Moody's Investors Service

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New York, New York 10007

September 5, 2008

By Electronic Mail

Ms Florence Harmon
Acting Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

RE: REFERENCES TO RATINGS OF NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATIONS – FILES S7-17-08, S7-18-08 AND S7-19-08 (THE "RELEASES")

Dear Ms Harmon:

Moody's Investors Service ("**MIS**") appreciates the opportunity to provide comments to the Securities and Exchange Commission ("**Commission**") on the Releases, which outline its proposals ("**Proposals**") to modify the use of credit ratings issued by Nationally Recognized Statistical Rating Organizations ("**NRSROs**") in the Commission's rules and forms. We believe that the dialogue the Commission has initiated about possible approaches to encourage more informed and careful use of credit ratings is important. Historically, MIS has supported discontinuing the use of ratings in regulation and the NRSRO system. We continue to hold this view.

We recognize, however, that in light of current market conditions, eliminating or reducing NRSRO ratings-based criteria should be pursued very judiciously to avoid further disruption in already fragile financial markets. Accordingly, we encourage the Commission to analyze carefully the potential, direct and indirect impact of each of its recommendations on market participants and financial markets.

In our response below, we discuss how the use of ratings as a regulatory tool for the oversight of regulated entities affects credit rating agencies ("**CRAs**") and their interactions with market participants and regulators. MIS recognizes that there are benefits from identifying and using objective, widely accepted standards for financial markets because this can facilitate efficient regulation. Credit ratings can be useful in this regard because they are easy-to-use, broadly disseminated, independent and reliably predictive opinions about relative creditworthiness. Nevertheless, we believe that widespread incorporation of ratings into regulation can affect the way ratings are used by regulated entities, the bases upon which issuers choose CRAs and the ways CRAs compete with each other. The appropriation of ratings for regulatory purposes also risks legislative or regulatory intrusion into the content of ratings, as the

authorities' interest in comparable ratings can pressure CRAs to produce homogenous opinions and undermine their ability to provide diverse, independent opinions. Accordingly, MIS supports initiatives to encourage market participants and regulators to consider carefully whether and how ratings should be used.

1. MARKET USE - HISTORIC ROLE OF CRAS AND ATTRIBUTES OF CREDIT RATINGS

The credit rating business began as a part of the publishing industry almost a century ago.[1] It has its roots in the American tradition of free speech and the competitive marketplace of ideas. Historically, in this "market use" model, two important groups of market participants were interested in ratings:

- Initially, investors (who were primarily institutional, rather than individual, investors) used credit ratings as an objective, "second opinion" against which to gauge their own views. In other words, credit ratings constituted an additional source of information that either supported or refuted, but did not supplant, the investors' own research, analysis and opinions. In general terms, the attributes of ratings that these investors found useful were as follows:
  - **Independence:** While investors might disagree with CRAs' opinions, they believed that these opinions were not biased toward a particular set of interests.
  - **Reliable, predictive content:** Over time, the ratings performance of certain CRAs demonstrated that their ratings generally served as reliable predictors of relative credit quality.
  - **Simplicity:** Rating symbols condensed a great deal of research into easy-to-use symbols.
  - **Breadth of coverage:** Globally active CRAs published ratings on a large and diverse group of entities and obligations. This breadth of coverage enabled investors to compare and rank credit quality across industry sectors, asset classes and jurisdictions.
  - **Rating stability:** As they began incorporating ratings-based criteria into their investment and portfolio composition guidelines, most investors also came to value not only rating accuracy (*i.e.*, predictive content) but also rating stability for the securities they owned.
- Issuers sought ratings to increase their investor base and marketability of their debt. Because of the rating attributes identified above, credible ratings could facilitate issuers' access to capital markets. Issuers naturally wanted to obtain the highest possible rating and exercise maximum control over the rating process. Since, however, investors demanded credible ratings, issuers were motivated to seek ratings from CRAs that had the best reputations among investors since such ratings would facilitate better access to capital markets. This was a form of "rating shopping" since issuers had a range of CRAs to choose from and could "shop" for the CRA that best served their objectives.[2]

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[1] The 1909 edition of John Moody's financial manual, *Analyses of Railroad Instruments*, introduced a system of opinions, expressed on a scale of letter symbols or ratings, about the creditworthiness of the railroads' bonds. Within a few years, three other firms (including two that later merged to form Standard & Poor's) also began publishing ratings using similar letter systems. By the end of the 1920s, the US bond market included 6,000 bond issuers with par amounts exceeding $26 billion. Nearly all of those issues were rated by CRAs.

[2] In recent decades, the term "rating shopping" has developed a negative connotation because, typically, the term has come to describe the practice where issuers "shop" for a CRA that will provide the highest rating, even if

Likewise, CRAs competed to deliver credible (*i.e.* objective, reliable and relatively stable) ratings. This is because, under the market use model, the credibility that they built with investors provided them with a competitive edge.[3]

Ratings have helped level the playing field between borrowers and lenders by reducing the natural, information asymmetry between those parties and communicating opinions in a readily understood language for credit risk. The attributes of ratings described above developed over a century of evolution in line with market-based needs. As discussed in more detail below, however, these attributes also led to the appropriation of ratings by policymakers and regulators pursuing public policy objectives.

2. Regulatory Use - Appropriation of Ratings for Regulatory Purposes

Leveraging the market's use of ratings, regulators in the U.S. and globally have incorporated ratings into regulations and rules. This is sometimes called the "regulatory use" model. There is an impression among some market commentators that regulatory use of ratings and the Commission's establishment of the NRSRO regime caused the development and success of the CRA industry. That impression, however, misconstrues the history of the use of ratings in federal securities laws, which occurred *because* CRAs already were providing a well-known and valuable product to market participants.

The appropriation of credit ratings for prudential and other standards is understandable from a public policy standpoint. As noted above, rating symbols are easy-to-use, and rating opinions are independent and relatively stable. Importantly, ratings have also demonstrated predictive ability to distinguish relative creditworthiness among securities and issuers. Moreover, ratings provided by the major CRAs are published for the equal benefit of all market participants, not just a select group of subscribers. As discussed in more detail below, however, by using credit ratings as a regulatory tool, policymakers can induce market participants, CRAs and regulators to change their behavior.

A. Impact on Regulated Entities' Behavior

The existing NRSRO system encourages regulated entities to treat ratings from recognized CRAs as interchangeable for regulatory purposes. Ratings, therefore, tend to become commoditized, which can affect the traditional incentives for these regulated entities to differentiate, or "shop", among CRAs based on the ratings' credibility. In other words, the incentive for entities to conduct their own credit analysis and use ratings as just one of several inputs in their decision-making process is weakened if the regulatory framework permits them to use an officially recognized rating without ongoing consideration of whether the rating conveys the information they need and is of sufficient quality.

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that rating is unlikely to be the most accurate rating. Shopping for a rating, however, occurs because there is competition among CRAs, and it is often suggested that more competition in the CRA industry would be beneficial. Neither rating shopping nor greater competition among CRAs, however, is intrinsically harmful or beneficial to investors and the markets generally. As discussed in more detail below, it all depends on which attributes of ratings are shopped for or along which CRAs compete.

[3] CRAs also may have competed for business on the basis of factors such as price, accessibility and service but we believe that credibility with investors was the preeminent, market-based attribute along which CRAs competed.

B. Impact on Issuers' Behavior

The NRSRO system introduces a new attribute into the CRA industry that market participants find valuable: official recognition. In other words, everything else being equal, if an issuer can choose between an officially recognized CRA and a non-recognized CRA, it may choose a recognized CRA because of the extra advantage it derives from getting a rating that can be used for regulatory purposes.[4] Moreover, issuers may consider "shopping" for the officially recognized CRA that will assign the highest possible rating because, at least in the short term, credibility with investors is supported by official recognition of certain CRAs.

In addition to shopping for the highest possible rating, issuers also may decide to shop for other rating attributes introduced by the regulatory framework. For example, if proposed paragraph (a)(3) of Rule 17g-5[5] to be adopted under the Securities Exchange Act of 1934 ("**Exchange Act**") is implemented as drafted, it likely will encourage issuers and underwriters of structured finance products to shop for the CRA that will demand the least information in the rating process.[6] This could lead to less well-informed and more volatile credit ratings, while failing to increase the amount of information available to investors and undermining the Commission's goal of facilitating unsolicited ratings.[7]

C. Impact on CRAs' Behavior

Since all officially recognized CRAs' ratings tend to be perceived as interchangeable, the incentives for these CRAs to compete on the basis of ratings quality and performance are diluted. This is because regulatory use of ratings introduces a second attribute along which CRAs may compete to attract business (either under the issuer-pays model or subscription-based model). Moreover, because credibility with investors is supported by official recognition of certain CRAs, officially recognized CRAs are in a position to compete for business from issuers (and/or subscribers) on the basis of attributes other than credibility, *e.g.*, by offering higher (or lower) ratings than their competitors, slowing (or increasing) the pace of rating actions, and/or demanding less information in the rating process.

D. Impact on Regulators' Behavior

The use of ratings-based criteria in regulation may inadvertently lead to substantive regulation of recognized CRAs' opinions, methodologies or rating processes.[8] Because of the important role that recognized ratings can play in a regulatory system with respect to the identification and management of risk, regulators may adopt requirements that put pressure on

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4 This does not mean that, in practice, issuers always choose recognized CRAs. There may be a range of other considerations, including the perceived credibility of a particular CRA's ratings in the market, which will influence the choice of CRA.

5 See *Proposed Rules for Nationally Recognized Statistical Rating Organizations* (File No. S7-13-08).

6 We discuss this issue in *Moody's Investors Service Comment Letter re File S7-13-08: Proposed Rules for Nationally Recognized Statistical Rating Organizations* ("**Comment Letter re File S7-13-08**) at 2-6.

7 The proposed amendments also could encourage issuers to seek ratings from non-NRSRO CRAs, which would not be subject to the proposed disclosure requirements. This in turn could create incentives for CRAs to decline to register as NRSROs or to relinquish their NRSRO status.

8 See, *e.g.*, the European Commission's *Consultation Document: Proposal for a Regulatory Framework for CRAs* (August 12, 2008).

CRAs to homogenize their methodologies and/or performance metrics to facilitate consistent assessment of relative creditworthiness. This is contradictory to the purpose of ratings, which is not to provide a common view of future credit risk but to provide *independent and competing* opinions about future credit risk.

In addition, regulators may come to rely upon credit ratings as a substitute for mandatory public disclosure of information needed to make investment decisions. For example, as noted above, the Commission recently proposed to make NRSROs the linchpin of a new disclosure regime for structured finance transactions, instead of revising the disclosure for structured finance issuers set out in Regulation AB, Rule 144A and other rules adopted under the Securities Act of 1933 and the Exchange Act.[9] Such a rule unintentionally miscasts NRSROs as creators and enforcers of disclosure requirements in structured finance markets and thereby conflicts with the Commission's stated intention to reduce market participants' over-reliance on credit ratings and CRAs.

E. Regulatory Use of Ratings and Market Forces

Of course, introducing a new use for ratings does not necessarily exclude other existing uses. Ratings continue to be sought for other reasons. For example, ratings-based criteria may be incorporated into investment and portfolio guidelines.[10] Accordingly, the incentives for issuers to seek ratings that are credible with investors and for CRAs to meet high performance standards have continued to operate and exert market discipline on the industry. If, however, these dynamics change, the incentive effects generated by the regulatory use of ratings may have a greater impact on the behavior of investors, issuers and CRAs. The effects of these incentives can be detrimental, if, for example, the regulatory use of ratings commoditizes ratings, puts pressure on CRAs to homogenize their rating methodologies or encourages issuers to shop for the CRA that will demand the least amount of information.

3. MIS's Recommendations

While historically MIS supported the wholesale abandonment of NRSRO ratings-based criteria in the Commission's rules and forms, we believe that implementing such an approach now may inadvertently lead to negative consequences in an already fragile market. Instead, we encourage the Commission to analyze carefully the potential, direct and indirect consequences of removing particular references to ratings. We support the healthy dialogue that the Commission has facilitated through the Proposals and believe it will encourage all users of ratings, whether they are market participants or regulators, to consider carefully whether ratings: (i) address some or all of the risks that the user is seeking to measure and manage; and (ii) exhibit the attributes

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[9] See MIS's Comment Letter re File S7-13-08 at 2-6.

[10] We understand that ratings-based criteria in privately established investment guidelines typically are intended to serve as just one of several essential criteria that portfolio managers are expected to consider in making investment decisions on their clients' behalf. Moreover, we understand that these guidelines typically refer to CRAs by name, which suggests that the individuals responsible for setting the guidelines considered qualitative and other substantive differences in various CRAs' ratings when determining which CRAs' ratings were appropriate for use in the guidelines. Because this type of use of ratings-based criteria involves the thoughtful consideration of whether a particular CRA's ratings are suited for the purpose intended in the guidelines and involves a consideration of qualitative factors, we are less concerned that the private sector's use of ratings in investment and portfolio guidelines will distort market participants' or CRAs' behavior.

that meet the user's needs. In our view, this type of analysis should be conducted periodically, since new risks can emerge, the relative importance of risks can change, new assessment tools are developed and the needs of market participants and regulators can evolve.

Ultimately, ratings are simply one tool that is available to market participants and regulators. We do not believe, and never have recommended, that they should be used as anything but an opinion about credit risk. We expect that the Commission's reassessment of the use of ratings in its rules and forms will help reinforce this concept.

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Once again, we appreciate the opportunity to comment on the Releases. We would be pleased to discuss our comments further with the Commission or its staff.

Sincerely,

Michel Madelain
Chief Operating Officer
Moody's Investors Service