. Since the mid-1970's, however, there has been a steady increase in the number of credit rating agencies operating in the U.S. and internationally, so that today it is estimated that there are more than 100 active credit rating agencies worldwide.¹⁵⁶

It should be noted that this growth in the number of entities issuing securities ratings began after the Commission started using the NRSRO concept for regulatory purposes. The expansion suggests a growing interest among market participants for advice about credit quality, and that new entrants are able to develop a following for their credit judgments. The Commission staff also has provided no-action letters to several small credit rating agencies since it began using the NRSRO concept for regulatory purposes.¹⁵⁷ Several of

¹⁵⁶ See Credit Ratings and Complementary Sources of Credit Quality Information, Basel Committee on Banking Supervision Working Papers (August 2000), at 14 ("[I]n September 1999, it was believed that there might be some 130 [rating] agencies world-wide, although industry sources indicated this number was closer to 150."). See also SEC Hearing Transcript, *supra* note 30, (November 21, 2003) (testimony of Gay Huey Evans, Director, Markets and Exchanges Division, The Financial Services Authority) ("There are [approximately] 150 [rating] agencies in total around the world and they vary in size and scope.").

¹⁵⁷ Duff & Phelps, Inc. began issuing credit ratings in 1974 and became an NRSRO in 1982. McCarthy Crisanti & Maffei began issuing credit ratings in 1975 and became an NRSRO by 1983. IBCA Limited and IBCA Inc. began issuing credit ratings in 1978

¹⁵² 15 U.S.C. 78c(f).

¹⁵³ 15 U.S.C. 78w(a)(2).

¹⁵⁴ See, e.g., 17 CFR 228.10 and 17 CFR 229.10.

¹⁵⁵ 17 CFR 270.2a-7.

these entities received no-action letters within five or six years of the date they began issuing securities ratings. The Commission preliminarily believes this may demonstrate that the proposed "NRSRO" definition could be met by small firms and, accordingly, appears to indicate that the proposed definition would not act as an unreasonable barrier to their meeting the definition of NRSRO.

The Commission believes that, at this time, eliminating the NRSRO concept would not be prudent, nor in the interest of investors and securities market participants. For example, the concept provides an easily ascertainable and non-arbitrary regulatory benchmark for broker-dealers to compute their capital charges.¹⁵⁸ At the same time, it provides that broker-dealers will use credit ratings that are recognized by the marketplace as credible and reliable and issued by entities that have adequate financial resources and operational capability. These assurances enhance a broker-dealer's capital adequacy and, thereby, protect customers and counterparties. Users of credit ratings and others generally agree there must be substantive threshold standards for being an NRSRO for the term to have meaning.¹⁵⁹ In essence, the proposed NRSRO definition is meant to reflect the fact that the marketplace views a rating agency's ratings as credible and reliable.

The Commission requests comment on all aspects of this analysis and, in particular, on whether the proposed NRSRO definition would place a burden on competition.

VIII. Consideration of Impact on the Economy

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, or "SBREFA,"¹⁶⁰ we must advise the Office of Management and Budget as to whether the proposed regulation constitutes a "major" rule. Under SBREFA, a rule is considered "major" where, if adopted, it results or is likely

and 1985, respectively, and were designated together as an NRSRO in 1990. Thomson BankWatch, Inc. entered the credit rating business in 1974 and became an NRSRO in 1991. A.M. Best began issuing credit ratings in 1999 and became an NRSRO in 2005.

¹⁵⁸ See, e.g., Letter from Cheryl Kallem, Chair, SIA Capital Committee, to Jonathan G. Katz, Secretary, Commission (July 28, 2003).

¹⁵⁹ See, e.g., SEC Hearing Transcript, *supra* note 30 (November 15, 2002) (testimony of Frank A. Fernandez, Senior Vice President, Chief Economist and Director of Research, The Securities Industry Association and testimony of Gregory A. Root, Executive Vice President, Dominion Bond Rating Service Limited).

¹⁶⁰ Pub. L. No. 104-121, Title II, 110 Stat. 857 (1996) (codified in various sections of 5 U.S.C., 15 U.S.C. and as a note to 5 U.S.C. 601).

to result in: (1) An annual effect on the economy of \$100 million or more (either in the form of an increase or a decrease); (2) a major increase in costs or prices for consumers or individual industries; or (3) significant adverse effect on competition, investment or innovation.

If a rule is "major," its effectiveness will generally be delayed for 60 days pending Congressional review. We request comment on the potential impact of the proposed rule on the economy on an annual basis. Commenters are requested to provide empirical data and other factual support for their view to the extent possible.

IX. Regulatory Flexibility Act

Pursuant to section 605(b) of the Regulatory Flexibility Act ("RFA"), the Commission hereby certifies that proposed Rule 3b-10, would not, if adopted, have a significant economic impact on a substantial number of small entities. Under the RFA, the term "small entity" shall have the same meaning as the RFA defined term "small business." According to section 601(3) of the RFA, "the term 'small business' has the same meaning as the term 'small business concern' under section 3 of the Small Business Act (15 U.S.C. 632), unless an agency, after consultation with the Small Business Administration and after opportunity for public comment, establishes one or more definitions of such term which are appropriate to the activities of the agency and publishes such definition(s) in the **Federal Register**." If the agency has not defined the term for a particular purpose, the Small Business Act states that "a small business concern * * * shall be deemed to be one which is independently owned and operated and which is not dominant in its field of operation." The Commission has not defined the term "small entity" in the context of NRSROs for purposes of the RFA. Therefore, for purposes of this rulemaking, the Commission is using the broader definition of "small business concern" as defined in the Small Business Act.

Currently, there are five credit rating agencies that we believe would meet the proposed definition of "NRSRO." Only two of the NRSROs are independently owned and operated. However, the two independently owned NRSROs are dominant in their respective fields as one has earned a national reputation for issuing ratings on insurance companies and the other on Canadian issuers. Accordingly, there are no small entities that currently would meet the proposed definition of NRSRO.

As noted above, it has been estimated there are between 100 and 150 entities that issue credit ratings or credit

analysis.¹⁶¹ It is likely that a substantial number of these credit rating agencies are small entities. The proposed definition could have an impact on one of these small credit rating agencies if it sought to become an NRSRO. However, in this regard, the proposed definition of NRSRO would closely track the current process under which the staff issues no-action letters. Thus, while the proposed definition may impact a small credit rating agency, such impact would likely be small.

For the above reasons, the Commission certifies that proposed Rule 3b-10 would not have a significant economic impact on a substantial number of small entities. The Commission requests comments regarding this certification. The Commission requests that commenters describe the nature of any impact on small businesses and provide empirical data to support the extent of the impact.

X. Statutory Authority

Pursuant to the Securities Act of 1933, and particularly Sections 7, 10, and 19 thereof, 15 U.S.C. 77g, 77j, and 77s, the Exchange Act, and particularly Sections 3(b), 15, 17, and 23 thereof, 15 U.S.C. 78c(b), 78o(c)(3), 78q, and 78w, the Investment Company Act of 1940, and particularly Sections 6c and 38a thereof, 15 U.S.C. 80a-6, 80a-36, the Commission proposes to adopt § 240.3b-10 of Title 17 of the Code of Federal Regulations in the manner set forth below.

Text of Proposed Rule

List of Subjects in 17 CFR Part 240

Brokers, Fraud, Reporting and recordkeeping requirements, Securities.

For the reasons set out in the preamble, Title 17, Chapter II, of the Code of Federal Regulations is proposed to be amended as follows.

PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

1. The authority citation for part 240 continues to read in part as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78u-5, 78w, 78x, 78ll, 78mm, 79q, 79t, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, and 7201 *et seq.*; and 18 U.S.C. 1350, unless otherwise noted.

* * * * *

2. Section 240.3b-10 is added to read as follows:

¹⁶¹ See *supra* note 156.

§ 240.3b-10 Definition of “nationally recognized statistical rating organization.”

The term *nationally recognized statistical rating organization* means any entity that:

(a) Issues publicly available credit ratings that are current assessments of the creditworthiness of obligors with respect to specific securities or money market instruments;

(b) 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

(c) 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.

Dated: April 19, 2005.

By the Commission.

Margaret H. McFarland,

Deputy Secretary.

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