**Moody's Investors Service**

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June 9, 2005

**By Electronic Mail**

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, NW
Washington, D.C. 20549-0609

**Re: File Number S7-04-05, Definition of Nationally Recognized Statistical Rating Organization**

Dear Mr. Katz:

In June 2003, the Securities and Exchange Commission (the "**Commission**" or the "SEC") published a concept release on Rating Agencies and the Use of Credit Ratings under the Federal Securities Laws (the "**2003 Concept Release**"),[1] which solicited public comment on three broad questions:

1) Should credit ratings continue to be used for regulatory purposes under the federal securities laws?
2) If so, what recognition criteria should be adopted for designating credit rating agencies as Nationally Recognized Statistical Ratings Organizations ("**NRSROs**")? and
3) What level of oversight should be applied to NRSROs?

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1 *See* SEC Release No. 33-8236 (June 4, 2003).

With respect to the first question, most commenters advised the Commission to continue the usage of the NRSRO system. They noted that the system is deeply entrenched in the United States regulatory and legislative structure. In addition, most commenters supported improving the clarity of the process for designating NRSROs and implementing some form of oversight of designated NRSROs.

In response, on April 19, 2005, the Commission published a proposed rule (the "**Proposed Rule**")[2] that would define the term NRSRO by specifying three components that must each be met in order for a credit rating agency to be an NRSRO. Moody's Investors Service ("**Moody's**") recognizes that the Proposed Rule is intended only to address the meaning of the term "NRSRO" as it is used by the Commission, and not to address questions of subsequent oversight originally raised in the Concept Release.[3] Accordingly, in the discussion below, Moody's offers the Commission our views on the Proposed Rule, although we note that currently the Commission is also considering the issue of continuing oversight of NRSROs.

We reiterate that we would support the elimination of the NRSRO system as a whole. As we noted in our comments to the Commission on the 2003 Concept Release,[4] an impression exists among some market commentators that the Commission's existing NRSRO designation process has created barriers to entry and unfavorably influenced the competitive structure of the credit ratings industry. Moody's believes that such interpretations misconstrue the history of the use of credit ratings in federal securities laws. When the NRSRO concept was established by the SEC in 1975, credit ratings from established rating agencies *already* had attributes that provided significant value to the market and, only coincidentally, also made them suitable for use in regulation. The widespread use of ratings in markets globally, many of which have neither ratings requirements nor governmental designation of rating agencies as exist in the United States, demonstrates that ratings are used where they are valued by market participants, and not solely or primarily because they are required by governmental action. Eliminating the NRSRO designation would further transparency about the market-based role and function of ratings. We believe that, without the NRSRO designation, credit rating agencies would continue to serve their primary objectives in support of market efficiency and investor protection.

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2 *See* SEC Release Nos. 33-8570; 34-51572; 1C-26854 (April 19, 2005).

3 Specifically, the Commission proposes to define the term "NRSRO" as an entity that (i) issues publicly available credit ratings that are current assessments of the creditworthiness of obligors with respect to specific securities or money market instruments; (ii) is generally accepted in the financial markets as an issuer of credible and reliable ratings, including ratings for a particular industry or geographic segment, by the predominant users of securities ratings; and (iii) uses systematic procedures designed to ensure credible and reliable ratings, manage potential conflicts of interest, and prevent the misuse of nonpublic information, and has sufficient financial resources to ensure compliance with those procedures.

4 Moody's Investors Service Comments to the Concept Release: Rating Agencies and the Use of Credit Ratings Under the Federal Securities Laws, File No, S7-12-03, July 28, 2003.

Nevertheless, governmental authorities use credit ratings from designated NRSROs in a variety of federal laws and regulations. Therefore, to enhance transparency and bolster confidence in the system, in deciding what recognition criteria to adopt we believe that the Commission should formally identify:

- the attributes of ratings that make them suitable for use in federal laws and regulation;
- which rating agencies have as performance objectives such attributes; and,
- the actual performance of such rating agencies against their identified performance objectives.

The fundamental attributes described in the Commission's proposed three-part test include criteria about the nature and availability of ratings, and several proxy measures for assessing the "credibility" and "reliability" of credit rating agencies and their ratings. We believe that credibility and reliability depend heavily on the ability of a rating agency to effectively predict relative creditworthiness with a ratings management system that is sufficiently judicious to support both investor protection and market stability. Moody's agrees with the Commission that recognition criteria should seek to assess a rating agency's ability to consistently produce reliable ratings.

We support the overall principles-based philosophy of the Proposed Rule as presently drafted. Moody's would discourage the Commission from adopting specific rules-based criteria which impose behavioral standards that influence the analytical methods or independent nature of credit ratings opinions. Rules that dictate a certain set of analytical methods will create a static system. Even if initially aligned with market practices, the inflexibility of such a system will make NRSROs less capable of responding to market innovation and meeting demands for investor protection over time. We therefore suggest that rating agencies should provide to the Commission and the market:

a) Ratings performance objectives and, where possible, performance data in order to measure the credibility and reliability of their ratings in the aggregate,[5] and

b) Transparent disclosure of policies, processes and ratings methodologies to allow ongoing market understanding and scrutiny.

[5] Where a rating agency does not have a sufficient performance track record, then the stated performance objectives, and the rating agency's commitment to publicly disclose its performance track record when measurable, could substitute.

### Background Information About Moody's

Moody's is an operating company owned by Moody's Corporation (**"MCO"**), a New York Stock Exchange traded company. Moody's is the oldest bond rating agency in the world, having introduced ratings in 1909. From its beginning, Moody's focused on rating debt instruments. By 1924, Moody's was rating nearly every bond in the United States bond market. Today, Moody's is a leading global credit rating and research firm with more than 1000 analysts worldwide. Our credit research covers a broad range of debt totaling over $35 trillion, and our analysts publish research covering thousands of institutions.

A major role of rating agencies is to be an independent credit information intermediary.[6] Moody's ratings and credit research are used by issuers, financial intermediaries, counterparties to financial and commercial contracts, investors and governmental authorities. While our ratings address only one attribute in the investment decision making process, the likelihood of debt being paid in full and on a timely manner, each type of user may have somewhat different objectives in their use of ratings. Our job, therefore, is to effectively meet broad market needs and expectations by striking an appropriate balance between the differing objectives and uses. For example, some of the most important attributes of credit ratings as currently made available by the major rating agencies include their independence, predictive content, broad coverage, and free dissemination to the general public These attributes are the result of decades of evolution in line with market-based needs.

Following are specific comments on the three proposed components of the NRSRO definition, as well as on related questions posed by the Commission.

### 1) The First Component

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

Moody's agrees that credit ratings on issuers of public debt and public debt instruments used for regulatory purposes should be made publicly available contemporaneously with their creation. Public availability supports the "public good" nature of ratings, avoids selective disclosure of information, and provides the opportunity for the marketplace to judge the credibility and reliability of an entity's credit ratings. A rating should not be construed as "publicly disseminated" if access to it is limited to subscribers, or made otherwise cumbersome or untimely. The public availability of ratings helps level the information playing field among investors. Moreover, since investor protection is one of the aims of securities rules and regulations, we suggest that an important incidental benefit of public availability of ratings is that

[6] Moody's believes that the proper role of rating agencies also includes publishing research, data and models related to credit, while avoiding improper selective disclosure.

it allows the market to judge the credibility and reliability of the rating system over time. We also believe that public dissemination of ratings enhances the transparency and efficiency of dissemination of information available in the market.

We also agree that ratings should reflect the current opinion of the rating agency. Moody's aspires to manage our ratings so that they are changed only after judicious deliberation and in response to changes in fundamental creditworthiness, not to transitory events. As a consequence, Moody's ratings are more stable and reverse themselves less frequently than other, primarily market-based measures of credit. Stability is important for at least two reasons. If ratings were highly volatile and subject to more frequent reversals, they would contribute to market instability and be a more costly tool for publicly or privately created governance mechanisms. So while ratings should not be any more stable than a rating agency's opinion of changes in fundamental creditworthiness, Moody's believes that "current opinions" as used for regulatory purposes should accommodate opinions that change in reaction to perceived changes in enduring, rather than transient, elements of creditworthiness.

> In its discussion of the first component, the Commission asks: *"Should the Commission provide additional interpretation regarding what it means for a credit rating agency's credit ratings to be 'current assessments'? Should the Commission specify the time period? Will the proposed rule's provisions provide sufficient assurance to the markets that ratings are current?"*

In its discussion, the Commission notes that the proposed definition *"…attempts to ensure that only 'current' credit ratings – meaning that such ratings are actively monitored and updated appropriately on a continuous basis – be used for regulatory purposes under the federal securities laws."* The Commission further states that *"a credit rating agency could meet the "current assessments" element of the proposed definition if it has and follows procedures designed to ensure that its ratings are reviewed and, if necessary, updated on the occurrence of material events…"* and that it *"is not proposing to prescribe a specific time period within which an NRSRO's ratings would need to be updated."* We suggest that requiring a specified time period for rating updates or rating reviews adds an unnecessary behavioral step, without necessarily increasing the reliability or credibility of ratings. Rather, Moody's endorses the SEC's principle-based approach of requiring rating agencies to have procedures in place to ensure that ratings are monitored on a regular basis and changed if and when, in the opinion of the agency, the underlying creditworthiness of the securities so warrant.

## 2) **The Second Component**

> *"The Commission is proposing that the second component of the NRSRO definition require a credit rating agency to be generally accepted in the financial markets. Such acceptance would reflect the markets' belief in the credibility and reliability of the ratings provided by the credit rating agency…"*

The second component introduces a market-based standard of "generally accepted" in the financial markets as a proxy for assessing whether ratings are credible and reliable. The Commission suggests that market acceptance, in turn, could be demonstrated by means such as: (1) reference to the views of financial market participants who hold large inventories of rated fixed income securities, or other users of ratings representing a substantial percentage of the relevant market; and (2) reference to a credit rating agency's statistical data that demonstrates market reliance on its ratings, such as through market movements in response to ratings changes. The Commission has asked:

> *"How else could the Commission define the term 'NRSRO' in order for users of a credit rating agency's ratings to determine whether such ratings are credible and are reasonably relied upon by the marketplace? Are the approaches discussed above useful for determining whether a credit rating agency meets the second component of the proposed definition? Are there other types of information that would be appropriate?"*

We recommend against adopting "generally accepted" as a criteria to meet the fundamental objective of identifying firms that consistently produce "credible and reliable" credit ratings. While this represents a market-based approach, which Moody's generally supports, such a standard may impose an unwarranted barrier to entry for firms that otherwise meet performance and behavioral objectives for use in regulation. A firm with low name recognition in the market could nonetheless have a well-performing ratings system, either broadly or related to a particular geography or sector. Moody's believes that factors that are not directly reflective of the ability to assign credible and reliable credit ratings should not be accorded primary weight in a designation system used in federal securities laws and regulations.[7]

In assessing ratings reliability, we believe that, where possible, a rating agency's rating performance track record should be taken directly into account. Moody's suggests that the second component should focus on a rating agency's statistical measures which support the agency's claim of credible and reliable ratings.[8] Where a rating agency does not have a sufficient performance track record, either because the agency is new or is rating new or limited classes of instruments that do not yet support statistical measures, then the stated performance objectives, and the rating agency's commitment to publicly disclose its performance track record when measurable, could substitute.

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[7] In addition, and as we stated in our comments on the Concept Release, a "market acceptance" test may be viewed to create a "Catch 22" regulatory barrier to entry. We speculate that the newly proposed "generally accepted" test will become synonymous with the existing "nationally recognized" test.

[8] Ratings performance measurement statistics used by Moody's include: default statistics, rating comparisons on issuers rated jointly with other rating agencies, default rates by rating categories over short and long horizons, average ratings on issuers prior to their defaults, rating stability measures, and accuracy ratios (or power curves) over short and long horizons which measure the ability of ratings to discriminate defaulters from non-defaulters. For a detailed review of some of these rating performance measures and others, see "Measuring the Performance of Corporate Bond Ratings," Moody's Special Comment, April 2003.

In addition, NRSRO recognition has, as a practical matter, historically implied that each agency's rating scale was treated as if similar levels of risk were associated with similar rating symbols. A rating agency's track record, however, generally provides straightforward evidence of whether its ratings have similar meanings to those of other NRSROs. In particular, markets may "accept" ratings from agencies that rate higher or lower on average than other NRSROs, because the market can and does make adjustments for systematic differences in rating scales when pricing securities.

### 3) **The Third Component**

> *"The third proposed component…is designed to ensure that to meet the definition of the term 'NRSRO', a credit rating agency uses systematic procedures designed to ensure credible and reliable ratings, manage conflicts of interest, and prevent the misuse of nonpublic information. It also addresses the need for credit agencies to have sufficient financial resources to ensure compliance with such procedures…"*

In its discussion, the Commission notes that the use of systematic rating procedures should *"…assist the credit rating agency in producing credible and reliable ratings, which…would further the purposes underlying the regulatory uses of NRSRO ratings."* The Commission cites a number of factors that would be important in this regard, including the experience and training of a firm's rating analysts; the average number of issues covered by analysts; the information sources utilized in the ratings process and how the integrity of such information is verified; procedures related to management of conflicts adopted by the agency; and the existence of policies and procedures that are designed to effectively protect non-public information provided by issuers.[9] Broadly, the Commission asks commenters if behavioral standards to assess such factors should be particularly specified.

Because there is no single or correct approach to developing reliable opinions about future creditworthiness, we agree with the Commission's general approach of providing prudential principles-based criteria, as among other things they allow for innovation in credit opinions that adapt with innovation in financial markets. Ratings are opinion forecasts of the future. Two rating agencies looking at the same set of facts may legitimately reach different conclusions, based on their individual points of view, understanding of market behavior, or analytical methodologies. Should the Commission put in place behavioral criteria that impose or encourage uniformity in symbols, approach, methodology or ultimately the rating opinion, it

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[9] The Commission also indicates important principles underlying its designation criteria, such as: *"credit ratings used for regulatory purposes should be the result of a competent and thorough analysis", "an entity must use systematic procedures designed to manage potential conflicts of interest", and "a credit rating agency…should have policies and procedures that are designed to effectively protect nonpublic information provided by issuers."*

would limit the diversity of rating opinions in the market (potentially even if more firms enter the market) and, therefore, the range of information available to the market.

The Code of Conduct Fundamentals for Credit Rating Agencies published in December 2004 by the International Organization of Securities Commissions (the **"IOSCO Code"** or the **"Code"**) contains a principles-based approach to standards for rating agency activities. The IOSCO Code provides for rating agencies to develop individual codes of conduct and related practices consistent with the Code, or to explain why they are not in compliance and how their practices are otherwise consistent with the Code's principles.

This approach provides regulators and market participants with a comprehensive framework to assess prudentially not only the policies, procedures and disclosures of credit rating agencies, but also the more basic question of whether agencies are trustworthy. In effect, the Code creates open conditions for future regulatory actions depending on the sufficiency of rating agency implementation. To the extent that rating agencies have indicated they support the Code, regulatory actions need not pre-empt this open assessment process, and credit rating agencies should be given the opportunity to demonstrate their adherence. We believe this outcome best serves market integrity and investor confidence, as it provides the market with information to assess the reliability of a given rating agency's practices, rather than imposing a set of static rules to induce "reliable" behavior.

Following are responses to a number of questions that the Commission has asked in seeking to assess whether specific prescriptive rules would more effectively serve the NRSRO designation process.

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

We agree with the Commission in its discussion with respect to the symbols used by rating agencies. As the Commission notes, *"rating symbols have been developed in response to market demand, and we imagine will continue to evolve in order to meet that demand."* We believe that requiring rating agencies to adopt uniform rating symbols, with resulting harmonization of rating opinions and meanings, would reduce the amount of information available to the market. For example, Moody's ratings are a measure of relative expected loss. They are based on an evaluation of the likelihood of default on a bond and the severity of loss in the event of that bond's default. Not all rating agencies intend to convey the same information with their ratings systems.[10] Harmonization of symbols alone could erroneously encourage

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[10] Some rating systems revolve on qualitative inputs, including the individual experience of the relevant rating committee members. *See also* Vladislav Peretyatkin and William Perraudin, *Expected Loss and Default Probability Approaches to Rating Collateralized Debt Obligations and the Scope for "Ratings Shopping," in* CREDIT RATINGS: METHODOLOGIES, RATIONALE AND DEFAULT RISK (Michael Ong ed., 2002).

investors to believe that all credit opinions attempt to measure exactly the same criteria in the same way and over the same time horizons. In addition, if all opinion providers were compelled to assign the same rating symbols or adopt the same rating definitions as other agencies, the diversity of information available to the market would be reduced, contrary to a primary objective of providing diverse opinions to promote efficient markets.

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

We believe that at the time of formulating an opinion, rating agencies should incorporate data and information from those sources that they believe are reliable. Rating agencies, however, possess neither the comprehensive nor independent first-hand knowledge to verify or test all of the data specific to an issuer or a third party vendor. With respect to issuers, we believe that it should be their responsibility to ensure that trustworthy information is provided to rating agencies. Issuers make disclosures to rating agencies knowing that agencies will rely on those disclosures in publicly rating their securities. Since ratings may be considered important information by the securities markets, issuers should not place false or misleading information into the markets using the mechanism of the rating agencies any more than by using the mechanism of public securities filings, press releases, public statements from management, or the like. This conclusion and recommended obligation follows from customary laws to protect the fairness and efficiency of securities markets.

With respect to third party vendors, it seems to us appropriate that the decision to rely on a vendor should be made on a case-by-case basis, based on an assessment by the rating agency based on factors such as previous experience with that vendor or its reputation as a data and information services entity.

- *"What specific conflicts of interest should be addressed in a credit rating agency's procedures and how should they be addressed? Should a credit rating agency that engages in activities that present potential or actual conflicts of interest be excluded from the definition of NRSRO? Alternatively, is it sufficient for a credit rating agency to impose and implement safeguards to prevent potential conflicts of interest from affecting the quality and independence of its credit ratings? Are there other practices that raise concerns similar to those raised by conflicts of interest, for example, those referred to in footnote 93 regarding unsolicited ratings, that should be addressed in a credit rating agency's procedures?"*

Moody's believes that the credit rating process should be objective and independent, and should be conducted with professionalism and integrity. In particular, we acknowledge that while default studies and other statistical tools may establish an agency's ratings to be predictive in the aggregate, specific ratings may nevertheless be compromised on an individual basis. Consequently, in addition to producing ratings with high predictive content, a ratings firm should have appropriate policies and procedures in place to address, among other things, management of conflicts of interest and use of confidential information. Moody's would suggest that, rather than proscribing specific activities, the Commission should require that rating agencies be transparent about their practices to allow the Commission, and other users of ratings, to make informed and prudential decisions as to the efficacy of procedures for managing potential conflicts of interest.

- *"As discussed above, to meet the third component of the NRSRO definition, should a credit rating agency demonstrate that it has systematic procedures designed to prevent the misuse of material non-public information? The Commission encourages commenters to provide information on appropriate procedures for receiving and adequately securing material non-public information."*

Because rating agencies may have access to material non-public information as part of the ratings process, they should have in place appropriate measures to protect against selective disclosure, or inadvertent dissemination, of non-public information in their possession. Moreover, NRSROs are subject to the securities and other laws that impose a fundamental level of responsibility for integrity on all participants in the United States financial markets. The SEC and other governmental authorities have recourse to these existing laws to impose civil and criminal sanctions for misuse of material non-public information.[11]

We thank the Commission for this opportunity to comment on its proposed NRSRO definition. We believe that the Commission's Proposed Rule, if applied properly, can satisfy regulatory objectives without any adverse impact on credit rating agencies and the markets they serve.

Sincerely,

Jeanne M Dering

Jeanne M. Dering

cc: Chairman William H. Donaldson
Commissioner Paul S. Atkins

[11] See, e.g., Commission v. Rick A. Marano, et al., Dkt. No. 04 Civ. 5828 (KMW) (SDNY July 27, 2004) (civil insider trading action brought by SEC against former analyst of Standard & Poor's).

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