Moody's Investors Service

99 Church Street
New York, New York 10007

March 12, 2007

By Electronic Mail

Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Proposed Rules Regarding Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations (Release No. 34-55231; File No. S7-04-07)

Dear Ms. Morris:

Moody's Investors Service ("Moody's") appreciates the opportunity to provide comments to the Securities and Exchange Commission (the "Commission" or "SEC") on the above-captioned proposed rules (the "Proposed Rules") implementing provisions of the Credit Rating Agency Reform Act of 2006 (the "Act"). The objectives of the Act are to foster competition, transparency and accountability in the credit rating industry. The Act delegates to the Commission authority to implement a registration and oversight regime for credit rating agencies that wish to be designated as Nationally Recognized Statistical Rating Organizations ("NRSROs") and have their ratings used under federal securities laws and other laws.

Moody's supports the broad objectives of the Act and believes that the SEC should allow more rather than fewer entities to be registered as NRSROs. Increased competition could increase the number of valuable opinions available to the financial markets, which in turn may reduce the likelihood that any one rating could cause excessive market reaction. Moody's further recognizes that the SEC has a valid interest in assessing both the quality of ratings and the integrity of the rating process. Regulators in the United States have increasingly utilized NRSRO ratings in their oversight of industries such as broker/dealers, banks and insurance companies. Therefore, in our view, regulatory measures that address these important interests are appropriate so long as they do not alter the core attributes of ratings, which are the result of decades of evolution in line with market-based needs and which have made ratings a useful tool both for the market and for regulators.

We believe many aspects of the Commission's Proposed Rules appropriately balance the needs discussed above with the objectives of the Act that the Proposed Rules be "narrowly tailored" to meet the Act's requirements and that they not "regulate the substance of credit ratings or the procedures and methodologies by which any [NRSRO] determines credit ratings." However, there are important aspects of the Proposed Rules that we believe diverge from these mandates or otherwise cause concern. Below is a summary of important general concerns with the Proposed Rules, followed by a more detailed discussion of issues and recommended revisions for each area of the Proposed Rules where we have significant concerns.

- ***The Scope of the Proposed Rules Should Not Inappropriately Extend to the Rating Agency's Related Entities***

Many aspects of the Proposed Rules extend to the NRSRO as well as "persons associated with the credit rating agency." As defined by the Commission, this term would capture any entity that has a legal relationship to the NRSRO and potentially the employees of those entities as well. We appreciate that there may be instances where the SEC has a valid interest in assessing the interaction between the NRSRO and its related entities, such as in reviewing the materiality of customer relationships within the NRSRO's controlled group. However, in several areas of the Proposed Rules (such as obligations to adopt policies pertaining to the use of material, nonpublic information[1] and management of conflicts of interest,[2] and the prohibition on soliciting payments from an entity for whom an NRSRO has published an unsolicited rating[3]), not only is it unnecessary to extend such rules to entities related to the NRSRO, but the rules may also be inconsistent with the nature of such entities' businesses and products. In our detailed discussion, we have made recommendations to narrow the scope of specific Proposed Rules as appropriate, for example by limiting their applicability to the NRSRO and its employees or to the NRSRO and controlled affiliates that provide credit rating services.

- ***The Proposed Recordkeeping Requirements Should be More "Narrowly Tailored"***

The Commission's proposed recordkeeping requirements would oblige rating agencies to create and retain voluminous records that may not be necessary or appropriate given their particular business models and analytical needs, and that would result in substantial compliance costs. In addition, the retention of many of these records is not necessary for the Commission to meet its oversight objectives related to the independence and integrity of the rating process. We believe the Commission can allow greater flexibility for rating agencies to design and implement appropriate record retention policies while still meeting its objectives. In our detailed discussion, we have suggested that instead of identifying specific records that an NRSRO must create and/or retain, the Commission should establish the objectives that record retention policies must address and then require NRSROs to implement conforming policies that would be subject to the Commission's review and inspection. We also discuss our concern that Commission access to an NRSRO's internal audit and compliance records could undermine the important roles that these functions perform for an NRSRO.

- ***The Form NRSRO Disclosure Requirements are Unnecessarily Extensive***

Under the Proposed Rules, a credit rating agency seeking to register as an NRSRO would be required to make public upon application for registration, and thereafter update, a wide range of information on Form NRSRO. We believe that greater transparency will help enhance the market's confidence in the rating agency industry and allow users to make informed decisions about the credibility and reliability of individual NRSROs. However, some of the proposed disclosure

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1 See Proposed Rule 17g-4.

2 See Proposed Rule 17g-5.

3 See Proposed Rule 17g-6(a)(5).

requirements are overly broad, such as the requirement to disclose background and other information for each of the NRSRO's analytical employees. In Moody's case, that would mean providing such information for more than 1,000 people. In our opinion, disclosures of this sort are not important to facilitate informed decision-making by regulators and the market about the qualifications and reliability of a given rating agency, and they may, in fact, serve to confuse rather than inform users of ratings. We have made specific recommendations where we believe the Form NRSRO disclosure requirements call for unnecessary or overly detailed information.

- ***Certain Proposed Rules Create Potential Conflicts of Law***

In implementing its Rules, we ask the Commission to remain mindful of the global nature of the rating agency industry, and therefore to refrain from imposing overly broad rules that may expose rating agencies to conflicts of law, especially in matters related to individual privacy. We have noted those instances where the Proposed Rules would require disclosure or other actions that could violate the laws of other countries in which rating agencies may operate.

- ***Certain Proposed Rules May Inappropriately Influence Rating Methodology and Undermine Rating Agency Independence***

As noted by the Commission, credit rating agencies use different analytical methodologies, measure different aspects of creditworthiness, and often arrive at different rating conclusions, all of which bring value to the market by delivering different analytical perspectives on issuers and securities.

Moody's believes that the independence of rating agency opinions from the influence of third parties, including governments, issuers, investors and competitors, is a cornerstone of their value to the market. Investors, regulators and other parties use the ratings of a given rating agency not only because of their predictive content, but also because they believe such ratings reflect the agency's bona fide opinion of the creditworthiness of a particular issuer, security or transaction. If rating agencies were compelled to adopt particular rating methodologies or to adopt the ratings of their competitors in their rating analysis and determination, they would in effect lose control over the rating opinions they publish. This would, in turn, undermine the independence that is fundamental to the credibility of ratings and would encourage harmonization of methodology and opinion, rather than encouraging rating agencies to strive to continue to improve based on the quality and usefulness of their ratings to meet the needs of diverse users.

We believe certain aspects of the Proposed Rules could have these effects and would threaten the independence and proper functioning of the rating agency industry as well as the pro-competition objectives of the Act. We are particularly concerned with Proposed Rule 17g-6(a)(4), in which the Commission seeks to prohibit certain practices related to rating structured finance transactions. This Proposed Rule, as drafted, is ambiguous and could be inappropriately interpreted to force NRSROs to accept the ratings of their competitors as their own, or risk being deemed to have acted in an abusive or coercive manner contrary to Commission rules.

We note that the Commission was asked by the Senate Banking Committee, in its report on the Act, to study the practices in question and assess whether a rule in fact was necessary to address any identified concerns.[4] However, it appears that the Commission is assuming, without conducting a study, that certain analytical practices related to structured finance ratings are, in fact, abusive or coercive. Moody's believes that these practices are analytically justified methods of forming an

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[4] S. Rep. No. 109-326, at 11 (2006) (the "Senate Report").

independent rating opinion. In addition, given that: (i) existing antitrust laws in the United States already provide robust protections and enforcement protocols against rating agencies that may improperly threaten to effect, or actually effect, a rating outcome for coercive or abusive purposes and (ii) Proposed Rule 17g-6(a) otherwise contains broad prohibitions against any such conduct, we believe Proposed Rule 17g-6(a)(4) is not warranted.

If this rule is retained, we urge the Commission to appropriately revise it to clearly prohibit only those practices that are motivated by unfair, coercive or abusive intent; state that no NRSRO is compelled to use as its own the opinions of other rating agencies; and allow NRSROs to continue to employ their independent analytical approaches in determining their rating opinions.

- ***The Proposed Rules Should Address Phase-In and Enforcement***

Although the Proposed Rules provide important guidance for addressing the objectives of the Act, we believe they also should address how the rules ultimately will be phased in and enforced by the Commission. As with any regulatory regime, it is critical for the Commission to adopt enforcement mechanisms that are clearly defined, flexible and proportionate and that balance the implications for all parties that will be affected by such enforcement, including NRSROs and the public parties that rely on their ratings. It is also critical that allowances be made for entities subject to the regulatory regime to take appropriate steps to achieve compliance with the rules.

These considerations will be especially important for the NRSRO regulatory regime, which is new and will likely encounter unforeseen complexities as it is implemented. We suggest that the Commission formulate an enforcement mechanism that clearly defines the consequences of breaching the rules that are narrowly tailored and proportionate to the character of the breach in question. We also ask that the Commission consider a phase in period of at least one year for rating agencies to bring themselves into full compliance.

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The sections that follow address each area of the Proposed Rules where we have important concerns. Once again, we appreciate the opportunity to comment on the Proposed Rules. We would be pleased to discuss our comments further with the Commission or its staff.

Sincerely,

Jeanne M Dering

Jeanne M. Dering

Executive Vice President
Global Regulatory Affairs & Compliance

I. PROPOSED RULE 17g-1: REGISTRATION REQUIREMENTS

A. Paragraphs (c) and (f): Updating Form NRSRO

Paragraph (c) requires rating agencies to update promptly the initial application on Form NRSRO when the information becomes "materially inaccurate," but paragraph (f), relating to updates after registration becomes effective (other than annual updates), does not contain similar qualifying language.

In addition, this duty to update applies to all information on Form NRSRO, but we believe it would be sufficient to update many of the items and exhibits annually. We recommend that the duty to update information on Form NRSRO outside the annual reporting mechanism should only be triggered when specified components of Form NRSRO become materially inaccurate. In our view, material changes in the following information should trigger the duty to update:

- Item 1 – the name and address of the NRSRO;
- Exhibit 3 – policies to prevent misuse of material, non-public information;
- Exhibit 5 – code of conduct;
- Exhibit 7 – policies to address and manage conflicts of interest; and
- Item 4 and Exhibit 9 – information related to the chief compliance officer.

In those cases where prompt updating is required, we do not agree with the Commission that, in most cases, it "should not take more than two days"[5] for an NRSRO to submit such updates to the Commission. This standard would place an undue burden on NRSROs and is not consistent with reporting requirements the SEC has imposed elsewhere in the securities laws. For example, reporting companies generally have up to four business days to disclose specified reportable events on Form 8-K. A bidder in a tender offer is allowed from five to twenty days to report material changes to previously disseminated tender offer materials.[6] Arguably, disclosures of this nature would have a more important potential impact on market stability and investors than the disclosures related to the internal operations of rating agencies. Given the less sensitive nature of the Form NRSRO disclosure requirements as compared to reporting requirements in other areas of the securities law, we recommend that the timeframe for prompt updating should be extended to 20 days.

We suggest the Commission modify the language as follows:

> (f) Updating Form NRSRO after registration. A rating organization amending its application for registration … must promptly furnish the Commission with the amendment if information submitted to the Commission upon registration or annual certification under Items 1 or 4 or Exhibits 3, 5, 7 or 9 is found to be or becomes materially inaccurate, on Form NRSRO that follows all applicable instructions for the Form.

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5 Proposed Rules at 23.

6 See Rule 14(d)-4(d) under the Securities and Exchange Act of 1934 (hereinafter the "Exchange Act").

B. Paragraph (h): Withdrawal of Registration

The Act specifies that an NRSRO's withdrawal of its registration can be made subject to terms and conditions the Commission may establish in the public interest or for the protection of investors. However, the Proposed Rules do not identify any such terms and conditions, which will be important factors for rating agencies when considering the costs and benefits of NRSRO registration. Terms and conditions that are overly broad or restrictive could undermine the voluntary nature of the NRSRO registration regime as contemplated by the Act. Therefore, we suggest that the rule be revised as shown below to specify that, upon the receipt of a duly authorized written notice of withdrawal by the Commission, such withdrawal will become automatically effective upon the expiration of a 90-day notice period. This should address public interest and investor protection objectives by allowing entities that rely on such NRSRO's ratings for regulatory purposes to prepare appropriately.

> (h) Withdrawal of registration. A rating organization wishing to withdraw ~~withdrawing~~ its registration must furnish the Commission with a written notice of withdrawal executed by a duly authorized person. Such withdrawal of registration shall become automatically effective 90 days after furnishing of such written notice to the Commission. During the 90-day notice period, the withdrawing NRSRO shall publish notice of its decision to withdraw by updating its Form NRSRO to specify the date its NRSRO status shall terminate.

C. Proposed Form NRSRO

1. Instructions to Form NRSRO

The rating agency industry is global in nature. NRSROs that operate in foreign jurisdictions – including "non-resident" NRSROs – will be faced with balancing the laws of the other jurisdictions in which they do business with the new disclosure and regulatory requirements promulgated by the Commission. In particular, with respect to disclosure of information regarding individual employees of a credit rating organization, the privacy and other laws of other jurisdictions, including several European Union countries in which Moody's currently operates, impose greater restrictions on the information that may be disclosed. Because imposing disclosure requirements that could lead to penalties by regulators abroad would have a chilling effect on a voluntary registration regime, we suggest clarifying in the General Instructions to Form NRSRO that credit rating agencies shall not be required to violate other laws by inserting the following additional instruction:

> A credit rating agency furnishing information on Form NRSRO shall not be required to violate the laws of other jurisdictions in which such credit rating agency operates in order to fulfill the requirements of this form. Registrants should indicate under each part of Form NRSRO any information that may not be furnished on Form NRSRO due to legal restrictions in other applicable jurisdictions.

2. Item 1: Annual Certification Requirement

Proposed Form NRSRO requires an annual certification that the information and statements contained in the Form "are accurate." We have no objection in principle to an annual certification requirement. However, the proposed certification requires an unqualified assertion of "accuracy," which would hold rating agencies to an unduly exacting standard that is not consistent with the intent of the Act or with analogous certifications under other securities rules. For example, annual CEO and CFO certifications required under Section 302 of the Sarbanes-Oxley Act of 2002 are qualified as to both knowledge and materiality. In addition, the Act established materiality standards for updating the Form NRSRO information, and the Commission discusses a standard of "material accuracy" in its description of the Form NRSRO certification requirement. We suggest that the proposed certification be qualified by "knowledge" and "materiality" as follows:

> The undersigned has executed this Form on behalf of, and on the authority of, the Applicant/NRSRO. The undersigned, on behalf of the Applicant/NRSRO, represents that, to the knowledge of the undersigned, the information and statements contained in this Form, including attachments, all of which are part of this Form, are accurate in all material respects as of the date hereof. If this is an ANNUAL CERTIFICATION, the undersigned, on behalf of the NRSRO, represents that, to the knowledge of the undersigned, the NRSRO's application on Form NRSRO, as amended, is accurate in all material respects as of the date hereof.

3. Item 8: Potential Statutory Disqualifications

Proposed Item 8 requires disclosure of certain criminal background information with respect to "any person associated with the credit rating agency." Based on the definition of this term under the Act, Item 8 would require a rating agency to collect and disclose such information for its worldwide employees and the employees of its affiliates, regardless of their role in determining credit ratings. We believe the volume and breadth of such disclosure would serve more to confuse investors than to facilitate informed decision-making on whether a rating agency's published ratings should be relied upon. We suggest therefore limiting the disclosure to only the rating agency and its controlled affiliates who also provide credit rating services.

In addition, for rating agencies that operate outside the United States, collecting and disclosing information of this sort for all persons associated with the rating agency will conflict with privacy laws in some jurisdictions, as discussed above, including certain countries in the European Union in which rating agencies currently operate.

We suggest revising proposed Item 8 to require such disclosure only with respect to key personnel. This approach is similar to the approach taken in other areas of securities laws where information must be disclosed regarding the officers and directors of the registrant.[7]

> (A) Has the credit rating agency, its controlled affiliates that provide credit rating services, or ~~any person associated with the credit rating agency~~ their key personnel, such as executive officers, directors, the designated compliance officer and persons in charge of a principal business unit, division or function of the rating agency or who perform a policy making function, whether prior to or subsequent to being employed by ~~becoming associated with~~ the credit rating

[7] For example, Rule 3b-7 under the Exchange Act defines "executive officer" as a registrant's "president, any vice president of the registrant in charge of a principal business unit, division or function (such as sales, administration or finance), any other office who performs a policy making function or any other person who performs similar policy making functions for the registrant."

> agency or its controlled affiliates that provide credit rating services, committed or omitted any act, ...
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> (B) Has the credit rating agency, its controlled affiliates that provide credit rating services, or ~~any person associated with the credit rating agency~~ their key personnel, such as executive officers, directors, the designated compliance officer and persons in charge of a principal business unit, division or function of the rating agency or who perform a policy making function, whether prior to or subsequent to being employed by ~~becoming associated with~~ the credit rating agency or its controlled affiliates that provide credit rating services, been convicted of any crime that is punishable by imprisonment for 1 or more years,…

D. Exhibits to Form NRSRO

We support the Commission's objective to reduce the administrative burdens on NRSROs by implementing a single form for collecting all information required from rating agencies. However, as discussed below, some of the disclosures required by Form NRSRO may conflict with the mandates and public policy objectives of the Act.

1. Exhibit 1: Credit Ratings Performance Measurement Statistics

We believe disclosure of ratings performance over time should be an important part of the NRSRO oversight framework, as it will provide objective criteria for assessing whether an NRSRO's ratings are suitable for use in regulation or by the market. Moody's publishes and makes freely available various statistical ratings performance reports, and we do not object to incorporating these reports by reference or furnishing them as part of Form NRSRO.

The Commission has asked for comments regarding whether the ratings performance measurement statistics to be disclosed in Exhibit 1 "should use standardized inputs, time horizons and metrics to allow for greater comparability."[8] While, on its face, presenting ratings performance data in a standardized format might appear to facilitate comparison of ratings accuracy and quality, in practice, we believe such standardization would not serve these objectives for the following reasons:

- Rating agencies do not all define their ratings in the same way. For example, Moody's ratings are intended to be measures of expected loss with relevance over multiple investment horizons; other credit rating agencies may intend their ratings to measure probability of default and/or may focus on specific horizons. A standardized format that focuses on default experience alone and/or a specific time horizons may accurately reflect the analysis employed by certain credit rating agencies, but would not effectively capture the overall predictive content of a Moody's rating.
- Definitions of default and loss vary across rating agencies, particularly with respect to structured finance transactions and bank loans.

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[8] Proposed Rules at 41.

- Methods of calculating long-term default rates vary significantly across rating agencies.[9]
- Issues such as how to present data on a sectoral basis would need to be considered.
- Symbol systems may vary by the number and meaning of rating categories.

Standardizing ratings performance metrics may imply direct comparability and thereby mislead users of ratings. It may also advantage or disadvantage one rating agency compared with another, giving rise to a mistaken impression that the methodologies utilized by a particular NRSRO may result in better ratings performance solely because the NRSRO's methodologies are better suited to the standardized criteria endorsed by the Commission. Moreover, it may result in regulatory encouragement of a more standardized industry approach to the substance of ratings. Rating agencies may alter their rating methodologies, procedures and definitions, not to improve their predictive content, but to maximize performance under the Commission's standards. We further note that a standardized approach could inadvertently result in an intrusion of the SEC into ratings procedures and methodologies contrary to the express language of the Act.

Rather than imposing one set of performance metrics on NRSROs, we believe it would be more useful to regulators and investors if NRSROs were provided the flexibility to determine how best to present their ratings performance, with appropriate disclosures and explanations. Users of ratings could then make their own judgments about relative ratings quality based on the information provided by different agencies and the comprehensiveness of their performance metrics. If a standard presentation were to be established, Moody's would also continue to provide to the market and our customers additional ratings performance information that we believe is most useful to understanding the quality and performance of our ratings. We believe that the Commission should focus its regulation on encouraging rating agencies to strive toward transparency that allows market participants to make their own judgments about the performance of rating agencies, rather than imposing a uniform set of performance metrics.

In this regard, the Commission has also asked "whether credit rating agencies or other persons currently use other performance measurement statistics or whether other performance measurement statistics would be appropriate as an alternative, or in addition to, historical default and downgrade rates."[10] Moody's tracks and reports a large number of metrics to measure the performance of our ratings on corporations.[11] We report on rating accuracy, defined as the power of the relative rankings implied by our ratings to discriminate relative risk of loss, over both long- and short-term time horizons. We also report absolute measures of risk represented in investment-grade loss rates, average ratings prior to default and average loss rates by rating categories over long-term horizons. In addition, we report on the stability of our ratings as

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9 To calculate long-term default rates from a mix of short-term and long-term rating histories, Moody's (but not all other rating agencies) adjusts its default rates for the censoring effect of short-lived rating histories. If the default rates are left unadjusted, the rating determination process would yield artificially low estimates of long-term default rates. See "Calculating Corporate Default Rates," Moody's Special Comment (Nov. 2006).

10 Proposed Rules at 41.

11 See "Guide to Moody's Default Research: February 2007 Update," Moody's Special Comment (Feb. 2007).

measured by the frequency of all rating changes, large rating changes (i.e., an increase or decrease in rating of three or more rating notches) within one year and rating reversals (i.e., where a rating upgrade is followed by a rating downgrade or vice versa) within one year.[12] We believe measures of this nature provide valuable performance data for users of Moody's ratings. However, we reiterate our position that the Commission should not regulate, directly or indirectly, the specific ratings performance measurements produced by rating agencies.

2. Exhibit 2: Procedures and Methodologies Used to Determine Credit Ratings

While we support disclosure of how rating agencies determine their ratings, we suggest that the SEC more narrowly define the information to be disclosed and simplify the process for disclosure. Requiring disclosure of all "procedures" may inadvertently capture detailed internal guidelines that rating agencies produce for their employees, which may not be appropriate for external review. Instead, we recommend that the Commission only require disclosure of "policies" that are high-level statements of the principles by which a credit rating organization and its employees operate. Moody's has publicly available policies regarding various aspects of our rating practices, including policies that address the core principles that govern the conduct of our rating committees, the designation of unsolicited ratings, the designation of ratings where the issuer does not participate in the rating process, and the withdrawal of ratings. We believe the type of disclosure we currently provide the market meets the objectives of Exhibit 2 and the Act.

For some of these policies, however, we have also developed internal procedural guidelines that explain how the policies should be applied by our employees in the day-to-day operation of our business. Because these internal procedural guidelines can be detailed and technical, we do not believe they would be meaningful to third parties in understanding the principles that govern our rating processes. Rather than requiring public disclosure of these more detailed internal guidelines, if the Commission feels it is important for its own oversight purposes to have access to them, we would of course make them documents available to the Commission in connection with its inspections.

With respect to "methodologies," Moody's applies this term to the documents that describe the analytical approach we take in developing ratings for a particular sector or type of security. Moody's employs hundreds of analytical methodologies across its various rating groups which are already disclosed on our public website.

We suggest that if a rating agency publishes its policies and methodologies on its public website, it be allowed to incorporate such information by reference on Form NRSRO. This would eliminate unnecessarily redundant and voluminous disclosure and allow NRSROs to efficiently amend Form NRSRO when necessary. We note that the SEC has provided an analogous framework under Items 406 and 601(14) of Regulation S-K, whereby a reporting company is permitted to disclose its code of ethics by publishing the code on its website and including the internet address in its periodic reports.

We suggest that the instructions to proposed Exhibit 2 be modified as follows:

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12 The utility of these metrics is discussed in "Measuring the Performance of Corporate Bond Ratings," Moody's Special Comment (Apr. 2003).

> Exhibit 2. This exhibit must include the ~~procedures~~ policies and methodologies that the credit rating agency uses to determine credit ratings, including unsolicited credit ratings. The ~~procedures~~ policies and methodologies furnished in this exhibit should include, as applicable: policies for determining whether to initiate a credit rating; a description of the public and non-public sources of information used in determining credit ratings, including information and analysis provided by third-party vendors; a description of any quantitative and qualitative models and metrics used to determine credit ratings; ~~procedures~~ policies for interacting with the management of a rated obligor or issuer of rated securities or money market instruments; the structure and voting process of committees that review or approve credit ratings; ~~procedures~~ policies for informing rated obligors or issuers of rated securities or money market instruments about credit rating decisions and for appeals of final or pending credit rating decisions; ~~procedures~~ policies for monitoring, reviewing, and updating credit ratings; and ~~procedures~~ policies for ~~to~~ withdrawing, or suspending the maintenance of, a credit rating. A credit rating agency may post these policies and methodologies on its Internet website, and incorporate them by reference by disclosing its Internet address and the fact that it has posted such policies and methodologies on its Internet website.

Our concerns relating to disclosure of procedures are also applicable to Exhibits 3 (policies and procedures to prevent the misuse of material, nonpublic information) and 7 (policies and procedures to manage conflicts of interest). We recommend revising the instructions to each of these exhibits to only require public disclosure of "policies" and not "procedures" and to permit disclosure by reference to disclosure on an Internet Website.

We also believe the definition of the term "unsolicited credit rating" provided in the instructions to Exhibit 2 should be modified to account for the fact that rating agencies have ongoing relationships with issuers and are sometimes asked to rate all or most of the issuances by that issuer. As such, there may be instances where, rather than being "requested" to rate securities on an issuance-by-issuance basis, there will be a master agreement that authorizes the rating agency to rate all of the issuances by that issuer. There also may be instances where an investor or market participant initiates the request for a rating, and with the consent of the issuer, the credit rating agency publishes a rating. Therefore, to ensure that these typical and uncontroversial business practices are not inadvertently captured by the term "unsolicited credit rating," we suggest that the definition of unsolicited ratings be tied to the issuer relationship rather than a particular issuance and that it capture the concept of "consent" as well as "request":

> For purposes of this exhibit: Unsolicited credit rating ~~means~~ is a credit rating published by ~~that the~~ a credit rating agency that does not have an existing credit rating relationship with the issuer, or ~~determines without being requested to do so by~~ where the issuer or underwriter has not requested or consented to the publication of the rating on the ~~of the rated~~ securities, ~~or~~ money market instruments or ~~the rated~~ obligor.

3. Exhibit 5: Code of Ethics

Exhibit 5 requires information regarding whether a rating agency has established a code of ethics. Moody's has endorsed the principles expressed in the IOSCO Code and is committed to implementing these principles through our own Code of Professional Conduct. The IOSCO Code is a recognized international standard for rating agency conduct endorsed by global regulators, including the SEC, and it addresses matters of objectivity and integrity. With its "comply or explain" mechanism, it can be adopted by rating agencies with various business models. Therefore, we believe it is appropriate for Exhibit 5 to require disclosure as to whether or not the rating agency's code of conduct is consistent with the IOSCO Code. (We have used the IOSCO terminology, which refers to a "code of conduct" rather than a "code of ethics.") We suggest revising Exhibit 5 as follows:

> Exhibit 5. This exhibit must include a copy of the written code of ~~ethics~~ conduct in effect at the credit rating agency or a statement of the reasons why the credit rating agency does not have a written code of ~~ethics~~ conduct. If the credit rating agency has a written code of conduct in effect, the credit rating agency shall state whether such code of conduct is consistent with the Code of Conduct Fundamentals for Credit Rating Agencies promulgated by the International Organization of Securities Commissions.

4. Exhibit 8: Information on Analytical Staff

Exhibit 8 requires a rating agency to disclose information regarding the responsibilities, experience, employment history and education of each of its credit analysts and supervisors. While we recognize that the SEC and the market may have an interest in understanding the qualifications of the NRSRO's analytical staff, we believe that providing and continuously updating the proposed information with respect to each analytical employee would be unduly burdensome for rating agencies and is not necessary to meet the Act's objectives.

NRSROs would initially have to accumulate the required information from their employee records, and thereafter update the information continuously for events such as hiring, employee terminations and changes in an existing employee's job title or responsibilities. This would result in unnecessary compliance costs for NRSROs, which could be material for those who have a large number of analysts working in numerous countries around the world. Moreover, for NRSROs with non-U.S. operations, disclosure of such employee information would violate privacy laws in certain jurisdictions.

We also question whether the suggested disclosure would enhance the SEC's or the market's ability to assess the quality of an NRSRO's ratings. For many rating agencies, including Moody's, ratings are the product of a committee voting process, not the opinion of any one analyst or supervisor. Moreover, users of ratings generally rely on the integrity of the rating agency as a whole. Disclosure of the background of each person involved in determining ratings could suggest to the market that the weight given to a particular rating should be influenced by the background of the individual analysts involved in the rating.

Given the concerns raised above, we believe that Exhibit 8 should be eliminated in its entirety. If it is retained in some form, we recommend that the instructions be revised to limit disclosure to descriptions of the typical job responsibilities and educational and employment backgrounds of a rating agency's analytical and supervisory staff.

> Exhibit 8. This exhibit must include a general description of the typical responsibilities, education, and employment background ~~the following information regarding each~~ of the credit rating agency's credit analysts in each representative category of seniority, and of ~~each~~ officers and employees of the credit rating agency responsible for supervising ~~the credit rating agency's~~ such credit analysts.

- ~~Name.~~
- ~~Title and brief description of responsibilities, including whether a supervisor.~~
- ~~Employment history.~~
- ~~Post secondary education.~~
  - ~~Whether employed by the credit rating agency full time (at least 35 hours per week) or part time.~~

> For purposes of this exhibit: Credit analyst means an individual associated with the credit rating agency who ~~is responsible for determining~~ participates in the determination of a credit rating using either a quantitative model, a qualitative model and analysis, or a combination of these methods.

5. Exhibit 9: Background on Compliance Employees

Although disclosure of the background of an NRSRO's compliance personnel is not mandated under the Act, we recognize that providing information on the designated compliance officer will help the SEC and the market evaluate an NRSRO's ability to manage its compliance activities. We believe, however, that requiring the same detailed disclosure for persons assisting the compliance officer would be of only marginal benefit and would present similar concerns of providing the market with irrelevant information and of conflicts with privacy laws as discussed in Exhibit 8. We therefore recommend revising Exhibit 9 to only require disclosure relating to an NRSRO's designated compliance officer:

> Exhibit 9. This exhibit must include the following information about the credit rating agency's designated compliance officer (identified in Item 4) ~~and any other persons that assist the designated compliance officer in carrying out the responsibilities set forth in Section 15E(j) of the exchange Act~~:

- Name.
- Title and brief description of responsibilities.
- Employment history.
- Post secondary education.
- Whether employed by the credit rating agency full-time (at least 35 hours per week) or part-time.

If the Commission were nonetheless to require disclosure regarding persons that assist the compliance officer, we believe disclosure should be limited to the persons who directly assist the designated compliance officer in conducting compliance reviews and providing a summary of the typical educational and professional backgrounds of such persons.

6. Exhibit 10: List of 20 Largest Issuer and Subscriber Customers

Exhibit 10 requires an NRSRO to disclose the "net revenue" received by the NRSRO and its affiliates from the NRSRO's largest customers. Net revenue is defined as "all fees, sales proceeds, commissions, and other revenue received by the credit rating agency and its affiliates for any type of service or product, regardless of whether related to credit rating services, and net of any fees, sales proceeds, rebates, and other monies paid to the customer by the credit rating agency and its affiliates."

The proposed definition would require an NRSRO to calculate revenue using amounts collected from a particular customer rather than amounts billed to the customer or the earned revenue recorded for such customer. We believe the definition should allow any of these approaches to accommodate different customer accounting systems that different NRSROs and their affiliates may utilize, provided that the NRSRO discloses the measurement being utilized and the reason for relying on such measurement. In addition, the required netting of amounts paid to the customer appears to include amounts paid for ordinary-course purchases of goods and services, if such customer is also a vendor of the NRSRO or its affiliates. An example of such a relationship would be where a rated utility issuer, such as a telephone company, also provides the NRSRO with telephone service. We believe netting of the amounts generated by the two relationships would underestimate the materiality of the customer relationship and should be removed from the definition. We suggest revising the instructions to Exhibit 10 to read as follows:

> Exhibit 10. This exhibit must include a list of the largest customers that used credit rating services provided by the credit rating agency by the amount of net revenue received by the credit rating agency and its affiliates from the customer during the fiscal year ending immediately before the date the credit rating agency submits an INITIAL APPLICATION. This exhibit must also disclose whether net revenue is based on amounts received, billed or earned and the reasons for relying on the selected method. In making this list of the largest customers, the credit rating agency should first determine the 20 largest issuer and subscriber customers in terms of net revenue received, billed or earned by the credit rating agency and its affiliates from the issuer or subscriber. …
>
> For purposes of this exhibit:
>
> Net revenue means all fees, sales proceeds, commissions, and other revenue received, billed or earned by the credit rating agency and its controlled affiliates for any ~~type of~~ service or product, regardless of whether related to credit rating services, and net of ~~any fees, sales proceeds, rebates, and other monies paid to the customer by the credit rating agency and its affiliates~~ rebates, allowances and adjustments; and…

In addition, we suggest broadening the term "credit rating services" to capture other products and services which are derived from the credit rating process, such as research and data products in order to convey accurately the extent of the relationship between the NRSRO and the issuer:

> Credit rating services means ~~any of the following~~ services that are derived from the credit rating process, including but not limited to: rating an obligor (regardless of whether the obligor or any other person paid for ~~the~~ such credit

> rating); rating an issuer's securities or money market instruments (regardless of whether the ~~issuer, underwriter,~~ obligor or any other person paid for ~~the~~ such credit rating); and providing credit ratings to a subscriber~~.~~; and the creation and sales of other products and services derived from the rating process such as credit research reports and data products.

7. Exhibit 11: Audited Financial Statements

Exhibit 11 provides that if a credit rating agency is a division, unit, or subsidiary of a parent company, it can provide audited consolidated and consolidating financial statements of the parent company rather than providing separate audited financial statements of the rating agency. If the consolidated parent company financial statements include operating segment disclosure for the rating agency consistent with Generally Accepted Accounting Principles and the Commission's segment reporting rules under Regulation S-X (such as those that would be included in Form 10-K), we recommend that such consolidated financial statements be accepted by the SEC in lieu of consolidating financial statements. We believe this would result in considerable cost savings for the rating agency while providing the Commission and the market with sufficient information to assess a credit rating agency's financial viability. We suggest revising the instructions to Exhibit 11 to read as follows:

> Exhibit 11 . . . If the credit rating agency is a division, unit, or subsidiary of a parent company, the credit rating agency can provide audited consolidated and consolidating financial statements of the parent company. If the audited consolidated financial statements include operating segment reporting for the credit rating agency in accordance with the applicable provisions of Regulation S-X, such credit rating agency shall only be required to provide consolidated financial statements.

8. Exhibit 12: Revenue Information by Product and Service

We recommend that this exhibit use the term "net revenue," as defined in Exhibit 10, to accommodate different approaches to product revenue accounting systems that different NRSROs may have.

II. Proposed Rule 17g-2: Recordkeeping

We recognize that the Act has authorized the Commission to require NRSROs to "make and keep … such records, … and make and disseminate such reports, as the Commission, by rule, prescribes as necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of [the Exchange Act]."[13] In addition, we note that in developing its proposed recordkeeping rules, the Commission intends to provide NRSROs with "flexibility to implement a recordkeeping system" that captures the required information "in a manner that conform[s] to the NRSRO's internal processes."[14] However, we are concerned that because the Proposed Rules enumerate specific records that must be created and/or retained, they are not "narrowly tailored" and may inadvertently impose a one-size-fits-all record retention approach

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13 Section 17(a)(1) of the Exchange Act.

14 Proposed Rules at 66.

for all rating agencies, regardless of their business model. We therefore believe the Commission should allow flexibility in the types of records NRSROs are required to create and retain to meet its objectives.

A. Paragraphs (a) and (b): Records to be made and, if made, retained

We propose that rather than enumerating specific records that must be retained by every rating agency, the SEC instead should require the adoption of and adherence to a record retention policy that meets certain minimum requirements. The Commission could then review the policy and its implementation to ensure that "necessary or appropriate" records are in fact being created and retained. Therefore, we propose that Rules 17g-2(a) and (b) read as follows:

> (a) Every credit rating organization registered with the Commission as a nationally recognized statistical rating organization ("rating organization") must adopt and adhere to a record retention policy that includes the following categories:
>
> > (1) Records supporting the rating organization's audited financial statements.
> >
> > (2) Records relating to the rating organization's rating process, including records evidencing: (a) the initiation of a rating; (b) the analytical process underlying such rating; (c) the rating determination; and (d) the publication of the rating.
> >
> > (3) Records evidencing the subscription or rating requests by the rating organization's clients and the compensation received from those customers.
> >
> > (4) Records relating to the rating organization's internal audit and compliance function.
>
> (b) A rating organization must furnish the Commission with complete and current copies of the recordkeeping policies implemented in accordance with Rule 17g-2(a) for review by the Commission to ensure that "necessary or appropriate" records are in fact created and retained.

We believe this approach effectively balances the objectives of the Act and the practical operation of rating agencies by allowing rating agencies sufficient flexibility to meet their business needs while providing the Commission access to those records important to its regulatory oversight.

Alternatively, if the Commission decides to implement Proposed Rules 17g-2(a) and (b) in substantially their current form, we believe the following revisions should be made to these subsections.

1. Paragraph (a)(2): Records With Respect to Credit Ratings

Because the determination of any given credit rating is a complex process and necessarily involves the use of a number of methodologies and procedures, we believe precisely itemizing and documenting the relevant procedures and methodologies, which is called for in subparagraph (iii), would be impractical, unnecessary and burdensome on credit rating analysts. We ask the Commission to narrow the scope of paragraph (a)(2) by eliminating subparagraph (iii).

2. Paragraph (b)(2): Records Used to Determine Credit Ratings

This subsection is overly broad because it would require that all interim work-product be retained, including notes of conversations, drafts of memoranda and worksheets, regardless of whether they are ultimately relied on in reaching the final rating determination. This would be particularly burdensome in the structured finance ratings area, where analysis of transaction structures using relevant models is performed on an iterative basis as arrangers make changes in their proposed structures, but only analysis of the final transaction structure is relevant to the rating outcome. In addition, paragraph (b)(2) would require retention of publicly available documents reviewed during the credit rating process (e.g., an issuer's Forms 10-K and Forms 10-Q), which a rating agency currently would have no reason to separately retain. We suggest limiting the scope of Proposed Rule 17g-2(b)(2) as follows:

> (2) Internal ~~records,~~ documentation used to form the basis for a credit rating determination, excluding notes, drafts and public information. ~~including non-public information and work papers, used to determine a credit rating.~~

3. Paragraph (b)(3): Reports Related to Credit Analysis, Credit Assessments and Private Ratings, and All Records Used to Form the Basis for the Opinions Expressed in Reports

For reasons analogous to those discussed with respect to Proposed Rule 17g-2(b)(2), we believe that the scope of paragraph (b)(3) should be narrowed as follows:

> (3) Credit analysis reports, credit assessment reports, and private rating reports and internal ~~records, including non-public information and work papers,~~ documentation used to form the basis for ~~the opinions expressed in these reports~~ such reports, excluding notes, drafts and public information.

4. Paragraphs (b)(4) and (5): Compliance Records and Internal Audit Records

Paragraphs (b)(4) and (b)(5) require an NRSRO to retain all compliance and internal audit records relating to the business of operating as a credit rating agency. For reasons similar to those outlined above under paragraph (b)(2) and referenced in paragraph (b)(3), we do not believe that the interim work-product of these two functions should be retained. We ask that the Commission also revise paragraphs (b)(4) and (b)(5) to provide an NRSRO with the flexibility to tailor its compliance and audit records to suit its particular business model. We are also concerned that, as drafted, paragraph (b)(5) could be interpreted to require an NRSRO that is a reporting company under the Exchange Act to reevaluate its retention practices with respect to audit records relating the its financial reporting obligations. We do not believe that the Commission intends to impose this requirement, and therefore have added clarifying language to that effect.

> (4) ~~All~~ Final compliance reports and final compliance exception reports that relate to its business as a credit rating agency.

> (5) ~~All~~ Final internal audit plans~~, internal audit reports, documents relating to internal audit follow-up measures that relate to its business as a credit rating agency, and all records identified by the rating organization's internal auditors as necessary to perform the audit of an activity relating to its business as a credit rating agency~~ and final internal audit reports that relate to the business of a credit rating agency. Nothing contained in this paragraph shall require any rating organization that is a reporting company under the Securities and Exchange Act

of 1934 to retain additional audit records with respect to its financial reporting obligations beyond those required under the Securities and Exchange Act of 1934.

5. Paragraph (b)(7): Internal and External Communications

We believe the Commission's proposed communication retention requirements should be limited to information that is substantively relevant to the credit rating process. For example, there may be numerous e-mail communications between an issuer and an analyst to arrange and confirm the date and time of a meeting. Such communications have no bearing on the credit rating assigned to the issuer, yet would need to be retained under the Proposed Rule. We believe Proposed Rule 17g-2(b)(7) should be more narrowly tailored as follows:

> (7) All substantive external and internal communications, including electronic communications, received and sent by the rating organization and its employees relating to initiating, determining, maintaining, changing or withdrawing a credit rating.

B. Paragraph (c): Retention Period

As a general matter, Moody's does not object to a three year record retention period. Paragraph (c), however, raises two key concerns. First, the requirement that customer-specific records be retained for three years after an NRSRO's business relationship with that customer terminates could result in inordinately long record retention periods, since rating agencies often have longstanding issuer relationships that may span many decades. Second, this rule does not account for the fact that some records may never be replaced by newer, more current records. For example, if a particular series of debt is rated and later redeemed, a new credit rating is never issued to replace the rating that existed at the redemption date. As a result, under Proposed Rule 17g-2(c), certain records may need to be retained indefinitely. We suggest that the SEC limit the retention period to three years in all cases, as follows:

> (c) Record retention periods.
>
> ~~(1) The records required to be retained pursuant to paragraphs (a)(1), (a)(2), and (a)(5) of this section must be retained for three years after the date the record is replaced with an updated record.~~
>
> ~~(2) The records required to be retained pursuant to paragraphs (a)(3) and (a)(4) of this section must be retained for three years after the date of the last receipt by the person in the record of a service or product of the rating organization.~~
>
> ~~(3)~~ The records required to be retained pursuant to paragraphs (a) and (b)~~(1) through (b)(9)~~ of this section must be retained for three years after the date the record is made or received by the NRSRO.

C. Paragraph (g): Furnishing Records to the Commission

We believe the Commission's inspection authority over the records created by an NRSRO's internal audit and compliance functions could have a chilling effect on these two very important internal control mechanisms. We recognize that such documents could potentially assist the SEC with its oversight function. However, we believe that direct access by the SEC to the documents produced by these functions could adversely affect an NRSRO's ability to conduct compliance and internal audit-related deliberations on a confidential basis and may discourage potential whistleblowers from reporting concerns. This, in turn, would undermine the key role that these functions play in supporting management's objectives to ensure that systems of internal control are designed and operating effectively. Because of the imbalance between the potential cost of compliance and the likely regulatory benefit, Moody's requests that the Commission's inspection authority under Paragraph (g) be limited as follows:

> (g) A rating organization must promptly furnish the Commission and its representatives with legible, complete, and current copies of those records of the rating organization required to be retained under this section, or any other records of the rating organization subject to examination under section 17 (b) of the Act (15 U.S.C. 78q(b)), except for those required to be retained under paragraphs 17g-2(b)(4) and 17g-2(b)(5), that are requested by the Commission and its representatives.

Alternatively, if the Commission determines that access to compliance and internal audit records is essential to its oversight function, we believe that such access should be limited to those compliance and internal audit records that are directly related to the rating process. As presently constructed, the records retained would include reviews of areas such as information technology, human resources and accounting that are largely ancillary to the rating determination process, but arguably related to "the business of operating as a credit rating agency." Therefore, we recommend the following revision paragraph 2(g):

> (g) A rating organization must promptly furnish the Commission and its representatives with legible, complete, and current copies of those records of the rating organization required to be retained under this section, or any other records of the rating organization subject to examination under section 17 (b) of the Act (15 U.S.C. 78q(b)), except for records retained pursuant to paragraphs 17g-2(b)(4) and 17g-2(b)(5) that do not relate to the credit rating process, that are requested by the Commission and its representatives.

III. PROPOSED RULE 17g-3: ANNUAL AUDITED FINANCIAL STATEMENTS

We believe that requiring audited financial statements (subsection (a) of Proposed Rule 17g-3) and supporting schedules (subsection (b)) can assist the Commission in its efforts to monitor the adequacy of the financial resources of NRSROs. We suggest, however, that the Proposed Rule be revised in two ways.

First, the standards we have suggested for the audited financial statements under Exhibit 11 to Form NRSRO should also be applied to these annual audit obligations. We recommend that paragraph (a) of Proposed Rule 17g-3 be revised as follows:

> (a) . . . fiscal year. Where the rating organization is a division, unit or subsidiary of a parent company, the rating organization may provide audited consolidated financial statements of the parent company if these statements include operating segment reporting for the rating organization in accordance with Regulation S-X.

Second, the schedules required under Proposed Rule 17g-3(b) should not be required to be audited. In addition to being costly, we believe that a separate independent audit of the schedules is unnecessary given the audited financial information and other extensive disclosure NRSROs will be providing to the Commission. We recommend that paragraph (b) of Proposed Rule 17g-3 be revised as follows.

(b) The audited financial statements required under this section must include the following supporting schedules~~:~~, which need not be audited;

We recommend that the suggestions we have made with respect to Proposed Rule 17g-3(b) and its associated exhibits be reflected in the "Note to paragraph (b)(3)" Accompanying Proposed Rule 17g-3(b).

IV. Proposed Rule 17g-4: Policies to Prevent the Misuse of Material, Nonpublic Information

We support the Commission's decision not to propose specific policies in this area, and instead to allow NRSROs the flexibility to develop policies tailored to their specific organization structures and business models. Below we discuss suggested revisions to certain of the Proposed Rules.

A. Paragraph (b): Securities Trading Policies

Paragraph (b) requires an NRSRO to implement procedures designed to prevent an associated person or member of an associated person's household from purchasing, selling or otherwise benefiting from any transaction in securities or money market instruments when the person possesses or has access to material, nonpublic information obtained for the purpose of developing a credit rating. The language of this paragraph is not consistent with and is broader than Rule 10b5-1 under the Exchange Act with respect to misuse of material, nonpublic information.[15]

In addition, we believe certain securities transactions that do not represent insider trading concerns or even actual conflicts of interest, such as transactions in diversified mutual funds, could be inappropriately captured by the Commission's proposed language. Moreover, the proposed language could apply to employees of Moody's who may technically "have access to" material, nonpublic information because, for example, they assist a rating analyst with resolving a technology issue and therefore briefly have the ability to access such material that may be on the analyst's computer, even if they never actually view or possess the information. Moody's recognizes the potential conflicts and concerns that arise in this area. As a consequence, we have taken precautions to restrict the trading, and even ownership, of securities of a rated entity within an analyst's primary area of analytic responsibility, even if that analyst does not rate that issuer or possess material, nonpublic information about such issuer. However, we believe the language of the Proposed Rule is overbroad, and we recommend that it be revised as follows:

(b) Procedures designed to prevent a person ~~associated with~~ employed by the rating organization or by its controlled affiliates that provide credit rating services or any member of ~~an associated~~ any such person's household from purchasing, selling, or otherwise benefiting from any transaction in securities or money market instruments when the person possesses ~~or has access to~~ material

[15] Rule 10b5-1 of the Exchange Act states that "a purchase or sale of a security of an issuer is 'on the basis of' material nonpublic information about that security or issuer if the person making the purchase or sale was aware of the material nonpublic information when the person made the purchase or sale." Possession of, not access to, material nonpublic information is determinative.

nonpublic information obtained in connection with the performance of credit rating services that affects the securities or money market instruments;. This prohibition shall not apply to transactions in diversified mutual funds, blind trusts, or similar investment vehicles where the investor cannot influence the transactions in the securities of the entity about which such person possesses material nonpublic information; and

B. Paragraph (c): Disclosure of Pending Rating Actions

Paragraph (c) requires an NRSRO to implement specific procedures designed to prevent the inappropriate dissemination within and outside the NRSRO of a credit rating action prior to making the action readily accessible. As the Commission recognizes, in certain circumstances an NRSRO may legitimately communicate information regarding a pending rating action to persons outside the NRSRO. For example, it is Moody's general practice to provide the issuer with a draft of the credit rating announcement for a limited review period so that the issuer can correct any factual errors and identify any material, non-public information about the issuer (other than the rating) that may have been included inadvertently. However, while an NRSRO can be expected to exercise control over its internal procedures in these circumstances, it will not be able to "ensure" that outside parties will not selectively disclose information regarding pending rating actions. We therefore suggest revising Proposed Rule 17g-4(c) as follows:

> (c) Procedures designed to prevent the ~~inappropriate~~ rating organization or its controlled affiliates that provide credit rating services or any person employed by the rating organization or its controlled affiliates that provide credit rating services from inappropriately ~~dissemination~~ disseminating within and outside the rating organization ~~of~~ a pending credit rating action prior to making the action readily accessible.

V. PROPOSED RULE 17g-5: MANAGEMENT OF CONFLICTS OF INTEREST

We are concerned that the Proposed Rules in this area apply not only to the NRSRO but also its "associated persons," which includes all affiliates of the rating agency and also could be interpreted to include employees of those affiliated entities. We believe the policies required under this rule are specifically designed for rating activities, and therefore their application should be limited to the credit rating agency, its controlled affiliates that provide credit rating services, and their employees. Extending them to any other related entities, over which the NRSRO does not have voting or economic control or that engage primarily in non-rating activities, would exceed the mandate of the Act.

A. Paragraph (b): Conflicts that are Prohibited if Not Disclosed and Managed

1. Paragraph (b) (2): Ownership Interest in a Rated Issuer or Obligor

We believe the definition of this conflict is overly broad because it appears to encompass all ownership interests in an issuer or obligor that the NRSRO or other "associated persons" may have. It should be limited to those ownership interests that create the potential conflict – ownership at the NRSRO level, its controlled affiliates involved in credit rating activities, and employees of the NRSRO or these controlled affiliates. We recommend revising Paragraph (b)(2) as follows:

(2) Owning securities or money market instruments of a person that is subject to a pending or issued credit rating of the rating organization where the ownership interest is held by either the NRSRO, its controlled affiliates that provide credit rating services, or any of their employees.

2. Paragraph (b) (4): Ownership Interest in a Subscriber that Uses the NRSRO's Credit Ratings for Regulatory Purposes

It will not always be possible for a rating agency to determine whether a subscriber intends to use credit ratings for "regulatory purposes." As a result, while we understand the Commission's concern, we do not believe that a rating agency can reasonably be expected to protect against the type of conflict addressed by Proposed Rule 17(g)-5(b)(4) when it may not have knowledge of the conflict. We suggest revising this rule to include a qualification for "knowledge" of the credit agency. Our remaining concerns with regard to Proposed Rule 17g-5(b)(4) are largely analogous to those outlined in our discussion of Paragraph (b)(2). We suggest revising Proposed Rule 17g-5(b)(4) as follows:

(4) Owning securities or money market instruments of, or having any other form of ownership interest in, a subscriber that, to the knowledge of the credit rating organization, uses the credit ratings of the rating organization for regulatory purposes and where the ownership interest is held by the rating agency, its controlled affiliates that provide credit rating services, or any of their employees.

3. Paragraph (b)(5): Having a Business or Personal Relationship or Affiliation With a Rated Issuer or Obligor, Underwriter of a Rated Issuer's Securities, or a Subscriber that Uses the Credit Ratings for Regulatory Purposes

We believe that the requirement proposed under Proposed Rule 17(g)-5(b)(5) would inappropriately capture normal course relationships that do not pose a conflict, such as an employee's mortgage loan relationship or a rating agency's deposit account with a major bank, and would also inappropriately extend beyond the parties who have access to relevant material, non-public information. We suggest the following revision:

(5) Having any other business, personal, or ownership relationship or affiliation (other than a bona fide arm's-length or ordinary course business relationship or affiliation) with a person that is subject to a credit rating of the rating organization, an underwriter of securities or money market instruments rated by the rating organization, or a subscriber that, to the knowledge of the credit rating organization or such person, uses the credit ratings of the rating organization for regulatory purposes where the relationship involves the rating organization, any of its employees, its controlled affiliates that provide credit rating services, or any of their employees.

B. Paragraph (c) of Proposed Rule 17g-5: Conflicts of Interest that are Prohibited

1. Paragraph (c)(2): Securities Ownership of, or Borrower or Lender Relationships with, Rated Entities

While we understand that the scope of paragraph (c)(2) is limited to those employees who have direct influence over the credit rating, it nevertheless raises issues as drafted because it may capture ownership interests, such as through diversified mutual funds, that are not influenced by the rating analyst and where the analyst's influence on the rating will not reasonably impact the value of the investment. We suggest revising Proposed Rule 17g-5(c)(2) to explicitly exclude from its scope ownership interests that are not considered direct ownership and arm's length business transactions:

> (2) The rating organization issues or maintains a credit rating with respect to a person where the rating organization, a credit analyst who participated in determining the credit rating, or a person associated with the rating organization who is responsible for approving the credit rating, owns securities of, or has any other ownership interest in, the rated person or is a borrower or lender with respect to the rated person, other than a bona fide arm's-length or ordinary course borrowing or lending relationship or an ownership interest through a diversified mutual fund, blind trust, or other investment vehicle where the investor cannot influence the transactions in the securities of the rated person or where the return on the investment vehicle is not significantly dependent on the investment in the securities of the rated person;

2. Paragraph (c)(3): Rating a Person Associated with the Rating Agency

We agree with the Commission that rating "persons associated with the rating agency" creates a potential conflict of interest. However, we believe such potential conflict can be effectively managed. For example, in addition to the transparency surrounding affiliations of its directors, Moody's Corporation has a policy that prohibits ratings personnel from discussing potential or pending rating actions with non-employee members of Moody's board of directors, unless and until that information has been publicly disclosed.

We do not believe that this conflict should be *per se* prohibited. Rather, rating agencies should be able to issue credit ratings related to persons associated with the rating organization if the potential conflict of interest is fully and publicly disclosed and the rating organization has implemented policies to manage it. This would, for example, allow rating agencies to acquire board members and investors in a manner consistent with long term needs while also ensuring that investors and regulators are provided with the disclosure they will need to assess conflicts of interest inherent in ratings of related parties. As a result, we recommend that the conflicts addressed in this section be moved to Proposed Rule 17g-5(b), which requires conflict of interest disclosure and related policies and procedures to manage them.

VI. PROPOSED RULE 17g-6: PROHIBITED ACTS AND PRACTICES

The Senate Report on the Act specifies that the Commission, as a threshold consideration, must determine that the practices specified in the Act are in fact unfair, coercive or abusive before prohibiting them.[16] In the Proposed Rules, the SEC notes that it has preliminarily made a determination, but it does not describe the process by which it did so or indicate whether additional review will be performed to finalize its determination. We believe Proposed Rule 17g-6 should not be enacted until these determinations have been finalized and publicized. In this regard, we are particularly concerned about Proposed Rule 17g-6(a)(4), since there has been a great deal of debate among market participants about possible interpretations and implications of this Proposed Rule. However, if the SEC does adopt any or all of Proposed Rule 17g-6, we

[16] Senate Report at 11.

suggest revisions below to address areas where we believe the proposed prohibitions are overbroad and may inappropriately regulate the substance of credit ratings or the procedures or methodologies by which an NRSRO determines credit ratings.

A. Paragraph (a)(1): Conditioning or Threatening to Condition the Issuance of Credit Ratings on the Purchase of Another Service or Product

As proposed, this prohibition would bar certain analytical practices where the determination of a particular rating is necessarily dependent on determining another type of rating. For example, in analyzing a subordinated issuance in an issuer's overall capital structure, a rating agency may first need to determine a rating for the issuer as a whole and/or its most senior unsecured debt to form a basis for assessing the relative credit risk of the subordinated instrument. In these circumstances, the issuance of one rating is conditioned on the issuance of another, even though the practice is not unfair, coercive or abusive. We believe Proposed Rule 17g-6(a)(1) should be narrowed as shown below to permit this practice:

> (1) Conditioning or threatening to condition the issuance of a credit rating on the purchase by an obligor or issuer, or an affiliate of the obligor or issuer, of any other services or products, including pre-credit rating assessment products, of the rating organization or any person associated with the rating organization, except in instances where there is an analytical purpose for conditioning the issuance of one rating on the purchase of another rating service or product.

B. Paragraph (a)(4)

In discussing Proposed Rule 17g-6(a)(4), the Commission states that it has made a preliminary determination that "it would be unfair, coercive or abusive for an NRSRO to issue or threaten to issue a lower credit rating, lower or threaten to lower an existing credit rating, refuse to issue a credit rating, or to withdraw a credit rating with respect to a structured product unless a portion of the assets underlying the structured product are also rated by the NRSRO."[17] The SEC indicates that with this provision it seeks to address a practice sometimes referred to as "notching," where a rating agency refuses to rate the underlying assets of, or discounts the rating for, a structured product because it has not rated all the underlying assets. The Commission further states that it believes that there could be legitimate reasons for an NRSRO to refuse to rate a structured product where the NRSRO has not rated the underlying assets.

Moody's agrees that if an NRSRO intentionally engages in coercive or abusive market practices related to structured finance ratings or any other area, it should be subject to restraint. Any SEC rules to address such practices should be "narrowly tailored," to address only the coercive or abusive practices and should not interfere with the legitimate "procedures and methodologies by which rating agencies develop their ratings", consistent with the mandates in the Act. We believe that the Commission is seeking to prohibit practices related to structured finance ratings that are motivated by bad intent on the part of the rating agency, and that it is not seeking to force rating agencies to rate structured transactions in a manner contrary to their legitimate, independently developed analytical practices or otherwise to interfere with those practices.

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[17] Proposed Rules at 102.

However, we believe Proposed Rule 17g-6(a)(4) does not clearly state what practices the Commission is seeking to prohibit or in what cases "bad intent" would be assumed. It is subject to interpretations that could force rating agencies to publish ratings on structured finance transactions that (i) incorporate as their own the ratings that other NRSROs may have previously assigned to collateral underlying such transactions, or (ii) do not reflect an evaluation of the credit risk of all assets in the collateral pool. Outcomes such as these would not only be contrary to the mandates of the Act, but they would also undermine one of the core principles underlying the value that rating agencies provide to the market and regulators – the determination of independent, legitimately held opinions on the creditworthiness of the securities they rate. In addition, the Commission provides no basis for its "preliminary determination" relating to the practices addressed in this Proposed Rule, whereas a firmly founded determination is critical given the important implications of this rule.

Below, we discuss Moody's structured finance rating practices, the "notching" debate associated with the Proposed Rule, our specific concerns with the Proposed Rule, and our recommendations for revising it.

1. Moody's Practices

When rating any structured product, Moody's evaluates the risk characteristics of the collateral pool backing the securitization in order to form its rating opinion on the securitization as a whole. In most cases (for example, most asset backed securities and residential mortgage backed securities transactions, which are backed by consumer assets that are not individually issued into the public debt markets), Moody's has not previously rated the underlying collateral assets and studies a wide variety of data supplied by the sponsor and from other market sources in order to form an independent opinion about the risk characteristics of the underlying collateral pool.

In certain other asset classes (particularly, collateralized debt obligations ("CDOs")) Moody's has often already issued ratings on many of the individual assets in the collateral pool (since they are securities that have previously been individually issued into the public debt markets), which obviates the need to do a new evaluation of risk for those particular collateral assets. For the portion of the collateral on which Moody's does not already have an opinion, however, we must perform additional analysis in order to form a judgment on the related credit risk. For the CDO market, Moody's uses one of three methods for estimating the credit risk of the collateral that we have not already rated, and the sponsor of the securitzation generally has the option of selecting the method it would like us to employ:

(a) Rating estimates derived by Moody's analysts, using fundamental and quantitative analysis;

(b) Internal ratings supplied by the collateral manager, provided Moody's can systematically review the manager's historical ratings, records, and procedures and develop a "mapping" from the manager's ratings to the ratings we believe Moody's would have assigned to the same securities had we been asked to do so by the issuer; or

(c) Ratings published by other credit rating agencies on the individual assets, provided Moody's can undertake a systematic review of the agencies' published ratings on securities in the same asset class and develop a mapping between those agencies' ratings and the ratings we believe Moody's would have assigned to the same securities had we been asked to do so by the issuer. This practice is often referred to by market participants as "notching".

We believe that our methods outlined above are analytically sound and allow us to form a reliable rating opinion.

2. The Notching Debate

As described above, most structured transactions are rated without the benefit of explicit public ratings on the assets in the underlying collateral pool. In order to rate any structured product, however, the NRSRO must form its independent opinion of the risk characteristics of the collateral pool, which need not take the form of explicit public ratings on each asset that is a part of such collateral pool. In broadly prohibiting the practices that it describes under the term "notching," we are concerned that the SEC would be prohibiting legitimate practices that a rating agency may employ in undertaking its independent opinion formation process.

Some market participants have proposed that rating agencies should be prohibited from forming their own opinions about the risks of collateral backing CDOs if the collateral securities are already rated by another NRSRO. These market participants would have the Commission compel an NRSRO that is rating the CDO to use the collateral ratings of other NRSROs as if those ratings were its own, rather than forming an independent opinion.

We strongly object to any measure that would compel an NRSRO to use other NRSROs' ratings interchangeably with its own. As discussed elsewhere in this letter, ratings published by different rating agencies are developed using different rating definitions and methodologies which result in different ratings that are often not directly comparable. Using ratings of another NRSRO to form part of a rating opinion on a pool of assets may be impossible if such ratings were developed using incompatible methodologies, and it may unintentionally compel rating agencies to mislead the market by inaccurately representing a rating as its own opinion.

3. Concerns with the Proposed Rule

Moody's is concerned that the Proposed Rule is ambiguous and subject to varying interpretations. As noted above, certain of these interpretations may result in inappropriate regulation of rating agency methodology, undermine the independence of NRSROs, or compel a rating agency to use the ratings published by other NRSROs as its own, resulting in ratings that are not accurate or reliable and do not reflect the bona fide opinion of the rating agency. We recommend that in clarifying Rule 17g-6(a)(4), the following issues be addressed.

(a) What practices is the Commission prohibiting?

It is unclear what the Commission seeks to prohibit by the phrase "issuing or threatening to issue a lower credit rating, or lowering or threatening to lower an existing credit rating, or refusing to issue a credit rating or withdrawing a credit rating." Does the Commission intend to prohibit an NRSRO from issuing a rating lower *than it otherwise would have issued*, or otherwise effecting an existing rating that it has published in a way *that is inconsistent with what it otherwise would have done*, based on its own independently formed policies and methodologies? Or alternatively, does the Commission intend to prohibit an NRSRO from issuing a rating that is lower *than a rating that is published by one of its competitors*?

If the Commission intends to prohibit an NRSRO from issuing a rating lower than it otherwise would have issued based on its own methodology, we suggest that clarifying language be added to appropriately convey this (we have provided such language below). If, however the Commission is proposing to compel NRSROs to use the ratings published by other NRSROs in place of performing their own independent evaluation, such a policy would:

- compel an NRSRO to use in lieu of its assessments, the published collateral ratings of other NRSROs in determining the ratings of structured finance products, even in instances where the NRSRO's own rating on a given collateral asset was declined by the issuer because it was lower than that of other NRSROs (this practice could become common as more NRSROs are registered making it easier for issuers of securities to engage in "rating shopping");
- require an NRSRO to publish an opinion potentially different than the opinion it would assign if permitted to independently rate the underlying assets, because of the application of different methodologies and the formation of different judgments on credit risk;
- breach the basic principle of the Act that the SEC should not regulate the "substance" of credit ratings; and
- impede competition because diversity of opinion is limited when different rating agencies are forced to accept each other's ratings as their own.

The value that NRSROs provide to the market is based on the quality of their analysis of the fundamental creditworthiness of securities and issuers. It would be a damaging outcome if NRSROs were held accountable for their ratings, but were compelled to issue flawed ratings because they were prevented from applying their own methodologies.

(b) Does the Commission believe rating 85% of the asset pool is "good enough"?

We believe that the Commission has proposed an 85% threshold below which refusals to rate a structured transaction would not be prohibited because the Commission generally agrees with Moody's that it is inappropriate to require NRSROs to treat other agencies' ratings as their own. However, it is not appropriate to assume that a rating agency can form an opinion on a structured transaction by only evaluating 85% of the underlying asset pool. For example, ratings on tranches of CDOs are sensitive to the accuracy of the ratings on even small portions of the CDO asset pool, whereby a single default can have a significant impact on the performance of the tranche. In addition, exempting 15% of an asset pool from rating agency evaluation would provide collateral managers with a perverse incentive to include the most risky securities in that 15%.

4. <u>Suggested Modifications to the Proposed Rule</u>

In light of the above discussion, we strongly recommend that the Commission strike paragraph (a)(4) in its entirety. Arguably, rating outcomes of any sort that rating agencies may determine based on improper motivations are already prohibited in paragraphs (a)(2) and (a)(3) of Proposed Rule 17g-6. In the case of paragraph (a)(4), the Commission has not identified with sufficient clarity the additional practices that it seeks to prohibit. If the Commission conducts further study in this area and identifies specific anti-competitive practices that are not already covered by paragraphs (a)(2) and (a)(3), we believe the Commission would have the authority to develop a rule specifically prohibiting those practices at that time.

If, however, the Commission determines to retain paragraph (a)(4) at this time, we believe the rule should be revised to clearly prohibit only conduct that is motivated by an "unfair, coercive or abusive" intent:

> (4) Issuing or threatening to issue a lower credit rating, or lowering or threatening to lower an existing credit rating, or refusing to issue a credit rating or withdrawing a credit rating, with respect to securities or money market instruments issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction, ~~unless~~ because a portion of the assets which comprise the asset pool or the asset-backed or mortgaged-backed securities ~~also are~~ has not previously been rated by the rating organization. These prohibitions shall not apply if any such action is taken in accordance with the rating organization's analytical procedures and methodologies for determining credit ratings. These prohibitions also ~~on refusing to issue a credit rating or withdrawing a credit rating~~ shall not apply if the rating organization has rated less than 85% of the market value of the assets underlying the asset pool or the asset-backed or mortgage-backed securities. If the rating organization has rated 85% or more of the market value of the assets underlying the asset pool or the asset-backed or mortgage-backed securities, it is permitted to use its analytical procedures and methodologies for assessing the credit risk characteristics of the portion of the pool that it has not previously rated. In no circumstance shall these prohibitions compel rating organizations to use or to rely upon the rating opinions of other persons as their own.

C. Paragraph (a)(5): Inducing an Issuer Rated on an Unsolicited Basis to Pay for the Rating or Any Product or Service of the NRSRO or Affiliates.

While we agree with the Commission that certain practices related to soliciting payment for unsolicited ratings could be coercive or unfair, we believe the Proposed Rule as drafted is overbroad. It would prohibit an NRSRO and any of its related entities from taking action to collect payment from the issuer for any other product or service the NRSRO or any of its related entities may provide to an issuer for which the NRSRO happens to publish an unsolicited rating. This prohibition would extend to services that are unrelated to the rating, such as selling credit research to the investment management division of a financial institution that is an unsolicited issuer, or selling educational textbooks or magazine subscriptions to a government entity that is an unsolicited issuer.

We also believe the indefinite prohibition on soliciting payment for an unsolicited rating would not allow rating agencies that use unsolicited ratings to develop a presence in new markets or asset classes to ultimately achieve commercial viability through issuer fees. We recommend that the Proposed Rule be modified as follows:

> (5) Issuing an unsolicited credit rating and communicating with the rated person for a period of five years from the date the rating is issued to induce or attempt to induce the rated person to pay for the credit rating ~~or any other service or product of the rating organization or a person associated with the rating organization~~.

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