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Formal Regulatory Handle Needed for NRSRO Designation: Part II

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*/ The views expressed herein are those of Commissioner Roberts and do not necessarily represent those of the Commission, other Commissioners or the staff.

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I. Introduction

As some of you may be aware, during a Commission meeting dealing with the adoption of amendments to Rule 2a-7 under the Investment Company Act, I expressed concern with the Commission's increased reliance on the judgment of so-called nationally recognized statistical rating organizations ("NRSROs"). I initially became concerned with the NRSRO designation process, and the absence of formal standards therefore, during the Commission's rulemaking proceedings leading to the Multijurisdictional Disclosure and Modifications to the Current Registration and Reporting System for Canadian Issuers ("MJDS").

The MJDS rules hinge more favorable regulatory treatment on the issuance of a high rating by an NRSRO; and the MJDS could well become the model for other such international accords. The result of all this is that the Commission's increasing dependence on the judgment of NRSROs has resulted in the designation of a rating agency as an NRSRO by the Commission being not only of domestic interest, but of international interest as well.

II. Growth of the Role of NRSROs in the Regulatory Arena

The term "NRSRO" originally was adopted by the Commission solely for purposes of distinguishing different grades of debt securities under its net capital rule, Exchange Act Rule 15c3-1. However, the use of certain debt ratings by NRSROs, as the basis for awarding benefits that otherwise are not available to securities that are unrated or rated in a lower rating category, has expanded well beyond the original, intended use of the concept in the net capital rule. The MJDS rules are one example. There are other examples which crop up in Commission regulations promulgated pursuant to the Securities Act, the Exchange Act and the Investment Company Act. The amendments adopted to Rule 2a-7 are the latest example. I have suggested extending the concept myself by recommending that the Commission propose a rule that would impose on broker-dealers a written suitability requirement when they sell unrated or low rated municipal bonds to retail investors.

Since I have brought up the subject of municipal securities, that area serves as a good example of the prominent role played by rating agencies in our capital formation system. The importance of ratings to municipal securities market participants

cannot be overemphasized. These ratings are relied upon by investors, municipalities, and underwriters. They have enormous impact on the investment decisions of both individual and institutional investors as well as the access to capital by municipal issuers.

Investors use ratings as part of their analysis in making an investment decision, including whether or not the entity is permitted to add a particular security to its investment portfolio or is required to divest itself of securities that it already holds; underwriters look at ratings in deciding whether to underwrite a particular issue; and brokers use ratings as part of their research reports for investors when making recommendations on particular securities. Moreover, the particular rating an issuer receives is an important factor in providing access to the market and in determining the interest rate that the municipality has to pay. In fact, ratings "enjoy universal use in the municipal bond market. They assist in the marketing of the many, and otherwise highly diverse, types of securities by compressing them into a few, relatively homogenous groupings."[1]

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[1] See Commission Staff Report, Transactions in Securities of the City of New York, Aug. 1977, 5-5.

While the term "NRSRO" has expanded beyond the original, intended use of the concept in the net capital rule, it is always defined as it is used in the net capital rule. Oddly enough, however, the Commission has never actually issued a definition of the term "NRSRO." It is time that the Commission did so.

A couple of days ago in another presentation and in an attempt to provide standardization for NRSRO designation, I urged the Commission's Division of Market Regulation (the "Division") to strongly consider recommending to the Commission that it propose amendments to the net capital rule that would, among other things, define the term "NRSRO." However, there are a couple of alternatives available for addressing the question of what is the appropriate regulatory treatment of rating agencies for purposes of the federal securities laws, other than proposing amendments to Rule 15c3-1. I wish to briefly go through them with you.

A. Other Alternative 1: Revision of the Current System so that the Division no longer relies on the ratings of NRSROs for purposes of the net capital rule nor designates rating agencies as NRSROs

I am inclined to believe that doing away with the concept of "NRSRO" in the Commission's rules and regulations is not a

realistic solution to dealing with the question of rating agencies. The practice of using ratings for regulatory purposes has become well established and is growing. When the Division first proposed using ratings, it carefully evaluated the appropriateness of their use in the net capital rule and determined that ratings of nationally recognized rating agencies could be of value. Since that time, the use of ratings has been deemed valuable for purposes of other Commission rules and regulations, as well as the rules of other regulatory bodies in the United States and abroad. Therefore, at this time, I would not recommend discontinuing the use of the term "NRSRO".

B. Other Alternative 2: Continuation of the Current System of Designating Rating Agencies as NRSROs

With the expanded use of the term "NRSRO" in Commission rules and regulations, obtaining designation as an NRSRO has become of increased importance to rating agencies and also has resulted in increased scrutiny of rating agencies and their ratings. When the Commission first used the term "NRSRO" in the net capital rule, it designated three rating agencies as NRSROs (i.e., Fitch, Moody's, and S&P). In the next seven years, it added two more to the list (i.e., Duff & Phelps and MCM, the latter, of

course, is no longer an NRSRO). Since October of 1990, the Commission has designated two additional rating agencies as NRSROs (i.e., BankWatch and IBCA); and the Division currently has active requests pending for the recognition of a number of additional foreign and domestic rating agencies. Nevertheless, rating agencies remain the only participants in the securities markets to be largely unregulated, despite the fact that their importance and influence is heavily documented.

Now, just because some securities activity is not regulated by the Commission, does not necessarily mean that I am interested in regulating that activity. However, the combination of the Commission's increasing reliance on NRSROs in our rules and regulations and of the growing number of rating agencies seeking NRSRO designation, particularly internationally, does lead me to believe that the Commission should have minimum published standards for NRSRO designation. I am unaware how the Commission could promulgate standards for NRSRO designation and for eligibility for continued designation without bringing NRSROs under direct Commission oversight.

Currently, all rating agencies designated as NRSROs are registered as investment advisers pursuant to the Investment

Advisers Act ("Advisers Act"). Because of this registration as investment advisers, the Commission receives the information the agencies are required to file as part of their registration under the Advisers Act. Additionally, the agencies are subject to inspection as part of the Division of Investment Management's examination program for investment advisers. However, if challenged, I am not entirely certain that the Commission could require rating agencies to register under the Advisers Act.

The only other means of authority that the Commission has over the rating agencies is through no-action letters designating the agencies as NRSROs, which is a process that I will expand upon to some degree in a few minutes. Each rating agency designated as an NRSRO is directed to bring to the Division's notice any material change in the facts of the no-action letter. If the Division determines that the facts so warrant, it can then withdraw the letter.

In reality, however, despite the importance of rating agencies and ratings to the securities markets, the Commission receives little information about the rating agencies and their operations. Often, the Division receives only informal information about the rating agencies, usually through business publications

or from competing rating agencies. For example, the Division learned about McGraw-Hill Inc.'s, S&P's parent company, acquisition of J.J. Kenny Co., a brokers' broker, from a Wall Street Journal article.[2]

As I have already discussed, although the NRSROs and their ratings have significant impact on the Commission's rules and on the securities markets, I do not believe that the Division has any meaningful authority over these organizations and their rating practices. Due to this continued growth in the use of ratings in the Commission's rules and the important role of rating agencies in the securities markets, it appears to me that the Commission should pursue a course of action that would bring NRSROs within the direct regulatory oversight of the Commission. Thus, in my judgment, the Division should strongly consider recommending to the Commission amendments to Rule 15c3-1 that would, among other things, define the term "NRSRO." Today, it is my intention to flesh out to some extent what I believe should be provided in those amendments.

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2 See McGraw-Hill Plans to Buy J.J. Kenny, Wall St. J., Dec. 13, 1989, at A4.

III. Proposed Amendments to Rule 15c3-1

Any proposed package of amendments to the net capital rule should of course first define the term "NRSRO." It is my opinion that the Division has developed sufficient knowledge of the ratings industry to allow it to formulate a definition of this term. Such proposed amendments should also provide specific criteria which must be met by a rating agency in order to satisfy the definition of "NRSRO" and thereby achieve "NRSRO" designation. Further, the proposed amendments should require that NRSROs register with the Commission in their capacity as NRSROs in order to insure continued satisfaction of the NRSRO criteria.

Currently, as I mentioned earlier, any rating agency that wishes to be designated as an NRSRO for purposes of our securities laws must work through the Division's no-action letter process. If the rating agency is successful in its quest, the Division will ultimately send the rating agency a no-action letter designating the agency an NRSRO for purposes of the net capital rule. Through this no-action process, the Division has formulated certain minimum standards that a rating agency must meet to be designated as an NRSRO. It appears to me that these standards

should be used as the criteria upon which a formal NRSRO designation process should be bottomed.

The first and single most important criterion appears to be that the entity be recognized in the United States by the preeminent users of rating services as an issuer of credible and reliable ratings. It is the integrity and responsiveness of the rating agencies that determines their reputation for credibility. The reputation of a rating agency is the sum: (1) of its rating methodology, which must be seen as credible, thorough, and comprehensive; (2) of its analysts and management personnel, who must be seen to be unbiased and immune from outside pressures; and (3) of its ratings, which must be viewed as timely and useful to issuers and investor alike. If the agencies do not develop these attributes, the value of their ratings will decline and so will the use of these ratings.

Rating agencies themselves recognize that their reputation for integrity and reliability is their most valuable asset. Officials for S&P have noted that:

> ratings are of value only as long as they are credible. Credibility arises primarily from the objectivity which results from the rater being independent of the issuer's

> business. The investor is willing to accept the rater's judgment only where such credibility exists. When enough investors are willing to accept the judgment of a particular rater, that rater gains recognition as a rating agency.[3]

The other specific criteria that the Division has determined are important to ensuring that a rating agency has a minimum level of operational capability and that its ratings are reliable are: (1) the availability of sufficient financial resources (to permit the agency to operate independent of economic pressures); (2) adequate staffing (so that the entity is capable of thoroughly and competently evaluating an issuer's credit); (3) the agency's reputation for integrity in the marketplace (this goes to the question of whether the agency has national recognition as a credible and reliable source of ratings); (4) systematic rating procedures (which are necessary to ensure credible and accurate ratings); and (5) the agency's establishment and compliance with

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3 Standard & Poor's Updates Its Guide to Rating Criteria, Bond Buyer, Dec. 23, 1983 at 12.

internal procedures designed to prevent misuse of non-public information.

The Division also has determined that it is important for the NRSROs to disseminate their ratings publicly. This is because the ratings of the organizations are used in the net capital rule, among other of the Commission's rules, and should be readily available for use and comparison. Nevertheless, not all of the rating agencies disseminate their ratings to newspapers or wire services, and copyright law may prevent such media sources from publishing the ratings without the express approval of the rating agencies. In any event, the Division believes that it is necessary to require the public dissemination of ratings by the NRSROs. Of course, most public disseminations of ratings (that is except for press releases) are ordinarily accompanied by disclosures of consideration received in order to avoid violating Section 17(b) of the Securities Act.

The Division's efforts to develop minimum criteria and standards for NRSROs has been complicated by both the different uses of the term in regulations and the differences in the uses of ratings in markets world-wide. However, if, as I expect, ratings of NRSROs will continue to be employed as an

integral and growing part of the Commission's regulatory program, they should meet certain published minimum standards of uniformity or comparability. Otherwise, users of ratings, including investors, issuers, and broker-dealers, will be confused or uncertain as to whether or not a particular rating agencies' rating qualifies a security for certain regulatory treatment. Additionally, without uniform standards, it will become more difficult for the Commission's and the self-regulatory organization's examiners to monitor compliance with the Commission's rules that use ratings.

Thus, while I believe that uniform standards are necessary, I am of the opinion that uniformity and comparability of ratings will be available only if each rating agency designated as an NRSRO is required to meet the same formal minimum standards.

IV. Clarify Authority of Commission to Propose Amendments

The adoption of amendments to the net capital rule is necessary to make sure that the use of ratings in the Commission's rules and regulations continues: (1) to enhance the financial safety and soundness of regulated entities, (2) to promote investor protection, and (3) to serve as a proxy of market liquidity and efficiency.

The difficulty with this approach, however, is that there remain lingering questions concerning the extent of the authority of the Commission to promulgate rules to require the registration of NRSROs or to regulate the ratings activities of these agencies. Without legislative authority to require such registration and to regulate these entities, it is possible that the Commission's authority to promulgate rules governing NRSROs may be challenged. Therefore, although, in my view, the Commission should propose for comment amendments to Rule 15c3-1 that would define the term NRSRO, require the registration of these entities with the Commission, and establish certain minimum standards or criteria that must be maintained by these entities, clarification of Commission authority to do so may be in order. Consequently, the Commission should also consider seeking from the Congress legislation that would define the term "NRSRO" for purposes of Section 3 of the Exchange Act and that would clarify the Commission's authority with respect to NRSROs.

By defining the term "NRSRO" in the Exchange Act, Congress would provide certainty to a term that, although it appears in many instances throughout the federal securities laws, is no where defined. Additionally, there does appear to be sound

and persuasive reasons for bringing the NRSROs squarely under the regulatory oversight of the Commission. As discussed previously, rating agencies, despite the great degree of influence that they exert in the financial markets, are not formally regulated. By obtaining the legislative authority to regulate the NRSROs, the Commission's regulatory authority to promulgate rules that would provide for both registration of the NRSROs and regulatory oversight over their actions would be clarified.

V. Conclusion

In conclusion, it is my judgment that, in addition to proposing amendments to the net capital rule that would define the term "NRSRO," require the registration of NRSROs, and set forth certain minimum standards to govern the operations of NRSROs, the Commission should also consider recommending to Congress that it pass legislation that would define the term "NRSRO' for purposes of Section 3 of the Exchange Act and that would clarify the Commission's oversight authority with respect to NRSROs.