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June 8, 2005

Jonathan G. Katz, Secretary,
Securities and Exchange Commission,
450 Fifth Street, NW,
Washington, DC 20549-0609.
United States

Re: File Number S7-04-05.

Dear Sir

Executive Summary

Rapid Ratings, a global corporate credit rating agency (using proprietary software and quantitative models) which covers 15,000 listed companies in the US, UK, Canada, Singapore, Australia, NZ and elsewhere, appreciates the opportunity to participate in the discussion about the Commission's proposal to define the term "NRSRO" in new Exchange Act Rule 3b-10, and to provide interpretations of that definition. We welcome the Commission's openness to new ideas and new entrants to the market. We are particularly grateful for the following statement in the document:

"Although commenters were generally of the view that credit rating agencies that rely solely on statistical models should not qualify as NRSROs, the Commission, in proposing to define the term "NRSRO," is not precluding through this proposed definition the possibility that a credit rating agency with a more quantitative business model than the current NRSROs could meet the definition of NRSRO. Accordingly, the proposed definition of the term "NRSRO" and the interpretations to the definition contained in this release should not be construed as excluding a credit rating agency that significantly relies on quantitative statistical models in developing credit ratings."

The market system is always strengthened where choice and the right to choose are fostered and protected in the market. But, as we elaborate below, there are still some anti-competitive features to the proposed NRSRO definition, which should be revisited, because they will impose significant revenue reductions and may add heavy compliance costs.

There are two types (or Tiers) of corporate credit rating agencies operating in the US market. Type 1 rating agencies are paid by second parties, which they rate, while Type 2 rating agencies are paid by third parties (institutional investors, investment banks, private banks, hedge funds, financial planning groups, accounting firms, large creditors, individual investors, government agencies). Type 1 rating agencies use a traditional approach, which provides a ratings opinion based on a mix of qualitative and quantitative analysis, while Type 2 rating agencies apply a proprietary software-based approach using quantitative models that, as is the case with Rapid Ratings, take a scientific approach to audited corporate financials, and use no other inputs. **The principal competitive advantages of Type 2 rating agencies vis-à-vis Type 1 rating agencies is that the former provide corporate credit ratings which are more accurate and predictive (provide much earlier warnings) at a much lower cost, and can produce high volumes of output.**[1] ***Because of these advantages, Type 2 rating agencies have the potential to challenge the dominant position of Type 1 rating agencies, as long as regulatory barriers to entry are minimized, and as long as the Type 1 rating agencies are prevented from taking over the Type 2 rating agencies.***

More details about the characteristics of Type 1 and Type 2 rating agencies are provided below:

Table 1: Type (Tiers) of Credit Rating Agencies: Points of Differentiation in Business Models

Rating Agency Characteristics	Type 1 Rating Agencies	Type 2 Rating Agencies
Business model	Paid by securities issuers	Paid through subscriptions by third parties
Organizational structure	Large businesses, protected by regulations, and with few if any links to companies they rate. Committee structure permits internal review of analyst ratings.	Typically smaller privately owned businesses, with no business ownership links to companies rated. Use software to generate ratings. Quality control teams and automated and manual programming are in place to screen data quality and output quality.
Size and quality of staff	Employ rating analysts to generate	Use proprietary software and models to generate

[1] Rapid Ratings' current rated capacity output is 40,000 company reports and ratings per day.

	ratings	ratings and reports for individual companies. Do not use analysts for individual company ratings.
Financial resources	Need to have sufficient financial resources to ensure that it maintains appropriate staffing levels to continuously monitor the issuers it rates and be free of pressure from dominant clients.	Type 2 rating agencies do not experience pressure from the sell side or the buy side to change ratings because their ratings process is automated and cannot be interfered with. But obviously, having sufficient financial resources is a reasonable criterion.
Independence from companies it rates	The development of relationships with the issuers creates potential for conflict of interest	No contacts with the companies rated. All information is secured from publicly available sources.
Rating procedures	Opinion based ratings using traditional qualitative and quantitative analysis	Software and/or model driven ratings and reports based on audited corporate financials.
Policy on non-public information	Internal procedures generally in place. Some mishaps can occur.	Never receives non-public information from issuers because there is no relationship.
Early warning signal ability	Traditional rating agencies issue down grades and upgrades that typically lag the share price by one to three years.[2]	Based on 1997-2000 financials Rapid Ratings rated Enron an average of 8 notches below investment grade for each year, providing early warnings well ahead of the rest of the market.

We are not proposing that Type 2 rating agencies replace Type 1 rating agencies. Rather, we are proposing that Type 2 Agencies be allowed to enter the NRSRO market on a non-discriminatory basis and compete on a playing field that is not discriminatory against Type 2 rating agencies. In essence, some criteria that are applicable to Type 1 rating agencies are not applicable to Type 2 rating agencies (as illustrated in Table1). Ratings from Type 2 agencies would make reliable and insightful first or (more likely) second opinions on the creditworthiness of securities issuers and their securities.

The Commission's criteria for defining the term "nationally recognized statistical rating organization" are in the first column of Table 2, followed by related proposed Commission requirements, barriers to entry issues and our proposed solution:

Table 2: New NRSRO Definition Criteria and Barriers to Entry: 3 principal concerns

We have three concerns with the proposed definition and the related clarifications provided in the Commission's proposal (http://www.sec.gov/rules/proposed.shtml):

1). The **proposed new "no cost" rule** (as part of the definition of **publicly available**) is anti-competitive. It would require rating agencies to issue the rating (but no other information) free of charge to the public, a criterion that perfectly suits the Type 1 rating agencies because that is what they currently do. This is not disruptive to their business model because most of their revenue comes from issuers of securities rather than third party subscribers, as is the case with Type 2 rating agencies. This proposed rule would act as a barrier to entry for Type 2 rating agencies because it undermines their revenue base. A solution to this problem is to specify that the concept of **"publicly available"** is to be understood exclusively to mean "the availability of such ratings (but with no other information) at standard subscription rates on electronic networks (such as Reuters, Thomson and Bloomberg etc) in the case of Type 2 rating agencies alone, or for both types. A less acceptable alternative would be to require the above plus a free listing of the Top 100 listed companies for the US. Because Rapid Ratings rates all US listed companies, posting thousands of free ratings would cannibalize our existing business.

2) The concept of "generally accepted" is anti-competitive and a major barrier to entry for Type 2 rating agencies. The dual concept of an NRSRO which is "**generally accepted"** as an issuer of **"credible and reliable ratings"** should place more emphasis on the presence or absence of "credibility and reliability" because it is the issuance of early warnings of both distress and default sufficiently ahead (a year or more) of a corporate crisis (like Enron or Parmalat) that determine the value of a rating.

Just because regulations require issuers to use 2 or more ratings from the traditional rating agencies and just because laws require users such as banks, insurance companies, mutual funds, pension funds, etc. to incorporate them in their

[2] Pinches, George E. & J. Clay Singleton, 1978, The Adjustment of Stock Prices to Bond Rating Changes, vol. 33 Journal of Finance pp, 29-55 at 39. Odders-White, Elizabeth R. and Mark J. Ready, 2003, Credit Ratings and Liquidity, Department of Finance, University of Wisconsin. Creighton, Adam, Luke Gower and Anthony Richards , 2004, The Impact Of Rating Changes In Australian Financial Markets, Research Discussion Paper 2004-02 , March 2004, System Stability Department, Economic Research Department, Sydney, Reserve Bank of Australia. Odders-White, Elizabeth R. and Mark J. Ready, 2003, Credit Ratings and Liquidity, Department of Finance, University of Wisconsin. Macey, Jonathan R. 2002, Cornell Law School, Testimony before the US Committee on Governmental Affairs March 20, 2002 , "NRSROs and Investor Protection" and additional research by Rapid Ratings.

portfolio construction strategies (hence making them by definition both generally accepted and nationally recognized thus creating a tautology and a major barrier to entry) does not make the ratings credible or reliable.

What counts is the anticipatory value of each rating and whether or not it beats the share price (which generally beats the traditional ratings by one to three years) or the bond price in sending out early warnings. Ratings from Type 2 rating agencies will gain acceptance as they prove their early warning ability. Meanwhile, the traditional rating agencies are not held to that standard because they have been grandfathered. The investing public needs a level playing field in this critical area. The solution is that successful Type 2 rating agencies, which have value will be generally available on electronic information networks (such as Reuters, Thomson and Bloomberg etc) provided through the Internet. Those that add value will survive, those that don't, should not and ultimately will not.

3) The Commission states: "…it could be important for a credit rating agency whose credit ratings will be used for regulatory purposes to involve in the rating process, when possible, an issuer's senior management, or, in the case of issuers of asset-backed securities, other appropriate parties." Given that many Type 2 rating agencies rate thousands of US listed companies, such a requirement would impose prohibitive compliance costs and become a major barrier to entry to Type 2 rating agencies.

NRSRO Criteria	Requirements	Barriers to Entry Issues	Solution
Issues publicly available credit ratings that are current assessments of the creditworthiness of obligors with respect to specific securities or money market instruments	**The rating (but no other information) would be "disseminated on a widespread basis at no cost" from the rating agency's website**	**This proposed *new "no cost" rule* creates a major barrier to entry for Type 2 rating agencies which depend solely, or mostly, on subscription revenues and are not paid by securities issuers for rating their securities.**	**"publicly available" should be taken to include mean exclusively "the availability of such ratings at standard subscription costs on electronic networks", including Bloomberg, Thomson, Reuters, Mergent, Telekurs, Track Data, Markit Partners, FT and other current and future electronic providers of financial information.**
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	**Issuer of credible and reliable ratings**	**Widespread use is no guarantee of credibility, hence the negative reactions in the market by the buy-side when the Big 3 rating agencies failed to downgrade Enron, WorldCom and others long in advance of their collapse.[3] The recent congressional hearings reflected this unease. The concept of "generally accepted" is an explicit barrier to entry the way it is currently conveyed.**	**Credibility should be based on accuracy in anticipating financial deterioration or improvement of companies, and the ability to make such anticipations ahead of the share price. Rapid Ratings has a successful track record in this area:[4] The value of these early warnings[5] is that they give companies and investors time to plan and act rather than waiting until the last minute when they are in the midst of a crisis.**
Uses systematic procedures designed to ensure credible and reliable ratings, manage	**(a) experience/ training of a firm's rating analysts** **(b) average # of issues covered by analysts**	**(a) (b) (d) (e) (f) are not relevant to Type 2 agencies because of their business model which involves being**	**Type 2 rating agencies should not be judged by, or forced to comply with, criteria, which are not relevant to their business model**

[3] Some of the key factors behind accuracy and timeliness problems in the traditional rating agencies are: (1) they do not use scientific approaches to assessing the financial health of the companies they rate and hence tend to provide warning signals that lag the share price by one to three years signal; (2) they always "look through the cycle" rather than "mark to market", a principal reason behind "rating stickiness"; (3) they have become so influential that their analysts are often concerned that a ratings change will have a disproportionate impact on the issuer's financial health, requiring future downgrades in an ever-deteriorating spiral (whereas if they acted earlier, the signal for restructuring would come earlier and the firm and market adaptations would be less dramatic; (4) use rating floors (BBB-, Baa3) because of concerns about causing disruption to capital markets.

[4] Rapid Ratings (1) downgraded both GM and Ford to sub-investment grade in 2000, 5 years before the traditional rating agencies (2) rated Parmalat at 4-6 notches below investment grade for 6 years prior to its collapse in December 2003, while traditional rating agencies tended to down grade Parmalat about a month before its collapse; (3) rated Enron at an average of 8 notches below investment grade during 1997-2000 4 years ahead of the traditional rating agencies before its bankruptcy in December 2001; and (4) rated HIH Insurance in Australia 7-8 notches below investment grade for the years 1996-2000, while traditional rating agencies reacted at the last minute.:
http://www.cfoweb.com.au/freearticle.aspx?relId=9462
http://www.asa.asn.au/Miscellaneous/RapidRatingsarticle.pdf (March 3, 2005, Australian Financial Review)
http://www.forbes.com/columnists/investmentnewsletters/2005/04/22/cz_rl_0422soapbox_inl.html (April 22, 2005);
http://www.forbes.com/free_forbes/2005/0523/236.html ;
http://news.moneycentral.msn.com/ticker/article.asp?Symbol=US:T&Feed=FRB&Date=20050505&ID=4792544
http://64.233.183.104/search?q=cache:u-gh1JYOGvcJ:www.thebullandbear.com/digest/0505-digest/0505-stocks.html+General+Motors+downgraded+by+rapid+ratings&hl=en

[5] See, Patrick J. Caragata, 1999, **Business Early Warning Systems: Corporate Governance for the New Millennium** (Butterworths).

potential conflicts of interest, and prevent the misuse of nonpublic information, and has sufficient financial resources to ensure compliance with those procedures."	**(c) information sources reviewed/ relied upon and how info integrity is verified (d) extent of contacts with issuer management (e) organizational independence from companies it rates and from potential conflicts of interest that may result business affiliations; (f) conflicts of interest policies affecting its ratings business**	**paid by third parties. Type 2 agencies typically have both simple and sophisticated procedures in place for verifying the quality of their data and their rating and report outputs.**	**and discriminate against them.**

Current and future proposals affecting NRSRO status should balance the interests of the ***sell-side*** and the ***buy-side so that while the opportunities for raising capital are enhanced, so too is the provision of more timely and accurate warning signals to wholesale and retail investors.*** This balance of interests will help to minimise both portfolio and product risk and enhance capital market efficiency.

We are grateful that the SEC, in this new document, has left open the door for quantitative-based or software-based rating agencies like Rapid Ratings. But there remain barriers to entry that need to be neutralized: (a) the "**Publicly available**" barrier needs to be adjusted by changing the **no cost rule** for public listing of ratings and accepting a broader focus on internet availability; (b) the "**publicly accepted**" criteria should shift focus on to the predictive credibility of ratings and away from current usage which protects incumbents; and (c) the potential rule proposal for mandatory contact with listed issuers should not proceed because it would add significantly to compliance costs for Type 2 Rating Agencies**.**

We would be pleased to respond to any further inquiries of the Commission with respect to this comment letter and, if appropriate, to meet with members of the Commission staff to discuss the proposal. Please contact our Managing Director and CEO Dr. Patrick Caragata, at info@rapidratings.com.

Yours truly,

Rapid Ratings Pty Limited

Dr. Patrick Caragata
Managing Director and CEO

FORMAL SUBMISSION TO THE SECURITIES EXCHANGE COMMISSION
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by

RAPID RATINGS PTY LIMITED

DR. PATRICK JAMES CARAGATA,
MANAGING DIRECTOR AND CEO

(a new generation corporate credit rating agency with offices in Australia, New Zealand, New York, Toronto, London and Singapore)

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regarding

SECURITIES AND EXCHANGE COMMISSION
17 CFR Part 240 [Release Nos. 33-8570; 34-51572; IC-26834; File No. S7-04-05] RIN 3235-AH28
Definition of Nationally Recognized Statistical Rating Organization

Submitted electronically to
rule-comments@sec.gov.

8 June 2005

I. Introduction

Rapid Ratings welcomes the proposal by the SEC to define the term "NRSRO" in new Exchange Act Rule 3b-10, and to provide interpretations of that definition.

In November 2003, Rapid Ratings made a formal response to the Commission's Concept Release and also made a submission In November 2004 Rapid Ratings also made a submission to IOSCO (the International Organization of Securities Commissions) with respect to its new "Code of Conduct Fundamentals for Credit Rating Agencies."

- http://www.sec.gov/rules/concept/s71203/rapid110603.htm,
- http://www.iosco.org/pubdocs/pdf/IOSCOPD177_1.pdf

We note that the Commission's proposal "does not attempt to address many of the broader issues raised in response to the 2003 Concept Release." We recognize that, because the Commission plays such a critical and instrumental role in managing public confidence in the market place, these steps must be carefully designed, be steady and not precipitous (i.e. full public consultation), and be effective in maintaining and strengthening public confidence.

We support the SEC's step-wise approach, but wish to point out that these "broader issues" are substantive and need to be addressed in the near future. Further, these broader issues should include, but not focus exclusively on those identified by various contributors to the current review:

(i) potential conflicts of interest caused by payment by issuers to NRSROs for their ratings;
(ii) exacerbation of those conflicts of interest due to the marketing by the NRSROs of ancillary services to issuers, such as pre-rating assessments and corporate consulting;
(iii) the potential for the NRSROs, given their substantial power in the marketplace, to improperly pressure issuers to pay for ratings;
(iv) the potential for the NRSROs, given their substantial power in the marketplace, to improperly pressure issuers to purchase ancillary services;
(v) the effectiveness of the NRSROs' existing policies and procedures designed to protect confidential information; and
(vi) difficulties in the Commission's examinations of the NRSROs from, among other things, the lack of recordkeeping requirements tailored to NRSRO activities, the NRSROs' assertions that the document retention and production requirements of the Investment Advisers Act of 1940 are inapplicable to the credit rating business, and the NRSROs' claims that the First Amendment shields them from producing certain documents to the Commission.

Other issues that need thorough consideration are as follows:

Rapid Ratings has taken a strong interest in the current proceedings and proposals because we recognise that the 1975 changes had a long-term impact and that any changes the Commission now makes with respect to rating agencies will have a similar impact not only on rating agency competition and related market entry, but also on the behaviour of investors and other regulators in the US and abroad. As the Commission notes "NRSROs today are used as benchmarks in federal and state legislation, rules issued by financial and other regulators, foreign regulatory schemes, and private financial contracts." This gives rise to several specific issues that need to be reviewed and addressed in the future:

Rating Thresholds and Default Probabilities:

1. Based on market interpretation of the usage of ratings in laws and regulations, existing rating scales used by the NRSROs are binary systems that divide the world into two parts: (1) investment grade companies and (2) non-investment grade companies. The corporate world is much more complex than that. In essence, there is always grey space, or transitions, between black space and white space. But the use of a single demarcation line like the investment grade threshold currently contributes to or creates many problems, some serious, in the market, notably rating floors, rating stickiness, and precipitous behaviour by investors. A solution to this problem is to create a new category called "borderline investment grade" that occupies the two notches immediately below BBB- (ie BB+ and BB). Rapid Ratings created this concept in 1998, and applies it globally.

2. The probabilities of default between BBB- and BB+ are not that significant, but because regulators and legislators, who govern the acts affecting banking, insurance, pension funds and mutual funds, have incorporated the NRSRO ratings in their laws and regulations, they have also absorbed these deficiencies. Thus, certain entities must dump their holdings of sub-investment grade assets as soon as the companies are downgraded to sub-investment grade.

3. Traditional rating agencies issue down grades and upgrades that typically lag the share price by one to three years.[6] But, because of the regulatory enshrinement of NRSRO ratings, there is also lagged behavior by investors in responding to the actual rating change. **That regulatory-driven bunching of behavior by institutional investors and various investment managers can conceivably exacerbate considerably a financial crisis through contagion effects and cascading behavior**.

4. There is a paradigm shift (Appendix 1) underway with respect to the source and value of ratings in the market driven by dissatisfaction from the buy side. This shift arises because current problem solving tools in the rating industry are breaking down at critical moments (Enron, Parmalat, WorldCom etc) as a result of changing conditions and circumstances and because of more active interest and pressure from the buy-side. The shift is exacerbated by the use of a binary black space/white space demarcation line (the investment-grade threshold) utilized by the existing NRSRO systems and imbedded in regulations and laws. Fortunately, however, as the problem-solving ability of reigning paradigms weaken, new paradigms with better problem-solving tools arise. The more barriers to the entry of these new tools, the greater the systemic risk to the market.

Competition and the Emergence of New Ratings Technologies

We note that, of the 5 surviving rating agencies, which have received NRSRO status since 1975,

- all except DBRS (which was founded in 1976) have been in business for 80-100 years;
- none are known for major technological innovations in the market;
- some have been the chief protagonists in mergers in the industry;
- most are known for very late warnings or no warnings about the major corporate collapses of the last several decades (Enron, WorldCom, Confederation Life in Canada, HIH Insurance in Australia etc); some of those rating alert failures provided the chief motivation for the current investigation and proposals; and
- all are Type 1 rating agencies because they cater principally to the sell side rather than the buy side (receiving their dominant revenue stream from issuers rather than third party subscribers) and hence potentially subject to various opportunities for conflict of interest. The buy side interests in the market need stronger support from the Commission, with a particular emphasis on competition and choice in the market.. Sell-side interests, with which the rating agencies have a strong, dependent commercial relationship, should not dominate the future rulings, clarification of definitions and periodic rule changes by the SEC.

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[6] Pinches, George E. & J. Clay Singleton, 1978, The Adjustment of Stock Prices to Bond Rating Changes, vol. 33 Journal of Finance pp, 29-55 at 39. Odders-White, Elizabeth R. and Mark J. Ready, 2003, Credit Ratings and Liquidity, Department of Finance, University of Wisconsin. Creighton, Adam, Luke Gower and Anthony Richards , 2004, The Impact Of Rating Changes In Australian Financial Markets, Research Discussion Paper 2004-02 , March 2004, System Stability Department, Economic Research Department, Sydney, Reserve Bank of Australia. Odders-White, Elizabeth R. and Mark J. Ready, 2003, Credit Ratings and Liquidity, Department of Finance, University of Wisconsin. Macey, Jonathan R. 2002, Cornell Law School, Testimony before the US Committee on Governmental Affairs March 20, 2002 , "NRSROs and Investor Protection" and additional research by Rapid Ratings.

Even as and when more new entrants are permitted in the market, there is the risk that they will be swallowed by the Big 3 incumbents. There are several ways to meet the Justice Department's earlier criticism that the existing regulations protect the NRSRO incumbents and erect serious barriers to entry: (1) permit Type 2 Rating Agencies (which are generally based on software or models to become NRSROs, but specify that the Type 2 rating agencies cannot be taken over by Type 1 rating agencies; and/or (2) encourage the Justice Department to enforce U.S. antitrust laws to ensure that the Big 3 incumbent NRSROs are precluded from taking over new competitors. The market system is always strengthened where choice is fostered and protected in the market.

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TEXT OF PROPOSED RULE and Comments by Rapid Ratings

The following is divided into four sections:

(a) Issues <u>publicly available</u> credit ratings that are <u>current</u> assessments of the creditworthiness of obligors with respect to specific securities or money market instruments;

"(b) Is <u>generally accepted</u> in the financial markets as an issuer of <u>credible and</u> <u>reliable</u> ratings, including ratings for a particular industry or geographic segment, by the predominant users of securities ratings; and"

"(c) Uses <u>systematic procedures</u> 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."

(d) Miscellaneous

<u>PART I OF OUR RESPONSE</u>

PART 240 — GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934
2. Section 240.3b-10 is added to read as follows: **240.3b-10 Definition of "nationally recognized statistical rating organization."** The term nationally recognized statistical rating organization means any entity that:

(a) Issues <u>publicly available</u> credit ratings that are <u>current</u> assessments of the creditworthiness of obligors with respect to specific securities or money market instruments;

<u>The Commission Elaborates:</u>

"The Commission is proposing that, in order to meet the definition of the term "NRSRO," a credit rating agency must issue credit ratings that are publicly available. The Commission is also interpreting "publicly available," as used in the definition, to mean that credit ratings used for regulatory purposes under Commission rules must be disseminated on a widespread basis at no cost. In this context, the rating could be published in a readily accessible manner on the credit rating agency's internet Web site. The Commission believes that it is important for credit ratings used for regulatory purposes to be publicly available, as public availability – at no cost – should assure wide dissemination of ratings and provide the opportunity for the marketplace to judge the credibility and reliability of an entity's credit ratings. This approach is consistent with the views of most commenters that it would be inappropriate to require users of credit ratings to subscribe for a fee to an NRSRO's services to obtain credit ratings for regulatory purposes. The Commission notes that in proposing to define the term "NRSRO" as an entity that makes its credit ratings publicly available, the public availability reference only would apply to the credit rating itself (i.e., the rating symbol), and not to other information otherwise developed by the credit rating agency (e.g., the credit rating agency's rating rationale). This approach should not result in NRSROs charging higher fees for their services because it would not require a credit rating agency to make available at no cost the analysis underlying its rating. The Commission notes that this approach is also consistent with the current practices of many credit rating agencies, including each of the current NRSROs, that already publish their credit ratings on a widespread basis at no cost."

Rapid Ratings Comments[7]

There is no need to require NRSROs to make their credit ratings publicly available, because (i) the ratings of the existing NRSROs –each of which is a Type 1 company- will almost always be publicly available at no charge for public issuers and/or publicly issued securities instruments, and (ii) the NRSRO market will not credibly expand as (a) Type 2 rating agencies will not seek the NRSRO designation because their business model does not support making their ratings available for free, and (b) securities issuers will not credibly support additional Type 1 rating agencies. Only 2 ratings are typically required by law or custom. If the market requires three ratings from an issuer, it certainly won't require four ratings, or five.

- The traditional *informal* NRSRO criteria[8] were designed for rating agencies with a traditional business model for the traditional rating agency industry (**Type 1 Rating Agencies**). **Business Model Type 1:** the rating agency is paid by second parties (issuers of debt) to rate those parties. New generation rating agencies, such as Rapid Ratings, have an entirely different business model.
- **Business Model Type 2: New generation rating agencies** are paid by third parties (banks, insurance companies, investment funds, pension funds, large creditors etc) to rate second parties (listed and/or unlisted companies). In the **Type 2** Model, there may be no contact between the rating agency and the companies it rates and no potential for conflict of interest. In such a case, it would be unfair to require a **Type 2** company to conform to criteria that pertain only to **Type 1** companies.

The Commission inserted the requirement that credit ratings be "publicly available", based, in part, on the analysis and conclusion of "most commenters that it would be inappropriate to require users of credit ratings to subscribe for a fee to an NRSRO's services to obtain credit ratings for regulatory purposes". Most commenters supporting this conclusion based their analysis on the premise that that the majority of ratings issued by existing NRSROs are already publicly available. This is a true statement. However, the oligopolistic nature of the industry has meant that no other business model could have been presented to the ratings market. Since 1975, when the Commission first issued the "NRSRO" designation, only five companies have received this designation and are still in business (Moody's, S&P, Fitch, DBRS and AM Best, the latter two entering earlier in 2005), each of which is a Type 1 company. Ratings from existing NRSROs are generally available to the public and will remain available to the public, because that is what the market and regulation require. More precisely, the market specifically demands and regulation supports, at no cost to buyers of securities, that a securities issuer and/or its securities instruments be rated by an NRSRO, of which the Big 3 control over 90% of the market.

The Big 3 have the power to move the market for securities issuers and/or securities instruments up or down by upgrading or downgrading their ratings. This power is derives from a combination of brand name dominance and the NRSRO designation.

In fact, many investment portfolios require a specific rating by Moody's and/or S&P in order for the securities issuer or its securities instruments to be eligible for investment. The market power and penetration of Moody's and S&P (and to a certain extent Fitch) forces public securities issuers to pay at least one of these companies, if not both, to rate them and their publicly available securities instruments. Since the market demands (and regulation requires) that public securities issuers and their publicly available securities instruments be rated by either or both Moody's and S&P and securities issuers pay for these ratings, the ratings of Moody's and S&P will continue, in most circumstances, to be available to the public without charge. Their market power and penetration, however, is a substantial barrier to entry to potential competitors that may have developed a more rigorous or efficient ratings model. This barrier to entry is a significant competitive impediment and underwrites the compelling public interest in improving ratings quality.

[7] In New Zealand, Rapid Ratings has established a subsidiary, which is traditional rating agency which specialises in rating non-bank finance companies. There are currently no plans for this subsidiary to enter the US market.

[8] "In determining whether to issue an NRSRO no-action letter, the Commission staff has considered the single most important factor to be whether the credit rating agency is "nationally recognized" in the United States as an issuer of credible and reliable ratings by the predominant users of securities ratings. The notion of "national recognition" was designed to help ensure that credit ratings used for regulatory purposes under Commission rules are credible and can reasonably be relied upon by the marketplace. Also reviewed in connection with the no-action letter process is a credit rating agency's operational capability and ratings process. Included within this assessment are: (1) the organizational structure of the credit rating agency; (2) the credit rating agency's financial resources; (3) the size and quality of the credit rating agency's staff; (4) the credit rating agency's independence from the companies it rates; (5) the credit rating agency's rating procedures; and (6) whether the credit rating agency has internal procedures to prevent the misuse of nonpublic information and whether those procedures are followed.

If Type 2 rating agencies are required to make their credit ratings available to the public at no charge, then the NRSRO market will not credibly expand because Type 2 rating agencies will not seek the NRSRO designation. Type 2 rating agencies developed their business of selling ratings to third parties because:

1. **securities issuers will generally not pay new entrants to the NRSRO market, because the new entrants will not have the market power and penetration of the existing NRSROs, regardless of whether they are a Type 1 or Type 2 company,**
2. **there is a need by investors to obtain a second opinion to confirm or reject the ratings of Moody's, S&P and the other Type 1 ratings agencies and**
3. **investors are willing to pay for this second opinion.**

Typical users of Type 2 rating agencies are third parties (institutional investors, investment banks, private banks, hedge funds, financial planning groups, accounting firms, large creditors, individual investors, government agencies) **who are seeking an "objective and independent rating" of a securities issuer. Type 1 rating agencies, by their very nature, cannot provide clearly "objective and independent ratings", because the securities issuers themselves pay for the ratings. In order to maintain their independent status, Type 2 rating agencies cannot accept fees for onsite ratings from securities issuers for their ratings. Instead, Type 2 rating agencies receive the bulk of their revenue from subscription services.**

However, if the ratings of Type 2 companies are available free of charge, third parties will not pay for them (with the Type 2 company's rating in hand, the incentive to pay for the backup report supporting the rating diminishes), as most investors still look at Type 2 company ratings as second opinions. Therefore, if Type 2 companies are required to make their ratings publicly available without charge, the NRSRO market will not credibly expand beyond the current five rating agencies (other than for the odd niche players in regions or industries), because Type 2 rating agencies will not seek the NRSRO designation as it is inconsistent with not only their business model, but their business viability.

Moreover, circumstances, conditions, opportunities and challenges change as technology changes. However, the existing NRSROs have not developed a significant technological advance during the past 30 years. It is Type 2 companies that are developing technological advances and it is Type 2 companies that will develop effective new technology that can provide the early warnings the market needs. But they can only survive by charging third parties for their services. Requiring Type 2 companies to make their ratings available at no charge will prevent Type 2 companies from entering the NRSRO market and deprive the NRSRO market of this new technology.
To erect barriers to Type 2 rating agencies would be similar to trying to prevent cable and satellite television from competing with free-to-air television. Quality comes with a cost.

In effect, this clarification by the Commission about the concept "publicly available" creates a serious barrier to entry for Type 2 rating agencies. There is a better option:

- Given the evolution in electronic network technology and the emergence of new national and global information providers, the meaning of "publicly available" should be taken to include the availability of such ratings on electronic networks, including Bloomberg, Thomson, Reuters, Telekurs, Track Data, Mergent, Markit Partners, FT and other current and future electronic providers of financial information.
- This option would not only provide evidence of widespread dissemination and demand, and hence public acceptance, but offers a low cost way of accessing such information.
- Just because information is offered free in the market, does not mean that it is reliable or accurate. More to the point, the treatment of information as a "free good", devalues the value that is added by proprietary technology and hence undermines the incentive for R&D to develop new techniques. This issue is connected to the related one of "credible and reliable" which is addressed below.
- The Commission should recognize the separate approaches to ratings by Type 1 and Type 2 rating agencies and not require Type 2 rating agencies to be forced into the Procrustean bed of Type 1 criteria.

Commission Questions: "How should it be determined whether an NRSRO is making its credit ratings readily available on a widespread basis?

Rapid Ratings Comments: Focus on Internet distribution, rather than simply website posting. The availability of ratings on various Internet distribution channels provides better evidence of acceptability and use, rather than just posting. But these distribution channels typically charge a nominal fee for access, as they have every right to do.

Commission Questions: Should our rule specify the manner and methods that must be used to distribute ratings?

Rapid Ratings Comments: Specify that the rating agencies should use one or more of the electronic providers such as Bloomberg, Thomson, Reuters, Telekurs, Track Data, Mergent, Markit Partners, FT and other current and future electronic providers of financial information

Commission Questions: Should internet posting itself be sufficient?"

Rapid Ratings Comments: Internet posting of zero cost ratings discriminates against Type 2 rating agencies, and acts as a significant barrier to entry.

The Commission Elaborates:

"Under the proposed definition, the Commission would interpret "current assessments" to mean that a credit rating agency's published credit ratings reflect its opinion as to the creditworthiness of a security or money market instrument as of the time the rating was issued and until the rating is changed or withdrawn. Under this interpretation, 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, including significant sector or issue-specific events. By including in the NRSRO definition that a credit rating agency's ratings need to be "current assessments," the Commission is responding to comments received in response to the 2003 Concept Release that a requirement that NRSRO ratings be kept "current" is desirable. Further, although the Commission is proposing to define the term "NRSRO" to require an NRSRO's ratings to be current, the Commission is not proposing to prescribe a specific time period within which an NRSRO's ratings would need to be updated. Specifying a time period within which a credit rating agency must update or affirm a rating might be problematic because the appropriate time period for responding to a material event may vary considerably based on, for example, the complexity of an issuer or the specific security being rated. Accordingly, it may be appropriate for a credit rating agency to have the flexibility to respond to material events relating to its ratings on a case-by-case basis. This approach responds to comments that the Commission should not set detailed standards as to when a rating agency should update its ratings.

Rapid Ratings Comments: Rapid Ratings supports this approach.

Commission Questions: 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?

Rapid Ratings Comments: The Commission should set a minimum time period of 12 months for a ratings re-assessment. Market events will drive the timing within a year.

PART II OF OUR RESPONSE

PART 240 — GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934 - 2. Section 240.3b-10 is added to read as follows: **240.3b-10 Definition of "nationally recognized statistical rating organization."** The term nationally recognized statistical rating organization means any entity that:

"(b) 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"

The Commission elaborates:

"The components of the proposed definition are designed to determine those credit rating agencies whose ratings are sufficiently reliable to be used for a variety of regulatory purposes, such as for purposes of the net capital rule. For example, the principal purposes of the net capital rule are to protect customers and other market participants from broker-dealer failures and to enable those firms that fall below the minimum net capital requirements to liquidate in an orderly fashion without the need for a formal proceeding or financial assistance from the Securities Investor Protection Corporation. The net capital rule requires different minimum levels of capital based upon the nature of the firm's business and whether the broker-dealer handles customer funds or securities. In relying on credit ratings believed to be sufficiently reliable, the Commission is using those ratings as a means to evaluate the

liquidity as well as the creditworthiness of certain securities held by a broker-dealer in establishing a sufficient capital cushion."

"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 and should provide some level of assurance to those relying on ratings with regard to the dependability and consistency of the ratings for a variety of regulatory purposes. For example, net capital calculations and haircuts that are determined through use of these credit ratings are more likely to be reliable than those determined without the use of such ratings and, thus, could be more likely to protect customers and other market participants from harm in the event of a broker-dealer failure. Further, linking the evaluation of a credit rating agency's ratings to the views of the predominant users of securities ratings would be helpful. Predominant users generally include financial market participants who hold large inventories of proprietary debt securities, preferred stock, and commercial paper, such as broker-dealers, mutual funds, pension funds, and insurance companies. These firms – given their large inventories of rated fixed income securities – generally have developed sophisticated internal credit rating departments which rate issuers and counterparties. However, they also rely on external ratings from credit rating agencies to compare against and test their internal rating and analysis. Given the importance of credit ratings to the business of these market participants, and to the stability of the financial markets as a whole, the Commission believes that incorporating their views into the definition of NRSRO provides a certain level of credibility and reliability to NRSRO ratings."

"The Commission proposes that a credit rating agency could meet the second component of the NRSRO definition through a variety of objective means. For example, in appropriate circumstances, a credit rating agency could do so through statistical data that demonstrates market reliance on the credit rating agency's ratings (e.g., market movements in response to ratings changes). A credit rating agency also might be able to satisfy the second component if authorized officers of users of securities ratings representing a substantial percentage of the relevant market attest that the credit rating agency's ratings are credible and actually relied on by the users."

Rapid Ratings Comments: "Credibility" should be interpreted to mean

- "accuracy in anticipating financial deterioration or improvement of companies". Evidence for success or failure of this test will be accumulated in the market by interested observers.
- the ability to make such anticipations ahead of changes in the related share or debt security price, which, is itself, often a lagged indicator of the underlying financial health of companies.

These points address the following ongoing concerns raised by the market:

- In a… "September survey by the Association for Financial Professionals, the poll found that 29% of financial executives who work for companies with rated debt believe their ratings are inaccurate, while 40% think it takes too long for changes in the company's finances to show up in the rating." ***Business Week Online*****,** December 9, 2002 *Opening Up the Credit Rating Club?*

- "… there is no question that the system for rating debt--corporate, municipal, mortgage and asset-backed and federal agency issues--could be vastly improved. According to a recent study by the Association for Financial Professionals (AFP), corporate credit analysis would do better by industry competition and a more vigilant U.S. Securities and Exchange Commission. The survey, released today at the AFP's annual meeting, polled 327 corporate finance executives and 181 financial industry service providers on their opinions of the state of credit rating." More Competition, better Ratings, ***Forbes***, November 4, 2002.

- "…a US university study released in June 2001 found that 71 percent of institutional investors (out of a sample size of 114) thought credit ratings on corporate bonds lagged behind an issuer's creditworthiness at any given moment. (Interestingly, though, they also polled 100 CFOs, of whom 74 percent believed that ratings were up-to-date)." *July 2002* ***CFOAsia***[9]

The **buy-side** will **"**attest" to the credibility of the rating agency's services through its purchases. The test should not be more complicated than that.

Commission Questions: Should a credit rating agency that does not rate specific securities or money market instruments be included in the definition of NRSRO? If so, under what circumstances?

[9] "Ratings Under Review" www.***cfoasia***.com/archives/200207-04.htm

Rapid Ratings Comments: Type 2 rating agencies typically provide earlier and more accurate warnings of deteriorating or improving financial health of companies than the Type 1 rating agencies. Such deterioration or improvement inevitably has a lagged effect on the quality of bonds, debentures, capital notes supplied to the market by issuers. Such warnings are advance warnings are instrumental variables for investors that wish to position themselves wisely in the market and not be caught out by big negative or positive surprises. Type 2 rating agencies can be used as a professional second opinion even if they do not rate specific securities. That being said, our experience in New Zealand, where we do rate both companies and all listed securities is that, much of the time, but not always, the securities are rated close to the same level as the company, i.e. sometimes above or at the same level as the company, but more generally one or two notches below, depending on factors such as seniority, liquidity, maturity, asset-backing, guarantees, insurance, covenants etc. We have no problem with being required to rate securities.

Commission Questions: 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?

Rapid Ratings Comments: Introduce a two-tier approach to rating agencies: Type 1 and Type 2. For the first 5 years, the Type 2 rating agencies will not be permitted to be the lead rating agencies; rather it will be a second opinion. Based on our experience with many ratings, including Ford and GM, which we downgraded to sub-investment grade in 2000, it can take quite some time for the Type 1 rating agencies to catch up.

Commission Questions: Are the approaches discussed above useful for determining whether a credit rating agency meets the second component of the proposed definition?

Rapid Ratings Comments: They are a partial answer. For an additional option, see above.

Commission Questions: Are there other types of information that would be appropriate? For example, should the fact that a credit rating agency has many subscribers support a finding that the credit rating agency satisfies the second component?

Rapid Ratings Comments: That is one way, but the best way is their availability on one or more Internet distribution channels. We believe that those other distributor channels are well recognized by investors and have wide acceptance and use despite the imposition of fees for their use.

Commission Questions: What types of statistical data could be relied on to determine if a credit rating agency's credit ratings are relied on by the marketplace? What standards should be considered to assess such statistical data?

Rapid Ratings Comments: We believe that market acceptance, as measured by the number of buy side clients, is a good indicator of market reliance; but this number would have to be confidential to the SEC.

Commission Questions: Should the views of issuers be a relevant consideration in determining whether a credit rating agency meets the second component of the NRSRO definition?

Rapid Ratings Comments: Use the number of buy side clients. This should be sufficient. There is the risk, on the sell side, that a rating agency, with ratings which are too high, will be preferred, whereas a rating agency with ratings that are too low would be rejected. The buy side will be more objective in determining the utility of the ratings because they are focused on risk/return analysis, and investment gains and losses.

Additional Rapid Ratings Comments: With respect to the issue of whether a credit rating agency that does not rate specific securities or money market instruments be included in the definition of NRSRO, our view is that ratings of securities are typically within one or two notches of the company rating. So the market would be well-served by such new ratings.

PART III OF OUR RESPONSE

PART 240 — GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934 2. Section 240.3b-10 is added to read as follows: **240.3b-10 Definition of "nationally recognized statistical rating organization."** The term nationally recognized statistical rating organization means any entity that:

"(c) Uses <u>systematic procedures</u> 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."

Rapid Ratings[10] Comments: By their very nature, because they do not go inside the companies they rate nor communicate with the companies they rate, Type 2 rating agencies have little potential for conflict of interest.

The Commission elaborates:
The third proposed component of the NRSRO definition is designed to ensure that to meet the definition of the term "NRSRO," a credit rating agency uses <u>systematic procedures</u> 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 rating agencies to have sufficient financial resources to ensure compliance with such procedures, if they are to meet the definition.

Rapid Ratings Comments: As a leading Type 2 rating agency, Rapid Ratings employs systematic procedures using software based on industry specific models covering more than a quarter of a million companies with about 30 years of data from more than a dozen countries using an industry-specific set of 24 multivariate econometric panel data models, all of which were peer reviewed by respected professionals and academics.

The Commission elaborates: "The Commission preliminarily believes that including in the proposed definition the requirement that an entity <u>use systematic rating procedures</u> in producing credit ratings should help to ensure that NRSRO ratings are based on a thorough credit analysis of issuers and their financial obligations. This type of analysis should, in turn, assist the credit rating agency in producing credible and reliable ratings, which as discussed above, would further the purposes underlying the regulatory uses of NRSRO ratings. The Commission preliminarily believes that the following would be important for assessing whether a credit rating agency meets the third component of the proposed definition:

Rapid Ratings[11] Comments: The following factors (in Roman numerals) are generally not relevant to Type 2 rating agencies whose ratings are based on software. These factors are input factors and not output factors. It is the accuracy and credibility of the ratings (outputs) as determined by the buy-side that are the key to a successful ratings market. Type 1 rating agencies, however, should set some minimum standards with respect to the factors below:

(i) the experience and training of a firm's rating analysts (pertaining to the analysts' ability to understand and analyze relevant information)[12];

Rapid Ratings Comments: Type 2 rating agencies generally do not employ rating analysts. Where they do, the background of the analyst is typically a Masters in Applied Finance, whose purpose is to examine and ensure quality control of data and output.

(ii) the average number of issues covered by analysts (relevant to whether analysts are capable of continuously monitoring and assessing relevant developments relating to their ratings);

Rapid Ratings Comments: Type 2 rating agencies do not employ rating analysts

(iii) the information sources reviewed and relied upon by the credit rating agency and how the integrity of information utilized in the ratings process is verified (relating to the extent and quality of information upon which a firm's ratings are based);

Rapid Ratings Comments: Type 2 rating agencies only use corporate financials and related notes.

(iv) the extent of contacts with the management of issuers, including access to senior level management and other appropriate parties (pertaining to, among other things, the quality and

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[10] In New Zealand, Rapid Ratings has established a subsidiary, which is traditional rating agency which specialises in rating non-bank finance companies. There are currently no plans for this subsidiary to enter the US market.
[11] In New Zealand, Rapid Ratings has established a subsidiary, which is traditional rating agency which specialises in rating non-bank finance companies. There are currently no plans for this subsidiary to enter the US market.
[12] In New Zealand, where we operate a traditional rating agency, our core rating staff members are typically ex-bankers with 15-30 years of lending/credit decisions.

credibility of an issuer's management and to attempt to better understand the issuer's financial and operational condition);

Rapid Ratings Comments: Type 2 rating agencies do not have contacts with the management of issuers.

(v) the organizational structure of the credit rating agency (to demonstrate, among other things, the firm's independence from the companies it rates and from potential conflicts of interest that may result from related businesses or those of an affiliate);

The Commission elaborates: "For example, such [corporate] structure should include a process for ensuring that credit ratings are analyzed, reviewed, and approved at all appropriate levels within the credit rating agency's organizational structure. Further, the organizational structure of a credit rating agency can also be designed to avoid or minimize potential conflicts of interest and prevent the misuse of nonpublic information (e.g., through firewalls separating ratings services and analysts from affiliated businesses). Though the Commission is not defining the term "NRSRO" to exclude a credit rating agency from being part of a larger business organization, certain affiliated businesses of a credit rating agency could interfere with the credit rating agency's ability to meet the proposed NRSRO definition. For example, a credit rating agency that is affiliated with an entity that underwrites securities rated by the credit rating agency would have a difficult time meeting the third component regarding procedures to manage conflicts of interest.

For the reasons discussed above, the Commission preliminarily believes that a credit rating agency's organizational structure would be relevant to determine whether the credit rating agency meets the definition of NRSRO.

Commission Questions: Would information on a credit rating agency's organizational structure be useful to users of ratings? If so, what information would be useful?

Rapid Ratings Comments: Because Type 2 rating agencies do not go inside companies and because they use software, they do not have the same structures as Type 1 rating agencies. However, Type 2 rating agencies should be asked to produce their corporate ownership structures and their organization charts.

(vi) how the credit rating agency identifies and manages or proscribes conflicts of interest affecting its ratings business;

Commission Questions: 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?

Rapid Ratings Comments: Because Type 2 rating agencies do not go inside companies, they do not have the potential conflicts of interest that characterise Type 1 rating agencies. This is one of their strategic advantages that should be recognised in the NRSRO process by recognizing Type 2 rating agencies as market entrants to NRSRO status.

Commission elaborates: "A separate area of concern arises when credit rating agencies issue unsolicited ratings. These are ratings that are not initiated at the request of the issuer. Specifically, one concern with unsolicited ratings is that they will be used by a credit rating agency to obtain business from issuers. For example, a credit rating agency could conceivably issue an unsolicited rating and send it to the issuer along with a fee schedule for its rating services. Moreover, the rating agency improperly might issue a lower than warranted rating in order to increase the issuer's incentive to purchase the rating service. We believe that unsolicited ratings raise sufficient concerns such that a credit rating agency should have procedures designed to avoid employing improper practices with respect to unsolicited ratings and to monitor and verify compliance with those procedures."

Rapid Ratings Comments: Type 2 rating agencies, such as Rapid Ratings, do not engage in unsolicited ratings. Their primary market is the buy-side because their business model is to rate second parties for third parties in order to produce independent and objective analysis and risk assessments.

(vii) how the credit rating agency monitors and enforces compliance with its procedures designed to prohibit the misuse of material, nonpublic information; and

The Commission elaborates: The Commission believes that for a credit rating agency to meet the proposed definition of the term "NRSRO," it should have policies and procedures that are designed to effectively protect nonpublic information provided by issuers. Accordingly, under the third component of the proposed NRSRO definition, a credit rating agency would be required to adopt and implement procedures designed to prohibit the misuse of material, nonpublic information obtained during the credit rating process. The Commission believes that to meet this component of the NRSRO definition, a credit rating agency should adopt procedures governing the receipt and use of nonpublic information that applies to all employees.

Commission Questions: 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 nonpublic information? What types of procedures are reasonable for a credit rating agency to protect material nonpublic information? Should a credit rating agency have personnel dedicated specifically to verifying employees' compliance with such procedures? Should persons performing this function provide ongoing training of employees and act as a resource to answer questions as they arise? Should the procedures provide for a system by which employees can report violations of the controls in place to protect nonpublic information or other inappropriate activities? The Commission encourages commenters to provide information on appropriate procedures for receiving and adequately securing material nonpublic information.

Rapid Ratings Comments: Type 2 rating agencies are never privy to non-public information by virtue of the nature of their business model of rating second parties for third parties.

(viii) the financial resources of the credit rating agency (regarding whether, among other things, a credit rating agency has sufficient financial resources to ensure that it maintains appropriate staffing levels to continuously monitor the issuers whose securities it rates and to operate independently of economic pressures or control from the companies it rates and from subscribers)."

Commission Questions: Should a credit rating agency make its audited financial statements readily available to users of securities ratings in order for such users to assess whether a credit rating agency has sufficient financial resources to satisfy the third component? What other types of financial information could a credit rating agency make available to users of securities ratings for purposes of the third component? Should a credit rating agency provide users of securities ratings with information relating to the percentage of revenue it receives from particular issuers or subscribers as compared to the credit rating agency's total revenues? Should a credit rating agency establish procedures to limit the percentage of revenues it receives from a single issuer or subscriber? How else can it be determined that a credit rating agency is financially independent of both subscribers and rated issuers?

The Commission elaborates: The Commission has proposed, however, that in order for a credit rating agency to meet the definition of the term "NRSRO," it would be required to have sufficient financial resources to ensure that it is able to comply with its procedures. For example, to meet the definition, a credit rating agency would need to have sufficient financial resources to ensure that it maintains appropriate staffing levels to continuously monitor the issuers it rates. Further, a credit rating agency with sufficient financial resources is less likely to be subject to conflicts of interest as described above because of its financial independence from subscribers and issuers it rates

Rapid Ratings Comments: Type 1 and 2 rating agencies could be asked for annual letters of comfort by the SEC along these lines. In our experience with buy-side clients none have ever sought to apply pressure on Rapid Ratings to change a rating, nor could such pressure be successful. Our ratings are generated automatically by software not by individual analysts who meet with issuers or subscribers. It is very important to recognize that Type 2 rating agencies have different structures and behavioural patterns, and should not be lumped into the same basket as Type 1 rating agencies.

The Commission elaborates: "In some instances, credit rating agencies rely on third parties that collect the information and disseminate it through proprietary data feeds. Generally, these vendors download or otherwise obtain public financial information (e.g., from 10-K's and 10-Q's) and repackage such information into data feeds to subscribers. The reliability of a credit rating agency's ratings depends, in part, on the integrity of the information upon which the credit rating agency bases its ratings. Therefore, the Commission believes that, to meet the third component of the NRSRO definition, credit rating agencies should have controls in place to reasonably assess the

integrity of the information sources they rely on in their ratings process. [13] For example, if a credit rating agency is relying on quantitative financial results, such as an issuer's quarterly earnings, provided by a third-party vendor, the credit rating agency should have a process designed to test the integrity of the vendor's information. This could include cross-checking a sample of the earnings reports against other sources such as audit reports, Commission filings (e.g., a 10-K or 10-Q), or by contacting the issuer.

Rapid Ratings Comments: We would support the use of a double-check system.

Commission Questions: Should a credit rating agency be required to test in some way the integrity of information provided directly by issuers (both public and nonpublic) 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?

Rapid Ratings Comments: Rapid Ratings has almost 8 years in working with corporate financials in its software, while its senior staff each have 15-20 years experience in this area. We also have about 5 years experience working with electronic data providers.

Rapid Ratings software was designed both as a rating tool and a forensic tool to probe for potential fraud and the risk of financial re-statement. Using only the publicly available financials for 1997-2000, the system rated Enron an average of 8 notches below investment grade during that period and picked out discrepancies between the publicly announced debt burden (given the use of 3000 SPVs to hide the debt) and the problems in debt servicing that have not been replicated elsewhere in the market. Similarly, Rapid Ratings rated Parmalat at 4-6 notches below investment grade for 6 years in a row before the company collapsed, using the manipulated data produced by Parmalat. When we received the true data released by PWC, the accounting investigator brought in by the Italian courts, Parmalat's rating fell 10% to our long term forecast. Hence, our system can measure the extent of cheating as well as probability of manipulation. With some exceptions, the companies that cheat on their financials have been declining or stagnating at lower levels for a few years. But the system is not perfect. Where a company has two completely different sets of books (one set honest and one not), and the completely fabricated set is presented, our system can be fooled. But this rarely happens. Most of the time, companies manipulate part of the balance sheet or part of the income statement, or part of both, but generally not all of each. Our use of 62 financial ratios, each with an industry-specific weight designed to detect the significance of the variable in anticipating success or distress in that industry, helps to point out the discrepancies resulting from the manipulation of financials.

We have also spent many years testing data from companies financial reports as compared to the data presented by electronic providers of large data sets of corporate financials. Our experience reveals that the error, which is dependent on the data entry judgment and habits of each provider, is minimal (in terms of our overall score) from the data provided by the company in its annual report, which is a perfectly acceptable margin of error.

Commission elaborates: "It was noted by commenters that requiring contact with issuer management could act as a barrier to entry for smaller credit rating agencies that cannot compel issuers to engage in a dialogue. Other commenters indicated that issuer management would be less inclined to talk to credit rating agencies issuing lower ratings.

Rapid Ratings Comments: We think that those are logical conclusions. We urge the Commission to adopt a rule that does not impose a barrier to entry.

The Commission elaborates: "The Commission's proposed definition of the term "NRSRO" does not explicitly limit the definition of the term "NRSRO" to entities that systematically contact an issuer's senior management.

Rapid Ratings Comments: We welcome that statement.

The Commission elaborates: "Nonetheless, it could be important for a credit rating agency whose credit ratings will be used for regulatory purposes to involve in the rating process, when possible, an issuer's senior management, or, in the case of issuers of asset-backed securities, other appropriate parties."

[13] The Commission clarifies: "We do not intend here to suggest that a credit rating agency must audit or otherwise ensure the accuracy of an issuer's financial condition."

Commission Questions: "In designing and implementing systematic procedures to ensure credible and reliable ratings, should a credit rating agency seeking to meet the definition of NRSRO address how and the extent to which it involves an issuer's senior management in the rating process? To meet the proposed NRSRO definition, should a credit rating agency's procedures require that the credit rating agency request an issuer's senior management to participate in the credit rating agency's rating process without incurring a fee?

The Commission elaborates: "The Commission is sensitive to the costs and benefits that result from its rules. We have identified certain costs and benefits of the proposed rule and request comment on all aspects of this cost-benefit analysis, including identification and assessment of any costs and benefits not discussed in the analysis. The Commission requests data to quantify the costs and the value of the benefits identified. The Commission seeks estimates and views regarding these costs and benefits from market participants who might be impacted by the proposed rule, including credit rating agencies, independent credit analysts, broker-dealers, mutual fund companies, securities issuers, and investors."

Rapid Ratings Comments: Rapid Ratings software-based rating process does not typically earn fees from rating issuers, nor does it solicit such business in the US. Currently, Rapid Ratings produces ratings for approximately 7000 companies each year (including 3500 US listed companies), and is actively testing data for another 8,000 companies in the US and abroad. It would be virtually impossible in terms of time and prohibitively expensive in terms of transaction costs for us to liaise with each company for which we issue ratings. It would be a significant entry barrier for Rapid Ratings to achieve NRSRO status if these liaisons we required, for the reasons stated above.

Type 2 rating agencies can add a significant degree of efficiency to capital markets by spotting discrepancies that the ratings agencies, the share price, the bond spreads and the credit default swap spreads cannot pick up because of the limitations in those signals, tools or methods. Why hamstring them with Type 1 rating agency criteria? We believe that the Commission should introduce sufficient flexibility in the NRSRO definition to permit alternative pricing models.

PART IV OF OUR RESPONSE

(d) Miscellaneous

Standardized Rating Symbols

The Commission elaborates: "Several commenters responded to the Commission's request on whether NRSROs should use uniform rating symbols to reduce the risk of marketplace confusion. Commenters generally supported the idea of uniform rating symbols by NRSROs, indicating that such standardization would be particularly helpful if the number of NRSROs increase.However, one credit rating agency indicated that mandated uniformity of rating symbols could mislead investors into assuming that all NRSRO credit ratings are comparable and involve the same analytical judgments, ratings criteria, and methodologies. Another commenter suggested that rather than establish uniform rating symbols, the Commission should require each NRSRO to annually disclose the definition and historic default rates for the rating symbols it uses. The Commission is not proposing to standardize the use of rating symbols by NRSROs. While the symbols used by an NRSRO to distinguish securities of varying risks may technically differ both in form and in meaning from those used by other NRSROs (e.g., S&P's lowest investment grade rating category for corporate debt securities is "BBB" and Moody's is "Baa"), the similarities in NRSROs' rating symbols (including the symbols previously used by entities that received NRSRO no-action letters but no longer exist) suggests the existence of a market-based standard. Similarly, there appears to be an existing market-based standard for credit rating agencies to have a consistent number of rating categories for distinguishing securities of varying risks. This latter standard is important for purposes of the NRSRO concept because a number of Commission rules referencing the term "NRSRO" also reference the NRSRO's levels of rating categories. For example, paragraph (c)(2)(vi)(F) of the net capital rule sets forth regulatory capital charges for proprietary positions of broker/dealers in nonconvertible debt securities rated in "one of the four highest rating categories" by at least two NRSROs.

Commission Questions: 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?

Rapid Ratings Comments: Rely on existing market-based standards.

Statistical Models

The Commission elaborates: "In the 2003 Concept Release, the Commission inquired whether credit rating agencies that solely use statistical models and no other qualitative inputs should be able to qualify as NRSROs. There was a general consensus among commenters that computerized statistical models may be helpful in the credit rating process, but that a credit rating agency that solely uses statistical models should not qualify as an NRSRO. Most commenters responding to this question identified limitations with regard to the use of such models for providing in-depth credit analysis. One commenter stated that the Commission staff does not have the expertise to evaluate the types of models used by most credit rating agencies. However, one commenter noted that purely quantitative credit models have gained acceptance by credit risk managers in recent years, and that such models should be further considered before restricting NRSRO status to companies who do not solely rely on statistical models. Although commenters were generally of the view that credit rating agencies that rely solely on statistical models should not qualify as NRSROs, the Commission, in proposing to define the term "NRSRO," is not precluding through this proposed definition the possibility that a credit rating agency with a more quantitative business model than the current NRSROs could meet the definition of NRSRO. Accordingly, the proposed definition of the term "NRSRO" and the interpretations to the definition contained in this release should not be construed as excluding a credit rating agency that significantly relies on quantitative statistical models in developing credit ratings.

Rapid Ratings Comments: We are grateful that the Commission has taken the first step in accepting that there are both Type 1 and Type 2 rating agencies.

Commission Questions: Should a credit rating agency that relies solely or primarily on statistical models be able to meet the proposed NRSRO definition? If so, under what circumstances? The Commission also requests comment on guidelines for assessing the relevance and reliability of statistical models used in the ratings process.

Rapid Ratings Comments: Yes, Type 2 rating agencies should be permitted to meet the NRSRO definition, but the definition needs to be structured to eliminate the anti-competitive elements noted above in our submission and the cover letter.

Type 2 agencies are innovators of new technology, as is the case for most small businesses, and they have a track record of providing early warnings of company distress and default.

Provisional NRSRO Status

The Commission elaborates: "In the past, a number of observers have criticized the regulatory use of the NRSRO concept – particularly the "national recognition" requirement – as creating a substantial barrier to entry. In essence, these critics contend that important users of securities ratings have a regulatory incentive to obtain ratings issued by NRSROs, and that without NRSRO status new entrants encounter great difficulties achieving the "national recognition" necessary to obtain an NRSRO no-action letter. For example, the U.S. Department of Justice ("DOJ"), commenting on the Commission's 1997 rule proposal, opposed the use of the "national recognition" requirement because, in its view, that criterion likely creates a "nearly insurmountable barrier to new entry into the market for NRSRO services." DOJ believed that, while the historical dominance of Moody's and S&P had eroded in recent years for certain types of securities ratings, the overall level of market power they retained continued to be a competitive concern. To ameliorate entry barriers, DOJ suggested the Commission consider giving "provisional" NRSRO status (for the first 12 to 18 months of existence) to newly-formed credit rating affiliates of established, well-capitalized firms that have reputations for quality financial analysis in the investment community (e.g., investment banks, commercial banks, insurance companies, consulting firms, or accounting firms). DOJ also recommended the Commission consider "provisional" NRSRO status for foreign rating agencies, and indicated they might initially specialize in rating U.S. companies with substantial operations abroad.

In response to these concerns, the Commission, in the 2003 Concept Release, sought comment on whether to consider a "provisional" NRSRO status for credit rating agencies that comply with NRSRO recognition criteria but lack national recognition. Most commenters generally did not support the concept of "provisional" NRSROs. Commenters supporting provisional NRSROs indicated that permitting them could promote competition among credit rating agencies by facilitating the entry of high quality but lesser-known credit rating agencies. One commenter stated that credit rating agencies that provide quality ratings but are not national in nature could be provisional NRSROs, while another commenter represented that it would support a time-limited provisional

NRSRO status if the Commission retains the "widely accepted" criterion. Commenters opposing the idea of provisional NRSROs represented that permitting two classes of NRSROs would likely cause marketplace confusion, and that permitting provisional NRSROs would have little, if any, effect on a credit rating agency's ability to compete with the larger NRSROs. Several commenters also indicated that certain investors likely would not use ratings from "provisional" NRSROs for regulatory purposes because securities purchased based on a provisional NRSRO's ratings would possibly have to be sold if the provisional NRSRO failed to continue to meet the definition. The Commission has considered the responses to the 2003 Concept Release and has decided at present against creating a "provisional" NRSRO status. The Commission's use of the term "NRSRO" is intended to reflect the fact that the marketplace views a credit rating agency's ratings as credible and reliable. Without such assurance as to the quality of the ratings issued by a credit rating agency, it may be inappropriate to rely upon a credit rating agency's ratings as a proxy for credit quality in regulation. The Commission understands that the rationale for permitting provisional NRSROs is to promote competition in the credit rating industry. To this end, defining the term "NRSRO" to include credit rating agencies that confine their activities to limited sectors of the debt market or to limited (or largely non-U.S.) geographic areas may be a more reasonable approach that attempts to address the concerns raised by commenters and preserve the Commission's intended regulatory objectives. The Commission also notes with respect to the competitive concerns raised by commenters that since the term "NRSRO" was first used in the mid-1970's, several credit rating agencies have been able to enter the credit rating business and achieve the requisite level of market acceptance to receive NRSRO no-action letters.

Commission Question: Does the Commission's proposed NRSRO definition and approach for promoting competition address the competitive concerns raised by commenters' supporting provisional NRSROs?

Rapid Ratings Comments: We are not concerned about deleting the opportunity for creating "provisional NRSROs". While we appreciate the initiative of the Commission moving forward the potential for recognizing Type 2 rating agencies which rate second partis and sell ratings to third party subscribers and that use software or quantitative methods, several barriers to entry in the current discussion:

(1) requiring Type 2 rating agencies to release their ratings on the internet at no cost.
(2) requiring Type 2 rating agencies to liaise with each of the companies that it rates. Rapid Ratings currently rates about 15,000 companies globally, and roughly 3,500 in the US.
(3) Reinterpreting "generally accepted" and "publicly available" along the lines proposed above by Rapid Ratings.

If this cannot be done, then the fall back position would be to argue for the retention of "provisional NRSRO status."

Staff No-Action Process

The Commission elaborates: "Currently, a credit rating agency initiates the no-action letter process by requesting a no-action letter that will state that the Commission staff will not recommend enforcement action against persons who use the firm's credit ratings for purposes of the Commission's net capital rule. Upon receipt of such a request, the Commission staff typically sends a letter to the credit rating agency requesting detailed information regarding the criteria discussed above. After receiving this detailed information, the Commission staff meet with the credit rating agency for an on-site meeting. During this meeting, the credit rating agency's senior management, analysts, and other persons who are knowledgeable about the firm's policies and procedures are interviewed. The Commission staff also contacts and interviews references provided by the credit rating agency and others to assess, among other things, the references' use of the credit rating agency's ratings, whether they believe the credit rating agency issues credible and reliable ratings, and how the credit rating agency compares to other credit rating agencies. The Commission staff then determines whether the credit rating agency[14] meets the NRSRO criteria and either issues the requested no-action letter, or informs the credit rating agency of its decision not to so issue a letter.

"There was strong support in response to the 2003 Concept Release for the Commission to establish a time period to serve as a goal for acting on requests for NRSRO status. Some commenters addressing this issue thought that the process for seeking NRSRO status should include deadlines once a credit rating agency has submitted all

[14] "These interviews have been useful indicators of a credit rating agency's marketplace recognition, and the Commission anticipates that, in connection with the noaction process, the staff will continue to interview references and other predominant users of securities ratings in determining which credit rating agencies should receive a noaction letter."

required information, and that such a time period could enhance the market's perception of the NRSRO process and afford greater certainty to a credit rating agency as to when a ruling will be made on its request. Some commenters believed that the Commission should act on a request for a noaction letter within 90 to 120 days after an entity has submitted all required information. Some commenters noted, however, that flexibility should exist if circumstances arise and an additional investigation needs to be conducted. Several commenters stated that credit rating agencies that do not obtain no-action letters should[15] be notified as to why so that they can improve their operations in the specified areas and increase their chances of submitting a successful request in the future. In this regard, we would expect that no-action requests would be considered by the staff, and resolved, in a timely fashion. The Commission believes that, if it were to adopt a definition of the term "NRSRO," the staff should be able to act on NRSRO noaction requests within 90 days after a credit rating agency has submitted all necessary information. Like any staff no-action position, the staff's views on whether an entity meets the definition of NRSRO would be conditioned on the facts and representations made by the entity. Of course, if the facts and circumstances upon which the staff relied to provide its guidance change, the staff position may no longer be applicable. In this regard, given the changing market conditions in this context, we understand that the staff will include expiration dates in NRSRO no-action letters that it issues. In addition, the staff's views on issues may change from time-to-time, in light of reexamination, new considerations, or changing conditions that indicate that its earlier views are not longer in keeping with the objectives of the proposed NRSRO rule or with the regulatory use of NRSRO ratings.

Rapid Ratings Comments: We welcome this proposal.

Benefits

The Commission elaborates: "The proposed rule would define the term "NRSRO" and thereby enhance the use of the NRSRO concept in Commission rules and regulations. Specifically, it would provide greater clarity to determine whether credit rating agencies are NRSROs. This would also assist credit rating agencies that are currently NRSROs in understanding how they can continue to meet the definition. For credit rating agencies that are not currently NRSROs, the definition would provide a better understanding of the enhancements necessary to meet the definition. This could reduce concerns related to barriers to entry for credit rating agencies seeking to become NRSROs. Moreover, concerns about barriers to entry also could be reduced by the interpretations of the proposed definition that would recognize credit rating agencies with an expertise in a particular industry or geographic region. This component could be particularly beneficial to smaller credit rating agencies in their efforts to meet the proposed definition of NRSRO. By lowering the barriers to entry identified above, the proposed rule could potentially increase the number of NRSROs. Issuers would be provided with more choices in terms of selecting NRSROs to rate their debt securities, which could lower their costs for this service. The greater competition in the market for credit ratings and analysis could provide for more credible and reliable ratings. Greater competition also could stimulate innovation in the technology and methods of analysis for issuing credit ratings, which could further lower barriers to entry. As previously noted, the NRSRO concept was first used by the Commission for the purposes of determining capital charges for broker-dealers with respect to their proprietary debt securities. Broker-dealers benefited from this use of the NRSRO concept in that it provided a simple regulatory benchmark. At the same time, the NRSRO concept benefited customers and counterparties of broker-dealers by linking the capital charge (and, consequently, the broker-dealers' capital adequacy) to a rating that is recognized by the marketplace as reliable and credible. These benefits would continue under the proposed rule. The benefit of the NRSRO concept as a regulatory benchmark and the beneficial impact of the proposed definition is indicated by its use in various other Commission rules and regulations.

Rapid Ratings Comments: The barriers to entry are not being lowered as much as might be expected.

Costs

The Commission elaborates: "The proposed rule would impose some costs on existing NRSROs. They could incur some costs in evaluating themselves against the proposed definition, and in seeking renewal of their no-action letters, should the Commission adopt a definition of NRSRO. However, in this regard, we note that the proposed definition of "NRSRO" is generally consistent with the criteria historically used by the Commission staff to identify NRSROs for purposes of no-action relief under the Commission's net capital rule. The proposed definition would not impose direct costs on credit rating agencies that do not currently meet the proposed definition of "NRSRO," since these entities would not be within its scope. A non-NRSRO credit rating agency likely would

[15] When issuing an NRSRO no-action letter, the Commission staff has consistently conditioned such letters on credit rating agencies not representing in any of their ratings, marketing, or similar literature that the Commission considers the credit rating agency to be an NRSRO.

incur costs if it sought to become an NRSRO, or needed to enhance its activities and operations to meet the NRSRO definition. An entity that is recognized nationally by the predominant users of credit ratings as issuing credible and reliable ratings generally would meet the proposed definition of "NRSRO" or would be able to meet the definition with little incremental cost. Accordingly, a credit rating agency seeking to meet the definition of "NRSRO" would not incur costs beyond those that normally would be expended to gain acceptance in the marketplace, on a national level, as a credit rating agency that is recognized as issuing credible ratings. As such, the Commission does not believe that the proposed definition would increase costs for a rating agency seeking to be an NRSRO.

"The Commission also notes that the internet permits credit rating agencies to publish their ratings to a worldwide audience – i.e., make the ratings publicly available – for a minimal cost. Thus, a credit rating agency could meet this component of the proposed definition without incurring substantial costs. Moreover, under the proposed definition, a credit rating agency could become an NRSRO if it is generally accepted in the financial markets as an issuer of credible and reliable ratings for a particular industry or geographic segment. This could make it easier for a smaller entity, with a specific ratings expertise, to become an NRSRO. As such, over time, the proposed definition could reduce costs by making it easier for a credit rating agency that focuses on a particular geographic area or sector to be an NRSRO.

"The Commission seeks comment on the costs that would be incurred by a non-NRSRO credit rating agency to meet the proposed definition. As mentioned above, to assist the Commission in evaluating the costs and benefits that may result from the proposed rule, the Commission requests comment on the potential costs and benefits identified in the release, as well as any other costs or benefits that may result from the proposed rule. In particular, the Commission requests comments on the potential costs for any modification to both computer systems and surveillance mechanisms and for information gathering, management, and recordkeeping systems or procedures, as well as any potential benefits resulting from the proposals for registrants, issuers, investors, brokers or dealers, other securities industry professionals, regulators, and others. The Commenters should provide analysis and data to support their views on the costs and benefits.

The Commission has found that opinions differ regarding the critical elements for success in the credit rating business (e.g., staff, experience, capital), and this may lead to varying views on the precise nature and extent of the costs and benefits.

Rapid Ratings Comments: The costs imposed by the "no cost rule" and the possible "consultation rule" are very high.

Commission Questions:

(a) **"**The Commission poses the following questions regarding the proposed rule: What are the costs for an entity to operate as a credit rating agency that is recognized on a national level by the predominant users of credit ratings as issuing credible and reliable ratings?

(b) What are the costs for an entity to enter into the credit rating business with respect to rating securities within a specific industry or geographic segment?

(c) What additional costs would such an entity incur to achieve national recognition? In answering these questions, commenters should provide detailed information on, or estimates of, the costs associated with maintaining an office, a staff, and the necessary communications and information systems and equipment as well as costs related to publishing credit ratings. We also seek comment on whether costs related to technology have significantly increased in recent years.

Rapid Ratings Comments:

For a Type 2 rating agency, the costs enumerated above are normal costs of developing a business and would not pose a barrier to entry. The two main cost-related barriers to entry involved in NRSRO status are: (1) the cost of giving away ratings for free because the Type 2 rating agency is dependent on subscriptions for revenue; and (2) the cost of consulting with all the companies it rates (who are not typically its customers). It will be extremely costly and difficult for a Type 1 rating agency to be recognized by the predominant issuers of publicly available securities instruments on any level, including on a national, geographic or specialty basis. To gain issuer usage, a Type 1 rating agency must have market power and penetration. This is an insurmountable task. Issuers of publicly available securities instruments rely almost exclusively on Moody's and S&P -even though there are three

other NRSROs- precisely because of their market power and penetration. Issuers have not supported new market entrants, including DBRS and AM Best, with a large increase in market share. Therefore, new Type 1 rating agencies must provide, at no charge to the issuer and to the market, years of consistently accurate ratings of publicly available securities instruments and then rely on the hope that issuers and the market will equate them with Moody's and S&P. This will be extremely expensive to achieve. Given the fact that there have been so few entrants into the NRSRO market since 1975 and neither Fitch nor DBRS or AM Best have been able to take market share from Moody's or S&P, it seems unlikely that a new Type 1 rating agency will ever become recognized by the predominant issuers of publicly available securities instruments. But, Type 2 rating agencies, which have a software-based or quantitative model-based low cost advantage and which can rate thousands of companies quickly, have the ability to become strong future rivals to the dominant traditional rating agencies, if their business model remains intact (getting paid by third parties) and if barriers to entry are removed or significantly lowered. For Type 2 rating agencies, issuers could become subscribers, but nothing more.

Consideration on Burden and Promotion of Efficiency, Competition, and Capital Formation

The Commission elaborates: "Section 3(f) of the Exchange Act requires the Commission, whenever it engages in rulemaking and must consider or determine if an action is necessary or appropriate in the public interest, to consider whether the action would promote efficiency, competition, and capital formation.152 In addition, Section 23(a)(2) of the Exchange Act requires the Commission, when making rules under the Exchange Act, to consider the impact of such rules would have on competition.153 Exchange Act Section 23(a)(2) prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. The Commission preliminarily believes that the proposed definition of "NRSRO" would not impose any burdens on efficiency, capital formation and competition and would, in fact, promote these interests. The proposed definition would provide greater clarity to the process by which credit rating agencies become NRSROs. This would also assist credit rating agencies that are currently NRSROs in understanding how they could meet the proposed definition. For credit rating agencies that are not currently NRSROs, the definition would provide a better understanding of the enhancements necessary to meet the proposed definition. This could reduce concerns regarding barriers to entry for credit rating agencies seeking to become NRSROs. Moreover, concerns about barriers to entry also could be reduced by the component of the proposed definition that would recognize credit rating agencies with an expertise in a particular industry or geographic region. This component could be particularly beneficial to smaller credit rating agencies in their efforts to meet the proposed NRSRO definition. By lowering any barriers to entry discussed above, the proposed rule could potentially increase the number of NRSROs. Issuers could be provided with more choices in terms of selecting NRSROs to rate their debt securities, which would lower their costs for this service. The greater competition in the market for credit ratings and analysis could provide for more credible and reliable ratings. Greater competition also could stimulate innovation in the technology and methods of analysis for issuing credit ratings, which could further lower barriers to entry. The Commission believes the resulting increased clarity from the proposed definition could have some positive impact on capital formation. As noted in the Benefits Section in Section VI., a number of Commission rules and regulations use the NRSRO concept. For example, certain regulations provide safe harbors to small businesses issuing securities and to all issuers in making non-financial statements in securities registrations.154 The NRSRO concept also is used in defining which debt securities can be held by a money market fund.155 In addition, as noted throughout, the NRSRO concept is used in the broker-dealer capital rule. Finally, states, foreign governments, and private entities use the NRSRO concept as well. The proposed definition, by codifying a component of the NRSRO concept, would provide clarity to its use in these rules and regulations which all relate in some respects to the issuance of debt securities. Accordingly, the proposed definition could assist in the underwriting and making of markets in corporate debt. While we believe the proposed definition could lower any barriers to entry and promote competition, we recognize that some market participants have argued that the NRSRO concept impedes competition by creating unreasonable barriers to entry. There is a widespread view that one of the most significant natural barriers into the credit rating business is the current dominance of a few highly-regarded, well-capitalized rating agencies that pioneered the industry many decades ago. This view may, in part, be a consequence of the fact that, until the mid-1970s, only a handful of firms (primarily three of the five current NRSROs) issued credit ratings on securities. These firms developed substantial brand names during the period when they were the only entities issuing securities ratings. Since the mid-1970's, however, there has been a steady increase in the number of credit rating agencies operating in the U.S. and internationally, so that today it is estimated that there are more than 100 active credit rating agencies worldwide. It should be noted that this growth in the number of entities issuing securities ratings began after the Commission started using the NRSRO concept for regulatory purposes. The expansion suggests a growing interest among market participants for advice about credit quality, and that new entrants are able to develop a following for their credit judgments. The Commission staff also has provided no-action letters to several small credit rating agencies since it began using the NRSRO concept for regulatory purposes. Several of these entities received no-action letters within five or six years of the

date they began issuing securities ratings. The Commission preliminarily believes this may demonstrate that the proposed "NRSRO" definition could be met by small firms and, accordingly, appears to indicate that the proposed definition would not act as an unreasonable barrier to their meeting the definition of NRSRO. The Commission believes that, at this time, eliminating the NRSRO concept would not be prudent, nor in the interest of investors and securities market participants. For example, the concept provides an easily ascertainable and non-arbitrary regulatory benchmark for broker-dealers to compute their capital charges. At the same time, it provides that broker-dealers will use credit ratings that are recognized by the marketplace as credible and reliable and issued by entities that have adequate financial resources and operational capability. These assurances enhance a broker-dealer's capital adequacy and, thereby, protect customers and counterparties. Users of credit ratings and others generally agree there must be substantive threshold standards for being an NRSRO for 157 Duff & Phelps, Inc. began issuing credit ratings in 1974 and became an NRSRO in 1982. McCarthy Crisanti & Maffei began issuing credit ratings in 1975 and became an NRSRO by 1983. IBCA Limited and IBCA Inc. began issuing credit ratings in 1978 and 1985, respectively, and were designated together as an NRSRO in 1990. Thomson BankWatch, Inc. entered the credit rating business in 1974 and became an NRSRO in 1991. A.M. Best began issuing credit ratings in 1999 and became an NRSRO in 2005. 158 the term to have meaning. In essence, the proposed NRSRO definition is meant to reflect the fact that the marketplace views a rating agency's ratings as credible and reliable. The Commission requests comment on all aspects of this analysis and, in particular, on whether the proposed NRSRO definition would place a burden on competition.

Rapid Ratings Comments: **While the Commission preliminarily believes that the proposed definition of "NRSRO" would not impose any burdens on efficiency, capital formation and competition and would, in fact, promote these interests, our finding is that Type 2 rating agencies would have some new barriers to entry added to the existing barriers, despite the potential recognition of rating agencies which rely largely on quantitative models and approaches.** Proposed Rule 3b-10 is not in compliance with Exchange Act Section 23(a)(2) to the extent that credit ratings be "publicly available" means that credit ratings of Type 2 rating agencies be available at no cost, because it will not promote competition within the NRSRO market. Because of the market power and penetration of Moody's and S&P, the only credible expansion of the NRSRO market is through Type 2 rating agencies, which, as discussed above, will not be able to enter the statistical rating market and qualify as an NRSRO if they are required to make their ratings publicly available at no charge, as their business model only supports payment for their ratings from third party subscribers and not from second party issuers. The entrance of Type 2 companies into the NRSRO market is a requirement for the NRSRO's market's expansion, as there is no credible support for additional Type 1 NRSRO rating agencies because the market will continue to demand that issuers obtain ratings specifically from Moody's and S&P. Fitch, DBRS and AM Best, individually and collectively, have made no significant inroads into the NRSRO market share of Moody's and S&P. ***Additional Type 1 rating agencies will only take market share from these second tier players and not from Moody's and/or S&P.***

Consideration of Impact on the Economy

The Commission elaborates: **"**For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, or "SBREFA,"160 we must advise the Office of Management and Budget as to whether the proposed regulation constitutes a "major" rule. Under SBREFA, a rule is considered "major" where, if adopted, it results or is likely to result in: (1) an annual effect on the economy of $100 million or more (either in the form of an increase or a decrease); (2) a major increase in costs or prices for consumers or individual industries; or (3) significant adverse effect on competition, investment or innovation. If a rule is "major," its effectiveness will generally be delayed for 60 days pending Congressional review. We request comment on the potential impact of the proposed rule on the economy on an annual basis. Commenters are requested to provide empirical data and other factual support for their view to the extent possible.

Rapid Ratings Comments: Proposed Rule 3b-10 will have an effect on Type 2 rating agencies to the extent that credit ratings be "publicly available" means that credit ratings be available at no cost. However, if credit ratings are not required to be made available at no cost, Rapid Ratings estimates that its business in the United States would increase significantly if it acquired NRSRO status. The NRSRO designation will increase the marketability of Rapid Rating to third-party users of credit ratings in the United States. *See also* comments above and in the cover letter.

Regulatory Flexibility Act

The Commission elaborates: **"**Pursuant to section 605(b) of the Regulatory Flexibility Act ("RFA"), the Commission hereby certifies that proposed Rule 3b-10, would not, if adopted, have a significant economic impact on a substantial number of small entities. Under the RFA, the term "small entity" shall have the same meaning as the RFA defined term "small business." According to section 601(3) of the RFA, "the term 'small business' has the

same meaning as the term 'small business concern' under section 3 of the Small Business Act (15 U.S.C. 632), unless an agency, after consultation with the Small Business Administration and after opportunity for public comment, establishes one or more definitions of such term which are appropriate to the activities of the agency and publishes such definition(s) in the Federal Register." If the agency has not defined the term for a particular purpose, the Small Business Act states that "a small business concern…shall be deemed to be one which is independently owned and operated and which is not dominant in its field of operation." The Commission has not defined the term "small entity" in the context of NRSROs for purposes of the RFA. Therefore, for purposes of this rulemaking, the Commission is using the broader definition of "small business concern" as defined in the Small Business Act. Currently, there are five credit rating agencies that we believe would meet the proposed definition of "NRSRO." Only two of the NRSROs are independently owned and operated. However, the two independently owned NRSROs are dominant in their respective fields as one has earned a national reputation for issuing ratings on insurance companies and the other on Canadian issuers. Accordingly, there are no small entities that currently would meet the proposed definition of NRSRO.

"As noted above, it has been estimated there are between 100 and 150 entities that issue credit ratings or credit analysis. It is likely that a substantial number of these credit rating agencies are small entities. The proposed definition could have an impact on one of these small credit rating agencies if it sought to become an NRSRO. However, in this regard, the proposed definition of NRSRO would closely track the current process under which the staff issues no-action letters. Thus, while the proposed definition may impact a small credit rating agency, such impact would likely be small. For the above reasons, the Commission certifies that proposed Rule 3b-10 would not have a significant economic impact on a substantial number of small entities. The Commission requests comments regarding this certification. The Commission requests that commenters describe the nature of any impact on small businesses and provide empirical data to support the extent of the impact.

Rapid Ratings Comments: We have concerns that Proposed Rule 3b-10, if adopted, would have an material economic impact on Rapid Ratings with respect to section 601(3) of the RFA, and section 3 of the Small Business Act (15 U.S.C. 632), but we have not had the time to investigate

We would be pleased to respond to any further inquiries of the Commission with respect to this comment letter and, if appropriate, to meet with members of the Commission staff to discuss the proposal. Please contact our Managing Director and CEO Dr. Patrick Caragata, at **info@rapidratings.com**.