

June 9, 2005

U.S. Securities and Exchange Commission
Washington, D.C.
Attention: Mr. Jonathon G. Katz, Secretary

Re.: Definition of NRSRO, File No. S7-04-05

Dear Mr. Katz:

Thank you for the opportunity to comment on the proposed definition of NRSRO. I respectfully submit the following comments and recommendations.

In General

It is important and timely for the SEC to address this issue. There is no doubt that the existing regulation and practice represent a significant anti-competitive barrier to entry. Although not intended when the regulation was introduced 30 years ago or any time since, the actual result of the SEC's actions has been to create what is in effect a government-sponsored cartel in the credit rating agency business.

A recent equity investment recommendation states:

“Companies are not unlike medieval castles. The most successful are those that boast some sort of economic moat that makes it difficult, if not impossible, for competitors to attack or emulate. Thanks to the fact that the credit ratings market is heavily regulated by the federal government, [this rating agency] enjoys a wide economic moat.” (emphasis added)

This is very true and well said.

I believe the Commission's goal in addressing the definition of NRSRO should be to remove such government-created protection or “economic moats,” and to promote a truly competitive rating agency sector, with all the advantages to customers of cost, efficiency and innovation that competition will bring.

Although the proposed definition makes one very good step in this direction, unfortunately it falls far short in most respects.

One Very Good Step

The proposal to include in the definition rating agencies specialized in a specific domain, such as a country or an industry, as “limited coverage” NRSROs is a very good, pro-competitive idea. This is a natural and logical way for certain competitors to enter the market and to provide value to the users of credit ratings.

Shortcomings

Most of the proposal, unfortunately, tends to continue the regulatory protection of the currently dominant suppliers. Specifically:

1. “Generally Accepted” Requirement. The proposed requirement that a potential competitor already be generally accepted before being allowed to compete creates an extreme barrier to entry, because the regulation itself prevents users of credit ratings from accepting them without the NRSRO designation. This requirement should be deleted altogether.
2. “Publicly Available” Requirement. The requirement that an NRSRO must issue ratings which are publicly available unfairly and unreasonably eliminates from competition any rating agency which provides private ratings for fees paid by investors. Such an arrangement is arguably a preferred incentive structure, and was the historical practice of the currently dominant suppliers. To eliminate it from NRSRO competition takes away by regulation a choice many users of credit ratings might wish to make. This proposed requirement should also be entirely deleted.
3. Maintenance of the Web of Interlocking Regulations. A central problem with the NRSRO definition is that it has become enmeshed in a very large and complex web of a large number of regulations from many regulators, as well as some statutory provisions, the combined effect of which is to spread the anti-competitive force of the SEC regulation throughout the financial system. A pro-competitive definition, such as the one recommended below, could help untangle this web.

Recommendations

I respectfully recommend that the Commission should make the following additional changes to its proposal:

1. New Definition. The definition of NRSRO should be: “NRSRO shall mean for any regulated entity, a credit rating agency approved, either specifically by name or in general by policy, by the primary regulator of that entity for use in

such manner as defined by that regulator.” This recognizes that reality of the interlocking web of regulations. Next to eliminating the term “NRSRO” altogether, which given the web is arguably impractical, it may be the best way to have multiple sources of decisions, as contrasted with the use of rating agencies being controlled by a narrow set of decisions made by the SEC staff. Multiple decisions made in multiple financial sectors, with more widely dispersed authority, would tend to promote more competitive outcomes.

2. Specific SEC-Approved NRSROs. Under such a general definition, the SEC would then adopt a specific approval, applicable only to securities firms, along these lines: “For purposes of calculating the required capital of securities firms subject to SEC regulation, and for no other purpose, the following credit rating agencies are designated NRSROs: [specify rating agencies].”
3. Profitability Study. I believe understanding of the rating agency business would be enhanced if the Commission would direct the staff to carry out a study of the profitability of all currently designated NRSROs, in order to determine the level of profits and returns to capital derived from the NRSRO franchise, indicating the extent of price and service competition in the sector.

Thank you for your consideration.

Yours truly,

Alex J. Pollock
Resident Fellow
American Enterprise Institute
Washington, D.C.