

**REFORMING CREDIT RATING AGENCIES:
THE SEC'S NEED FOR STATUTORY
AUTHORITY**

HEARING
BEFORE THE
SUBCOMMITTEE ON
CAPITAL MARKETS, INSURANCE AND
GOVERNMENT SPONSORED ENTERPRISES
OF THE
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U.S. HOUSE OF REPRESENTATIVES
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REFORMING CREDIT RATING AGENCIES: THE SEC'S NEED FOR STATUTORY AUTHORITY

Tuesday, April 12, 2005

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE,
AND GOVERNMENT SPONSORED ENTERPRISES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to call, at 2:05 p.m., in Room 2128, Rayburn House Office Building, Hon. Richard Baker [chairman of the subcommittee] presiding.

Present: Representatives Baker, Ryun, Kelly, Brown-Waite, Hensarling, Kanjorski, and Wasserman Schultz.

Chairman BAKER. [Presiding.] I would like to call this meeting of the Capital Markets Subcommittee to order.

Today, the committee meets for the purpose of receipt of testimony from Annette Nazareth, who is the director of the Division of Market Regulation of the U.S. Securities and Exchange Commission.

The committee has had for some number of years interest in and perhaps concern for the manner by which rating agencies are regulated and overseen in their function, consistent with the requirements of the Investment Company Act, which when a public operating company chooses to issue debt and enter the public markets, must receive at least two ratings from independent rating agencies for that debt to be properly issued. That, of course, sets in motion a number of concerns as to the independence and insightfulness of the agencies which are charged with the responsibility to conduct these ratings.

A brief summary of our history and how we arrive at our hearing today, it was in 1994 that the SEC first established the nationally recognized credit rating agency definition and left unclear exactly what it was required of an entity to become an NRSRO. Subsequent to the 1994 establishment of that principle, in 1997 the agency issued a subsequent release which was not adopted because of opinions issued in writing by the Department of Justice indicating that the standards attempting to be established would prohibit, in all likelihood, entry into the market or make it substantially difficult so that there would not be an ability of competitors to enter into the rating agency business.

In 2003, the SEC issued another release posing 54 questions for public comment. A number of issues were raised as a result of

those responses and yet no action of a substantive form was taken at that time. A rule is now pending issued by the SEC which is making the attempt, as I view it, to redefine what constructs the elements of an NRSRO. There are three specific items listed, but unfortunately I have come to the conclusion that those elements are not sufficiently different or unique from the understandings originally posed by the term "NRSRO."

Subsequently to the 2003 questions issued to stakeholders and the number of issues raised in that release and public comment period, I consider the current rule to be inadequate in scope and in content. In order to make the point of our concerns, there is publicly disclosed information by one rating agency on its financials and in the year 2004 enjoyed an unbelievable 690 percent return on equity. I know of no other public operating company that is even close. While more remarkably, the other principal agency engaged in the market does not even disclose its financials at all.

Further, there has been neither establishment of nor disclosure of the methodologies by which a rating agency enters into a corporation and comes to its ratings determinations. That remains unclear. The ability to rate a public operating company without being requested by that company, and of course subsequently sending the company an invoice, presents some clear ethical question, at least in my mind, that needs to be addressed.

In summary, I feel that the rating agencies are somewhat of mystical anointed monopoly, not unlike our good friends Fannie and Freddie, but with even less accountability. I hope today in the course of our questions and answers with Ms. Nazareth to be able to come to a better understanding of what action, if any, the Congress should take in assisting the SEC to come to final resolution on all these matters of public importance.

Mr. Kanjorski?

Mr. KANJORSKI. Thank you, Mr. Chairman.

We meet for the third time in the last 2 years to explore the issue of regulating credit rating agencies. As I have regularly noted during the past examinations, entities like Moody's, Standard and Poor's, and Fitch have long published their views on the credit worthiness of issuers of debt securities. The significance of these opinions has also greatly expanded in recent years as a result of increases in the number of issues and issuers, the globalization of our financial markets, and the introduction of complex financial products.

Although rating agencies received some scrutiny after the recent surge of corporate scandals, we have not yet mandated any substantive changes in their practices. One witness at one of our past hearings nevertheless noted that the agencies "played a significant role" in Enron's failure. A Senate investigative report also determined that the monitoring and review of Enron's finances "fell far below the careful efforts one would have expected from organizations whose ratings hold so much importance."

Outside Enron's auditors, the rating agencies probably had the greatest access to non-public information about the firm's complicated financial arrangements. Even with this data, the agencies exhibited a disappointing reliability in the accuracy of their coverage. In fact, the three existing nationally recognized statistical

rating organizations at the time of Enron's failure, rated the company at investment-grade until 4 days before its bankruptcy filing.

The failure of the nationally recognized agencies to lower their credit ratings in a timely manner in this case and other instances such as the WorldCom bankruptcy, New York City's debt crisis, Washington Public Power Supply System's default, and Orange County's collapse has resulted in great financial losses for many Americans who little understood the true credit risks of their investments.

This issue is therefore one on which we should focus our attention in the 109th Congress. During our past hearings, it has also become increasingly clear to me that while our capital markets and the rating industry have evolved considerably in recent years, the Commission's rules in this area have changed little, even though it has studied these issues for more than a decade. Additionally, The Washington Post late last year in a series of investigative reports on credit ratings concluded that although the agencies with national recognition are the gatekeepers of capitalism, they have no commensurate oversight or accountability.

The regulation of rating agencies, I believe, is ripe for examination and action. I know that the Securities and Exchange Commission agrees. Today's witness, Annette Nazareth, the Commission's Director of Market Regulation, has previously observed that while rating agencies have generally performed their work well for nearly a century, they have also missed some colossal failures in recent years. She has further described our debt markets as the dark corner of the securities industry. The time has come to shine some light into this dimly lit field.

Accordingly, I was pleased that the Commission recently and finally put forward for public comment a proposed rule to define what constitutes a nationally recognized statistical rating organization and the process for making such a designation. While this proposal is a good step, more still needs to be done in the area of rating agency oversight. The agencies, as I am aware, are also working with the Commission to establish a voluntary framework to improve transparency.

While some hope that this agreement will be effective, many have lingering doubts. After all, Chairman Donaldson has already indicated that he does not have the confidence that these discussions will result in substantive reforms because the existing agencies with national recognition have taken the position that they will not allow the Commission to conduct inspections or take enforcement actions.

As you know, Mr. Chairman, top officials at the Commission have also regularly suggested that additional legislative authority may be needed in the area of rating agencies. Consequently, I have come to conclude that it is time for us to ask the Commission what specific authorities it believes it needs to effectively oversee rating agencies. I will therefore be sending a letter to the Commission after today's hearing to request this technical assistance. The Congress will ultimately decide whether to consider a bill related to these issues, but obtaining the insights of the experts at the Commission will help us in crafting an appropriately balanced piece of legislation that addresses First Amendment concerns.

Learning of the Commission's views now on the needed statutory authority will also help us to expedite future action if the voluntary framework negotiations break down or result in a flawed product.

In closing, Mr. Chairman, we must act to ensure the continued integrity of the rating agencies and the credit rating process. I also look forward to hearing from our witness today and to moving forward prudently and promptly on these important matters.

[The prepared statement of Hon. Paul E. Kanjorski can be found on page 28 in the appendix.]

Chairman BAKER. I thank the gentleman.

I am advised that no other member desires to make an opening statement at this time, but all members' statements, if submitted, will be made part of the official record.

At this time, I would like to recognize Ms. Annette Nazareth, Director, Division of Market Regulation.

Your official statement will be made part of the record. Please proceed at your leisure, and welcome.

STATEMENT OF ANNETTE NAZARETH, DIRECTOR, DIVISION OF MARKET REGULATION, UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Ms. NAZARETH. Thank you, Chairman Baker, Ranking Member Kanjorski and members of the subcommittee. Thank you for the opportunity to testify before you today on behalf of the Securities and Exchange Commission.

Today, I plan to provide you with an overview of the SEC's recent work concerning credit rating agencies. I will begin with a brief history of the SEC's involvement in this area and then I will discuss recent SEC initiatives regarding credit rating agencies.

Since 1975, the SEC has relied on credit ratings by market-recognized rating agencies for distinguishing among grades of credit worthiness in various rules under the federal securities laws. These nationally recognized statistical rating organizations, or NRSROs, have received no-action letters from the SEC staff. To date, nine firms have received such no-action letters. However, during the 1990s, several NRSROs consolidated so that there are currently five such NRSROs: A.M. Best Company, Dominion Bond Rating Service, Limited, Fitch, Inc., Moody's Investor Service, Inc., and Standard and Poor's Division of McGraw Hill Companies, Inc.

The term "NRSRO" was originally adopted by the Commission solely for determining capital charges on different grades of debt securities under the Commission's net capital rule for broker-dealers. Over time, however, the NRSRO concept has been incorporated into a number of additional SEC rules and regulations, including rules issued under the Securities Act of 1933, the Securities Exchange Act of 1934, and the Investment Company Act of 1940.

Congress also has used the NRSRO concept in legislation, as have other regulatory bodies including banking regulators both at home and abroad. During the past few years, the Commission has pursued several approaches on its own and at the direction of Congress to conduct a thorough and meaningful study of credit rating agencies and the use of credit ratings under the federal securities laws. For example, approximately 2 years ago, the SEC responded to a congressional directive under the Sarbanes-Oxley Act of 2002

by issuing a report on the role of credit rating agencies in the securities markets.

To assist in preparing the report, the SEC held 2 full days of public hearings. Hearing participants included representatives from credit rating agencies, broker-dealers, buy-side firms, issuers and the academic community. The Sarbanes-Oxley report identified a number of substantive issues that the Commission planned to explore in more depth, including improved information flow in the credit rating process, potential conflicts of interest, alleged anti-competitive or unfair practices, potential regulatory barriers to entry in the credit rating business, and ongoing regulatory oversight of credit rating agencies.

On June 4, 2003, the SEC issued a concept release seeking public comment on the issues raised in the Sarbanes-Oxley report. Generally, the SEC sought comment on whether credit ratings should continue to be used for regulatory purposes under the federal securities laws and if so, the process of determining whose credit ratings should be used. The Commission also sought comment on the appropriate level of oversight that should be applied to credit rating agencies.

Forty-six commenters responded to the concept release. Most of the 46 commenters supported retention of the NRSRO concept. Many represented that eliminating the concept would be disruptive to the capital markets and would be costly and complicated to replace. Only four commenters supported elimination of the concept and there was very little discussion of regulatory alternatives.

Generally, commenters supported improving the clarity of the process for identifying NRSROs to the extent credit ratings continued to be relied upon by the Commission in its rules and regulations. Specifically, commenters generally supported the Commission's suggestions to specify in more detail what credit rating agencies need to provide to obtain an NRSRO no-action letter. With respect to ongoing oversight, a number of commenters recommended that the Commission enhance the staff's ability to verify whether an NRSRO continues to meet the minimum standards that led to its designation.

However, a number of commenters, including each of the current NRSROs, also raised concerns about the extent of the Commission's authority to impose requirements on NRSROs. These commenters argued that the SEC does not have explicit regulatory authority over NRSROs and that NRSRO rating activities are journalistic and are afforded a high level of protection under the First Amendment.

More recently, the Commission on March 3, 2005 voted to issue a rule proposal that would define the term "NRSRO" for purposes of commission rules. The proposal builds on earlier commission work relating to the credit rating agencies. The goal of the proposal is to provide greater clarity and transparency to the process of determining whether a credit rating agency's ratings should be relied on as NRSRO ratings for purposes of commission rules.

The proposed definition and the interpretations thereof are intended to provide credit rating agencies with a better understanding of whether they qualify as an NRSRO. The proposed definition of the term "NRSRO" is composed of three components

which the Commission believes to be the most important criteria in determining whether an entity's ratings should be relied upon for purpose of commission rules and regulations.

Specifically, the Commission is proposing to define the term as an entity that issues publicly available credit ratings that are current assessments of the credit worthiness of obligors with respect to specific securities or money market instruments; that 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 finally, uses systematic procedures designed to ensure credible and reliable ratings, manage potential conflicts of interest, and prevent the misuse of non-public information and has sufficient financial resources to ensure compliance with these procedures. These three components are described in more detail in my written testimony.

The rule proposal also states the belief that while adopting a definition of NRSRO would help address commenter concerns regarding transparency, credit rating agencies might desire to continue to seek no-action letters in order to clarify the ability of third parties to rely on their ratings for regulatory purposes. As such and in light of the longstanding reliance by broker-dealers, issuers, investors and others on the existing staff no-action process, the Commission states in the proposal that if it were to adopt a definition of NRSRO, it plans to continue to make commission staff available to provide no-action letters as appropriate to those entities that choose to seek it. No-action letters would be granted for a specific period of time, after which the relief would need to be reconsidered.

As I mentioned previously, a number of commenters to the 2003 concept release recommended that the Commission enhance the staff's ability to verify whether an NRSRO continues to meet the minimum standards that led to its designation. Due to apparent limits on the Commission's authority in this area, the Commission staff has worked with the current NRSROs during the past 6 months to craft a framework for voluntary oversight by the Commission. At this time, our dialogue with the industry has not resulted in an agreed upon voluntary oversight framework.

Nonetheless, I believe a strong and effective industry-led regime could prove to be a constructive and reasonable approach to address a number of concerns involving the credit rating industry that have been raised in recent years by Congress, the Commission and others such as the International Organization of Securities Commissions.

That said, the Commission believes that to conduct a rigorous program of NRSRO oversight, more explicit regulatory authority from Congress is necessary. The Commission has not taken a formal position on whether additional legislation should be forthcoming, but it does believe that congressional hearings on this issue are useful to ensure that this important question is properly vetted. A well thought-out regulatory regime could provide significant benefits in such cases as recordkeeping and addressing conflicts of interest in the industry.

As Chairman Donaldson said last month before the Senate Committee on Banking, Housing and Urban Affairs, the Commission

welcomes congressional attention and of course would stand ready to work with Congress on crafting appropriate legislation if Congress determines such legislation is necessary.

Thank you for inviting me to testify. I welcome any questions.

[The prepared statement of Annette Nazareth can be found on page 30 in the appendix.]

Chairman BAKER. Thank you very much, Ms. Nazareth.

I really want to start with your conclusions reached. In Sarbanes-Oxley, there were a specific list of, I will list them as concerns or subjects to explore, which you made reference to in your remarks. It would seem that the current definition discussion by the SEC relative to what constitutes an NRSRO really focuses on one of those points raised in the Sarbanes-Oxley recitation, which is the potential regulatory barrier to entry into the market.

However, the other four principal points, conflicts of interest, anticompetitive or unfair practices, regulatory oversight, would seem to fall in the area that you made reference to in your concluding remarks that may be outside the scope of current authority of the agency requiring going forward some legislative action. Is that a fair conclusion to reach from your comments?

Ms. NAZARETH. Yes. Basically, we have the authority to use the term in our rules and to define what the term meant. But as you pointed out in your statement, this is a very important area and one where people have become very reliant on this term. As a result, we believe that it is important to not only determine that a credit rating agency has met the terms of the definition at the outset when the no-action letter is issued, but also that it continue on an ongoing basis to meet that definition.

In order to do that effectively, one would at the very minimum need a voluntary framework to be able to oversee the process and to ensure that those conditions continue to be met or have a more rigorous oversight program through legislative authority which would give us the ability to require recordkeeping and examinations and other things that are more akin to what a full regulatory program would entail.

Chairman BAKER. Assume for the moment that we enter into a voluntary agreement. I have some familiarity with voluntary agreements with other enterprises. If they then choose not to comply, the penalties are some adverse market reaction or litigation over the terms of the contract, which would seem to me to put the regulator in a very deficient posture.

What I am proposing is that if we can identify the areas beyond the definition of NRSRO, that currently are not within your enforcement authority, I would be very interested in a statutory framework enabling the regulator to take on at least as a minimum scope those five points identified in Sarbanes-Oxley because that did pass the scrutiny of the committee, voted on by the Congress. There should not be debate that those five points are good public policy to implement. You would not, I take it, see that as an inappropriate thing for the committee to pursue.

Ms. NAZARETH. No, not at all.

Chairman BAKER. As to the proposed definition that is now pending, it basically requires that the entity making application for admission issue publicly available ratings, is generally accepted in

the market as an issuer of reliable ratings, and uses systematic procedures. I am not sure I understand how those three elements constitute something different from what has been historic practice.

Even though we talk about “nationally recognized” as being the art term, when the Commission reviews applicants’ requests for approval, it is that you have to be in the business of credit ratings. You have to be viewed as a credible person or entity giving good information out. Obviously, you have to have some process to arrive at a rating.

So I am having a little trouble understanding how this three-pronged approach is significantly structurally different from the current NRSRO requirement. Can you enlighten me on what you think is the distinction?

Ms. NAZARETH. It is not dramatically different. You are correct. I think after all of this analysis and the hearings and the comments that we analyzed, it was clear that while there are some concerns about competitive impact, the strong majority of opinion was that this is a process that the marketplace has come to rely upon and that there would be great market disruption to abandon this process entirely.

That having been said, I think that we were looking to improve the current situation. So what we did was, this is the first time we have actually defined the term, which adds greater transparency, makes it easier for new entrants to understand what they will have to evidence in order to obtain a no-action letter. We also did try to be somewhat broader in the scope of the entities that we would recognize under the definition.

So for example, for the first time we made it very clear that you could be nationally recognized even if your expertise was in a limited sector, either geographically or by topic, that you did not have to be nationally recognized as in everybody was using you for all purposes. So we have tried to find other ways to address some of the competitive concerns. So in that respect, it is a little bit different, but again we were hoping that the transparency of the definition would also make it somewhat easier to apply and might encourage others to apply.

Chairman BAKER. My time is out, but I am going to ask one more, and given the fact that we have other members, try to keep it within reasonable time constraints. The definition says that the entity making application must have a systemic process by which its ratings are achieved.

Ms. NAZARETH. Yes.

Chairman BAKER. Does Standard and Poor’s have some systemic process they publicly disclose as to how they go about their rating process?

Ms. NAZARETH. I believe that each of the NRSROs does have internal processes that they follow in order to issue credit ratings.

Chairman BAKER. But they are not necessarily the same? They are not necessarily disclosed to the person who is being reviewed? In other words, if I am the business guy and I want a rating, I would like to know what is it you are going to need to know so I can prepare when you knock on the door. What is worse is when you show up unannounced and do it to me anyway, but that is another point.

Ms. NAZARETH. Yes, which is another problem. I do think that they do endeavor to apply consistent policies and procedures across whatever sectors they are covering. I believe that they make it clear to the entities that they are rating what it is that the entities will need to evidence to them. A number of their procedures, including their conflicts procedures and the like, actually they do publish and are on their Web sites. We think it is very important that there not only be rigorous procedures, but that they be uniformly followed. Obviously, it would be problematic if they had certain high standards for rating some entities and then did not apply those standards to others. It is a critical issue.

Chairman BAKER. Just a quick follow-on, then. If I were to request of you help secure for the committee S&P, Moody's, Fitch, the other two entities, their systematic review of just financial service entities. Let's just make it just banks. That we should expect each of those systematic reviews to be somewhat comparable and similar?

Ms. NAZARETH. That is their role, that they should be comparable.

Chairman BAKER. Do you have knowledge that they are? Or that is what you believe as to their professional responsibility?

Ms. NAZARETH. I believe that they have procedures that establish that they should uniformly apply with respect to their reviews. Whether or not they actually do that is another question. I would hope that they do that, but given that we do not have examination authority or the ability to audit that, I cannot represent that that is what happens.

Chairman BAKER. I appreciate that problem. Thank you very much.

Mr. Kanjorski?

Mr. KANJORSKI. Ms. Nazareth, we talked about the discussions that are ongoing. I suspect that is between the SEC and the rating agencies?

Ms. NAZARETH. Yes.

Mr. KANJORSKI. How long have they been ongoing?

Ms. NAZARETH. Well, it has been off and on. There were holidays in between and other events, but I think we started talking around November.

Mr. KANJORSKI. Could you give us just your initial reaction of how successful those discussions have been to date? I notice the one suggestion that they are not able to be regulated because of the protection of the First Amendment. Are the major five rating agencies asserting that on a regular basis, seemingly without fear?

Ms. NAZARETH. It is a complicated process. I have to say that in the past when we have negotiated voluntary initiatives with entities, they tended to be entities that we had regulated for other purposes and therefore were used to SEC oversight. The question was whether or not in a new area of their business they would agree to some sort of voluntary regime.

This is a little more difficult. I believe that the rating agencies are dealing with us in good faith, but it is more difficult given that they are not really as used to SEC oversight. There are some legitimate questions on First Amendment issues and concerns about regulators imposing themselves into the editorial process that they are

very sensitive to. So I think it has made the discussions somewhat more complicated, to say the least.

Mr. KANJORSKI. Are you more optimistic than Chairman Donaldson seemed to be in his testimony before the Senate?

Ms. NAZARETH. I don't know if I would say more optimistic. I certainly agree with the tenor of his testimony. I am certainly willing to continue our discussions, but I think Congress should continue its review at the same time and we will see where we come out.

Mr. KANJORSKI. You heard in my opening statement the fact that I am addressing a letter today to the Commission to give us an outline of the additional authorities you think you may need in order to carry on an officially sanctioned involuntary regulation of these entities. From what I gather from the chairman's comments, he tends to agree that we now need that. Can that be forthcoming in a reasonably short period of time?

Ms. NAZARETH. Yes, we could definitely do that.

Mr. KANJORSKI. I have a feeling that we have had some consideration of this issue for a number of years now. Can you give me a qualitative evaluation of success in that ongoing process? Or is this just dragging along at the slowest rate to accomplish no regulatory authority?

Ms. NAZARETH. I think certainly we have had some progress in the sense that the Commission now has proposed a rule that is intended to add greater transparency to the process of granting no-action relief regarding NRSROs. That is progress. I think it is progress that Congress is partnering with us to look at this issue and to determine whether now is the time to have additional authority or whether to rely on private sectors means. But I do think that this is the next opportunity to make some progress in this area.

Mr. KANJORSKI. My druthers would be that we do not have to regulate, as I am sure Mr. Donaldson and you would join us in that. But do you think that they doubt that we have the backbone here in the Congress to take such action?

Ms. NAZARETH. Who would doubt the backbone?

Mr. KANJORSKI. These rating agencies.

Ms. NAZARETH. I do not think anyone doubts your intentions.

Mr. KANJORSKI. Is there any stronger message that we can send to them? Would it be introduction of authorizing legislation to give regulatory authority to the Commission? Would that help in the discussions?

Ms. NAZARETH. I think they are well aware of Congress's efforts. I think to be frank, I think there is a bit of a dilemma that they have as well, because if they start investing the time in a voluntary initiative and congressional authority is forthcoming, it may be that they have to switch gears and do things somewhat differently. So they have a little bit of a dilemma themselves in terms of whether they should at this point invest the resources in that effort, or should they wait for Congress to give us authority and then just wait for a rulemaking.

Mr. KANJORSKI. Does that underlie the observation on your part that they perhaps are not doing their best in investing time and effort in these ongoing discussions?

Ms. NAZARETH. I think it is a factor. I would not say they are not doing their best. They are five very different organizations with different structures that also have to try to come to some common conclusion on what to do. But I certainly think the combination of Congress's review of this issue as well as a number of initiatives in Europe has made it difficult for them to assess what exactly is going to be the landscape in which they are operating, and should they take the lead or should they wait to see what happens.

Mr. KANJORSKI. Well, if I can again urge you to get that outline of the authorities necessary to pursue this as fast as possible to see whether or not they can invest some of their time in responding to the actual legislation.

Thank you.

Chairman BAKER. I thank the gentleman.

Mr. Hensarling?

Mr. HENSARLING. Thank you, Mr. Chairman.

Ms. Nazareth, I think you indicated in your testimony we have five recognized NRSROs. I am curious, does the SEC have information on just how many market participants there are out there, how many credit rating agencies there are who have not achieved the NRSRO status?

Ms. NAZARETH. The information that we have is that there are probably at this point over 100 credit rating agencies. The number of participants has actually expanded quite a bit. I think the FSA recently discussed the number of participants and it was quite interesting to us. A great number of them have not expressed any interest in applying for this. In other words, their business models do not dictate that they have to be in this NRSRO business in order to be successful.

Mr. HENSARLING. Would you say that the number has been increasing in recent years?

Ms. NAZARETH. I believe it has been increasing, yes.

Mr. HENSARLING. Can you discuss aspects of market evolution or technology that might account for this fact, I guess really over the last couple of decades, since the SEC first designated the NRSRO regulation, back in 1975? Can you talk about trends that might have led to the fact that there are indeed more rating agencies now and what has led to that?

Ms. NAZARETH. I gather that there is obviously a tremendous appetite for investment in debt securities and the number of products and the complexity of debt products have really been explosive in the last several decades. There is an appetite and a market for good in-depth analysis in order to understand these products. So a number of market participants are willing to pay for these analyses to help them better understand their particular issues.

Mr. HENSARLING. It sounds like there has been an increase perhaps in the number of these rating agencies who are dealing in niche markets. I believe on page six of your testimony you talk about that even though a credit rating agency might only rank debts, say, in a limited sector of the market or in a geographic area, they might be able to achieve the NRSRO status. But it does not sound like in reality or in practicality that is actually happening, since we still have only five. Is this correct?

Ms. NAZARETH. This is the first time we have articulated this goal of recognizing entities that are in these limited sectors, although we have historically done so. Again, I think it depends on whether these market participants choose to apply. We have had several instances in the past where we would have been more than happy to entertain the requests, but there was no interest on the part of those credit rating agencies to apply.

Mr. HENSARLING. Last year before this subcommittee, there was a gentleman from the American Enterprise Institute, Alex Pollock, who called the current NRSRO designation a catch-22 because, and I am sure you have heard the argument, if you are a non-NRSRO you have to become widely accepted to become an NRSRO. But if you are not an NRSRO, say that three times quickly, you cannot become widely accepted. So how do you address his argument that we will continue to have a catch-22 under these new guidelines? If so, how will we ever go beyond our five recognized agencies?

Ms. NAZARETH. Again, I think there are, as we have said earlier, there are over 100 of these entities, many of which are very highly regarded in their niche markets. Should they choose to apply, we would be very pleased to consider their applications. We have in the past recognized NRSROs within 5 years of their beginning to rate debt securities.

So it is something that we are very obviously concerned about and interested in. We believe that it is important for purposes of SEC regulations that the term apply to firms that really are providing a rating that is based on a process with high integrity and that is widely recognized in the marketplace.

That having been said, we do not want this regulation in any way to impede competition or the ability for new entrants to enter. So hopefully this new definition with its emphasis on the niche players as well will assist in that area.

Mr. HENSARLING. I see I am out of time.

Thank you.

Chairman BAKER. Ms. Wasserman Schultz?

Ms. WASSERMAN SCHULTZ. Mr. Chairman, I do not have any questions. Thank you.

Chairman BAKER. I thank the gentlelady.

Ms. Kelly?

Mrs. KELLY. Thank you, Mr. Chairman, for holding this hearing.

Quite frankly, I appreciate your appearing here, Ms. Nazareth. You state in your testimony that Congress has given no authority to the SEC to regulate nationally recognized credit rating agencies.

In my estimation, the ability of the SEC to identify and define the NRSROs contains the ability to define NRSROs to exclude from the definition any institution that fails to meet the standards the SEC expects. Do you agree with that? Could you please explain it?

Ms. NAZARETH. Yes, we certainly have the ability to define the term and to interpret which entities meet that definition. What we do not have express authority to do is to have an ongoing oversight regime to ensure that those who meet the definition continue to do so and that some of the really fundamental principles on which we determine to grant the no-action letter continue to exist.

Mrs. KELLY. Which means that you are seeking authority from Congress to rate the raters. Is that correct?

Ms. NAZARETH. No. We are not seeking authority. We have no official position on seeking authority. What is being discussed is granting the Commission authority to have an oversight regime for those entities who fit the definition and who have applied for recognition.

Mrs. KELLY. The courts ruled that speech about credit worthiness is protected by the First Amendment. Wouldn't the explicit regulation of the NRSROs violate their First Amendment right to speak freely on the financial markets?

Ms. NAZARETH. There are issues on journalistic privilege and First Amendment issues that do factor into this analysis, which is why we feel that it is very important for Congress to be involved in this determination. If Congress determines that more regulatory oversight is necessary in this area, for Congress to expressly grant that authority because we feel that to take an aggressive position in this area, particularly where there are First Amendment issues involved, would not be appropriate.

Mrs. KELLY. I am not quite sure how the SEC authority, how broad that is. Is it limited to how the publicly traded companies use the information that they get, whether it is paid or unsolicited from credit agencies? Can you define just a little bit more about how broad that is?

Ms. NAZARETH. Yes, the term was originally used for a very limited purpose, which was to describe those entities who rated debt securities, whose investment-grade ratings could be relied upon by broker-dealers for purposes of some capital benefits under the net capital rule. So it basically said if a broker-dealer had in its portfolio bonds that were rated investment grade, those bonds would have a lower haircut or a lower capital charge to the firm's capital than would bonds that did not have such a rating.

So it was really a way for the Commission to determine that to give this regulatory or capital relief, but doing so in a way that it felt was responsible in that the ratings that were being relied upon were generally accepted as reliable and credible ratings. It was used for that purpose.

What happened was the term over time became a useful proxy for creditworthy ratings, and was used in other SEC regulations and then was used in a number of regulations, both by the states and abroad. We feel that given the reliance that is put on this definition that it would be certainly more appropriate to have some sort of ongoing review of whether the entities that enjoy this designation continue to meet up to the terms of the definition.

Mrs. KELLY. Credit rating agencies have been accused of maintaining high ratings on some issuers and arbitrarily lowering others. I am amazed at some of the stories that I have read where schools have been bent over backwards by some of these agencies, municipalities, businesses. I think the public really does not know that schools, municipalities and businesses have to pay the credit rating agencies in order to get those credit ratings.

It seems to me that instead of trying to regulate the NRSROs, the market might be best served to encourage as many people to go into the credit reporting field as possible in order to provide a lot of viewpoints, and then let market forces make whatever correc-

tions they are going to make in that field. I would be interested in what your response is to that.

Ms. NAZARETH. I think, as I said before, there are a number of people in this field. There are over 100 credit rating agencies. Again, this term was used by the Commission for much more narrow purposes and has taken on a life of its own. There is nothing in the use of the term or there is nothing that would in any way require investors to rely solely on the ratings of these raters. There are a number of other services that they could use.

Mrs. KELLY. I am sorry. I really did not understand that. You said there are a lot of people in the field, but there are only five NRSROs.

Ms. NAZARETH. Right.

Mrs. KELLY. There are hurdles, if I understand the Chairman's and Mr. Kanjorski's and Mr. Hensarling's comments, hurdles that these other agencies really have to jump, and there have been precious few. It seems to me congressional pressure has pushed the SEC to at least admit two more agencies because there were originally only three.

I do not see how these others in the field are going to get into the business if we have high hurdles and more regulation.

I am out of time. Thank you, Mr. Chairman.

Chairman BAKER. I thank the gentlelady.

Ms. Brown-Waite?

Ms. BROWN-WAITE. Thank you very much, Mr. Chairman.

I came in probably towards the end of your testimony, but the basic question that I have is that in your new proposal, you are apparently limiting it solely to implementation of a definition and you do not plan to take any other action with regard to NRSROs without specific statutory authority.

Have you asked for that statutory authority? You may have covered this in your testimony.

Ms. NAZARETH. The Commission has not yet taken a position on whether it is requesting statutory authority. What the Commission has done is make clear that it believes that to do more would require statutory authority.

Ms. BROWN-WAITE. I think you are repeating what I said. Are you requesting statutory authority?

Ms. NAZARETH. No, we are not at this time officially requesting statutory authority.

Ms. BROWN-WAITE. So if I understand you correctly, then you are just going to do the same old-same old and not expand the number of them?

Ms. NAZARETH. That has nothing to do with the statutory authority question. That goes to the definitional question. We would be able to, I believe, designate or recognize additional credit rating agencies as NRSROs under this definitional rulemaking that we have done. Whether or not we have the authority to do more ongoing oversight of those entities once they receive the no-action letter, that goes to the issue of authority, ongoing oversight, examinations, recordkeeping requirements, potential registration requirements.

But the Commission does have the authority to define the term "NRSRO" and that is what the proposed rulemaking seeks to do.

It also seeks to expand potentially the universe of firms who would be able to satisfy that definition by making it clear that one could be “nationally recognized” even though that firm is really more recognized for a limited sector of the market or a limited geographical area. So there is a recognition that while we feel we need to have high standards in the definition, we also do not want the definition to preclude additional parties from being able to apply and to obtain the NRSRO no-action letter.

Ms. BROWN-WAITE. After Enron and WorldCom, I think the question needs to be asked: Who really has oversight over these NRSROs? Do the firms require continuous education? Our whole economy was thrown on its heels partially as a result of the Enron and WorldCom scandals. So what kind of self-governing, maybe is my question, do they engage in?

Ms. NAZARETH. Well, all the credit rating agencies have policies and procedures in place that include standards on the educational backgrounds of the people they hire and on how frequently they review the firms that they rate and the like. Those procedures are supposed to obviously be rigorously internally enforced.

Frankly, one of the issues that we will have whether or not the Commission gets authority here is that there are some things that it will be difficult for regulation to address. Regulation is not going to make anybody faster or smarter, but we can require that people have rigorous procedures that they follow and hopefully that in and of itself will improve the process. Certainly having procedures on conflicts of interest and disclosure of nonpublic information and the like is important to have in any industry. But it certainly will not be a guarantee against mistakes in the future in any area.

Ms. BROWN-WAITE. I do not think you answered my question, and maybe you are not the right person to answer this, but who really governs the NRSROs?

Ms. NAZARETH. They are not regulated.

Ms. BROWN-WAITE. They are not regulated at all? Totally not regulated?

Ms. NAZARETH. As part of the no-action process, they were registered as investment advisers, but really their advisory work is minimal at best. So for these purposes, their credit rating processes are not regulated.

Ms. BROWN-WAITE. Thank you.

Chairman BAKER. I am going to start a second round. Since we have a limited number of members, it will not take long.

Just to follow on to Ms. Brown-Waite’s observations, there is no process clinically established in law or in regulation on how you become one of these things. Up to the contemplated rule now pending, you had to be nationally recognized. If you were not national, you could not be considered.

Now we have a three-part test which is sort of nationally recognized. You do not have to be national in organizational scope, with offices from California to New York, but you have to be recognized nationally for your work in the field of oil futures. You have to have the financial stability to be able to operate on a national basis and have a proven record of credible, reliable, analytical work.

Strangely enough, that standard does not now apply to those who are NRSROs. We do not know, for example, that all five have the

similar procedure for gauging the financial credit worthiness of all those in the oilfield sector. One could be using one methodology; one could be using another. But the investment company world requires that that oilfield company which is going to issue public debt have at least two ratings from two independent entities.

When you look at the way the structure of the current process works, the profit margins are excessively egregious, and that is only because we have the voluntary disclosure by some of their rates of return. Some do not even disclose their financials period. They are the only entities that have an exception from Reg FD. They can get access to material fact that no other person can get and make disclosure of subsequent to some civil or criminal action, and they can make selective disclosure of information pursuant to executive interview.

Then they say if we are going to have the SEC either by rule or by statute come in and perform an audit of the books to find out if somebody has cooked their books or if somebody is running off to Tahiti with shareholder funds, they say wait a minute, you are going to abridge our First Amendment rights. Huh? If you want to find out as to the analysts who are performing the work have been previously accused of fraudulent activities in the world of accounting, they hold up the First Amendment shield.

Now, the First Amendment shield only goes to the preparation and release of a statement publicly made. By removing their designation as an NRSRO, they can still make all the statements they want, they just cannot charge very much for them. Therein is the problem. We have a monopoly governmentally granted without a clear standard of conduct to maintain professional accreditation. By the way, there has never been any entity designated an NRSRO that has ever been decommissioned, and I would like in a minute to ask what is the process to decommission someone if you find out that they have engaged in blatant fraudulent conduct.

These enterprises are not outside the law. There is no law. This is the Wild West, and if you ride through their ranch and you do not pay their fee, you get shot. You are required under the Investment Company Act to ride across their ranch. If you do not pay their freight, you are in real trouble. Plus, they will show up on your ranch unannounced, perform an audit, and then give you a B rating when you ought to be an A rating. What is your recourse?

They have the public operating companies of this country by the throat. This has got to be at least subject to disclosure and awareness by the public as to what is going on here because 4 days before Enron, the three NRSROs that were designated at that time in our country's history all of them listed Enron as investment-grade investments.

Now, you remember what this committee did to the analysts and the investment bankers for missing it by a year? What are we going to do to these guys for missing it by 4 days? And yet we still have a commission that has been reviewing this matter for over a decade. This committee has been looking at it for almost that long.

I do not make this to be interpreted as any kind of threat at all. I am saying this out of frustration. We need to help you. We need to give you the authority to act. We need to make sure that these

people are responding to the market need in professional criteria. And we will have legislation.

Now, I cannot speak to the content of that bill. I do not know your ability, given the lack of commission direction at this point to be able to comment, and I do not want to get you in that adverse position. But should you and those of your office choose to work with us in the formulation of a bill that is responsive, I have no confidence in a voluntary agreement. I have had bad experiences with those.

So I think going forward, we are just going to have to give the agency the ability to regulate and subsequently to that or concurrent with that, figure out a way to get past this NRSRO designation business and let people who want to rate, rate. We do not do that in the securities and the equities world. We have all sorts of analysts giving all kinds of ratings all day long. If you want a rating, I am sure you can find the one you want because they are all over the map. The point is the market works without having a governmental designation of who should become a rating agency.

Back to my question, since I rambled on for my entire time, has there ever been an NRSRO once designated ever decommissioned? And is there a process for doing so?

Ms. NAZARETH. There has not been one that has been decommissioned. Again, I am not sure what I would conclude from that because certainly one of the issues is the ability to do a rigorous ongoing oversight, which more authority would give us. Since there has not been as rigorous ongoing review—

Chairman BAKER. Let me help you. What you are saying is the regulator does not have the tools to know whether they are doing a good job or a bad job. Therefore, how could you decommission them without the facts?

Ms. NAZARETH. But we certainly do have the authority to remove the no-action letter. As with any market participant, we have enforcement authority to go after any sort of illegal act under the securities laws.

Chairman BAKER. So you would tell me that over the course of the 1980s and the 1990s, when investment bankers, analysts, securities markets, mutual funds, everybody you can name in the financial services sector got it wrong and there were people held criminally accountable in most cases, that the monopoly of the credit rating agencies was above the fray and did everything right.

Ms. NAZARETH. It was not subject to the same regulatory oversight as those entities.

Chairman BAKER. Thank you very much.

Mr. Kanjorski?

Mr. KANJORSKI. Mr. Chairman, what I love about you is you make me look like a flaming conservative.

[Laughter.]

I think we are pretty much in agreement that the committee wants to do something that will arm the SEC with the authority to accomplish its end. I do not know I am as far as the Chairman on these conclusions, but certainly we are both thinking along those lines.

Chairman BAKER. I will give you a little time. You will get there.
[Laughter.]

Mr. KANJORSKI. I will come there.

The one question I did want you, Ms. Nazareth, to address, in the 1990s the Commission came very close to issuing rules and regulations regarding the control of the credit rating agencies, and then they did not act. At that time, therefore they must have made the conclusion that they had the legal authority to do that. Has anybody revisited why that has changed? I know at the time I do not think they could get a majority of the Commission to adopt the rule, but somebody must have structured the legal authority there in existing law.

Ms. NAZARETH. Even in the 1990s, the proposal from 1997 was quite similar to the proposal that the Commission put out for comment last month. It was marginally more aggressive on the authority side, but not terribly so. I think that in light of various challenges to the Commission's authority and in light particularly of the First Amendment issues that have been raised, we think it would be prudent to wait for authority to do anything beyond the definitional term.

Mr. KANJORSKI. The comments that the Chairman made regarding almost extortion, have you heard complaints of this or factual information that would support that in some instances these entities have acted in that regard?

Ms. NAZARETH. I think historically there were complaints about unsolicited ratings. My understanding was that several years ago the Department of Justice actually looked at it and took no action. My understanding is also that since that time, the rating agencies became I think more sensitive to the issue. I have not heard quite the number of complaints in recent years that we did in the past. I think that there has been more of a sensitivity to indicating on the rating itself that it was unsolicited. But I think unsolicited ratings do still exist, but I am not sure at quite the same magnitude that they did in the past.

Mr. KANJORSKI. Okay. The only other question that I have is, you talked about a remedy as releasing the use letter? Or withdrawing the use letter?

Ms. NAZARETH. Withdrawing the letter, yes.

Mr. KANJORSKI. How could you do that if you have no criteria on which it is issued?

Ms. NAZARETH. The criteria was always articulated in the area, what we had looked at in order to issue the letter. So certainly if we became aware of the fact that the basis on which the letter was issued no longer applied, we could withdraw the letter. The question is how much comes to our attention and whether there is an ongoing process to examine for that.

Mr. KANJORSKI. There is no question, though, that we should get involved in this area.

Ms. NAZARETH. I think Chairman Donaldson was quoted that we welcome your involvement.

Mr. KANJORSKI. Thank you very much, Mr. Chairman.

Chairman BAKER. I thank the gentleman.

Ms. Kelly?

Mrs. KELLY. Thank you, Mr. Chairman.

Ms. Nazareth, I received a letter that indicated, it was actually from S&P. It indicates that S&P ratings was designated as an

NRSRO in 1976, although it did not affirmatively seek that status. If they could be declared an NRSRO without applying and without affirmatively seeking that status, can't the SEC just declare a company an NRSRO without asking the designee?

Ms. NAZARETH. At that time, the request was made by members of the brokerage industry who wanted to be able to rely on S&P ratings for purposes of the capital rule. So there was a request. It was not made directly by S&P.

Mrs. KELLY. If other agencies now, credit rating agencies, had the same event happen, couldn't the SEC declare a company an NRSRO without the designee asking?

Ms. NAZARETH. It is a little difficult because it still requires the cooperation of the entity because there are a number of things, as the definition of the proposed rule would imply, that we would have to look at. There is a lot of proprietary information that we would only be able to get if we had the cooperation of the entity. But certainly, more recently I think the requests have come directly from the credit rating agencies themselves, but originally the procedure was that the securities industry would ask whether they could rely on the ratings of a particular credit rating agency for purposes of the rules.

Mrs. KELLY. What if a consumer asked for a credit agency to be rated? What you implied by your answer to me, if I understand you correctly, is yes, the SEC could if the person who someone has asked to be rated an NRSRO, if they cooperated with you, you could go ahead and rate them as an NRSRO if someone came forward and said, I would like to see this agency put in. Can the consumer do that?

Ms. NAZARETH. We have two different ways. Either the credit rating agency that wishes to be considered an NRSRO asks directly, or an entity that has to make use of the term for our rules has to ask for it. So it is not just a consumer asking for it. A consumer I do not believe would have standing here. It would either be in this case S&P or someone who has to use the term for purposes of the rules.

Mrs. KELLY. I am just thinking of a group of schools or colleges. If they banded together and said, look, we would like you to declare this credit rating agency, which is currently not an NRSRO, to be an NRSRO, and that credit rating agency worked with you, you could in fact declare them to be an NRSRO. Is that correct?

Ms. NAZARETH. Yes. Any credit rating agency could apply. As long as they cooperate, we could treat it as if they had applied themselves.

Mrs. KELLY. I have another question about the rule that has not yet been published. Basically, from what I understand, there are a bunch of different prongs. One of them says that an NRSRO must be "generally accepted" as an issuer of credible and reliable ratings. Another one says an NRSRO must use systematic procedures to ensure ratings quality, manage conflicts, prevent misuse, et cetera, et cetera.

My question is that both of those terms, "generally accepted," "systematic procedures," are very difficult to define. Without very precise wording on the definitions, I do not see the transparency needed here for people to understand what your rule is going to

say. Are there going to be very specific definitions beyond just these two terms?

Ms. NAZARETH. Those are the definitions that the release, which you have not had the opportunity to read, will set forth on how one would go about satisfying the various prongs. It would give examples of what a credit rating agency could show the Commission to evidence that it meets that criteria. It asks whether, because it is a proposal, it asks whether other indicia should be considered as well. So at this point, obviously it is a proposal. It is not the final rule, but it does give a lot more meat to the definition and asks for comment on additional criteria.

Mrs. KELLY. I think the most important thing here is that we make sure that anything that happens with regard to oversight, and it is clear to me, I agree with our chairman and Mr. Kanjorski, I think there is a need for us to really examine this and get it right. But we definitely need transparency, and I am very concerned about reducing regulatory barriers because to do that opens up the market which I think can only be good. I am a true believer in free markets.

Thank you very much for testifying today.

Ms. NAZARETH. Thank you.

Chairman BAKER. Thank you, Ms. Kelly.

Ms. Wasserman Schultz?

Ms. WASSERMAN SCHULTZ. Thank you, Mr. Chairman.

Ms. Nazareth, I just wanted to ask you to clear up some confusion because a couple of minutes ago in response to a question you said that you would welcome, as a result of Chairman Donaldson's indication, our involvement, but you are in the process of preparing a voluntary framework.

So I guess I want to have you clarify the seemingly conflicting statements. Do you think a voluntary framework is enough and how would it work? Or do you think we should get involved as a congress and statutorily require regulation?

Ms. NAZARETH. We have not arrived at a final voluntary framework, so it is not possible for us to say whether that would be sufficient. I do think that this committee has expressed enough concern about the issue that I think it would be inappropriate to say that the committee should not on its own consider the issue, particularly since it is a very nuanced one. It does go beyond simply regulating an entity. It does raise First Amendment and other issues that have to be balanced in the process. That is why I think it is an appropriate issue for Congress to address.

Ms. WASSERMAN SCHULTZ. Do you have an opinion on whether or not you think a voluntary framework is enough? It is not that it is not appropriate for you to comment. You are in the process of developing a voluntary framework.

Ms. NAZARETH. I cannot speak for the Commission on the issue, and frankly I do not think the Commission has really been able to fully vet the issue either. But I guess what I am concerned about is that, or at least to be cautious about, is that Congress rightfully has high expectations of what they expect to happen in this area, and if you are looking, frankly, for a regime that is most similar to other regulatory regimes we have, it would be very difficult for a voluntary initiative to meet all of those criteria.

For instance, to require people to maintain books and records similar to what a broker-dealer would require or to permit our examiners to go in and request emails, all the things that we do with broker-dealers I think would be unlikely to be achieved through a voluntary initiative.

On the other hand, I am sure there are some real benefits that we could achieve through a voluntary initiative. So it partly depends on what people's expectations are, whether they want to do it in a two-step process to see how a voluntary initiative goes, or whether they think now is the time to go consider a more full-blown regulatory program.

Ms. WASSERMAN SCHULTZ. Okay, thank you.

I yield back the balance of my time.

Chairman BAKER. I thank the gentlelady.

I certainly want to express my appreciation to Ms. Nazareth for appearing here today. As is evidenced, the various members have different perspectives on the issue, but suffice it to say there is concern about moving forward. We certainly wish to be cooperative with and of assistance to the SEC in its deliberations.

We look forward to working with you in the coming days.

Ms. NAZARETH. Thank you very much.

Chairman BAKER. Our meeting stands adjourned. Thank you.
[Whereupon, at 3:19 p.m., the subcommittee was adjourned.]

A P P E N D I X

April 12, 2005

Prepared, not delivered

Opening Statement
Chairman Michael G. Oxley
House Financial Services Committee

**Subcommittee on Capital Markets, Insurance, and
Government-Sponsored Enterprises**

**Reforming Credit Rating Agencies:
The SEC's Need for Statutory Authority**

April 12, 2005

Good afternoon. I would like to commend Chairman Baker for holding this important hearing, our third on this subject in the past two years.

Credit ratings serve a vital function in our capital markets system. That is why we need to take very seriously all of the concerns regarding the role and performance of rating agencies and the SEC's regulatory approach that have been raised in recent years.

As a matter of first principles, I remain unconvinced of the necessity for a governmental role in determining which ratings firms deserve a seal of approval. Would it be appropriate for the government to also recognize some brokerage firms for issuing "reliable and credible" stock recommendations? Not a perfect parallel perhaps, but it does underscore the government's unusual, unintended, and arbitrary role in supervising this industry.

I also question some of the criteria used by SEC staff in making the NRSRO determination. Many commentators have rightly noted the classic chicken-and-egg problem — a firm cannot receive NRSRO status without being nationally recognized but how can a firm become nationally recognized without NRSRO status? Another point of major concern is the Commission's ability to monitor the firms' operations once they receive the staff's seal of approval through the no-action letter process.

The SEC's recent proposal defining for the first time the term NRSRO is a modest step in the right direction, but in my view does not go nearly far enough to address the fundamental problems plaguing this industry and the manner in which it is regulated.

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First and foremost, I am troubled by the oligopoly that exists in this industry. Two for-profit agencies control the vast majority of market share. As the Justice Department explained in 1998, the SEC staff requirement that a rating agency be nationally recognized acts as a “nearly insurmountable” barrier to entry for new credit rating agencies. In a free market system, that is not a healthy situation, especially when the industry wields quasi-governmental power. The SEC’s preservation of the national recognition requirement needs to be reconsidered, or at least modified to grant provisional status to those ratings firms that meet all of the other criteria except for national recognition, affording them an opportunity to develop nationally recognized ratings over time instead of being barred outright from entry.

Second, I have concerns about the conflicts of interest which plague the industry. Ratings firms have expanded into new areas which, many commentators have suggested, further compromise their objectivity.

Third, the recent SEC proposal does not address unsolicited ratings. Given the inherent conflicts and evidence that unsolicited ratings tend to be lower, this practice begs for reform, if not outright prohibition.

In prepared testimony to be delivered later today, the SEC witness will state that the “Commission believes that to conduct a rigorous program of NRSRO oversight, more explicit regulatory authority from Congress is necessary.” I agree.

Based on the problems I have discussed, I believe that, at a minimum, Congress has an obligation to inject some competition into the ratings industry, to make the ratings process more transparent, to reduce the cost and improve the quality of ratings, and to ensure adequate oversight of ratings firms. These reforms would provide enormous benefits to the market participants using these ratings.

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Congressman Michael G. Fitzpatrick

4/12/2005

Capital Markets, Insurance and Government Sponsored Enterprises Hearing: "Reforming Credit Rating Agencies: The SEC's Need for Statutory Authority"

Even though I am new to this Committee, it seems to me that the oversight of the credit rating industry is insufficient. It is troubling that the largest nationally recognized statistical rating organizations – S&P, Moody's, and Fitch – rated Enron at investment grade until four days before its bankruptcy filing in 2001, and all three rated WorldCom at investment grade until 42 days before its filing in 2002.

Rating agencies play an important role in our market. Far more debt is issued than stock, but there is an inherent conflict of interest. Rating agencies earn fees charged to the companies whose debt they rate. This divergent business model means that the paying customers for these agencies are the corporations they analyze, not the investors who look to the ratings for help in assessing a company's creditworthiness.

Let me provide a local example that I believe illustrates the problems with the industry and the manner in which it is regulated. In 1998, Egan-Jones Ratings of Philadelphia applied unsuccessfully to the S.E.C. It rates approximately 800 companies and had warned of problems at WorldCom, Enron and Global Crossing well before other agencies. Egan-Jones does not have a conflict of interest like the other nationally recognized statistical rating organizations. It does not accept payment from the companies it rates; the investors who use its services pay for the analysis.

A recent academic study compared ratings by Moody's with those of Egan-Jones. Reputable academics found that Egan-Jones's ratings changes were more timely than those of Moody's. The study also found much higher stock returns after rating changes by Egan-Jones than by those of Moody's. The study concluded that Egan-Jones is more responsive and closely associated with investors.

Timely, accurate credit ratings are critical for our robust marketplace. We must be certain that we are protecting the investor, in particular small investors. These investors will continue to be hurt until someone addresses the basic problems of the ratings industry.

Opening Statement

Congressman Paul E. Gillmor (R-OH)

**Subcommittee on Capital Markets, Insurance and Government Sponsored
Enterprises**

April 12, 2005

*Hearing entitled: "Reforming Credit Rating Agencies: The SEC's Need for Statutory
Authority."*

Thank you, Chairman Baker, for calling this hearing today. I appreciate your efforts at reforming the credit rating agencies and continuing to investigate ways to provide effective oversight.

When Enron failed in late 2001, the credit rating agencies maintained that the company was of investment grade quality until just four days before the company went bankrupt. While there is no doubt that the downgrading of a company's rating should be a serious matter, surely the credit rating agencies could have provided investors with clues that Enron was in dire financial trouble.

I am particularly interested in hearing the SEC describe its current efforts in reforming the credit rating agencies and providing more competition with increased oversight. With the strong interest of this Subcommittee, the Congress and the public, I am curious as to why the SEC has delayed reform for so long. If there are statutory authority questions that the SEC would like Congress to address before moving forward, I look forward to working with Chairman Donaldson to ensure that the SEC has the tools and authority necessary to reform the credit rating system and provide investors with the best available information so that if another Enron occurs, they are given more than four days notice.

I thank the Chairman for calling this hearing.

**OPENING STATEMENT OF
RANKING DEMOCRATIC MEMBER PAUL E. KANJORSKI
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE,
AND GOVERNMENT SPONSORED ENTERPRISES
HEARING ON REFORMING CREDIT RATING AGENCIES:
THE COMMISSION'S NEED FOR STATUTORY AUTHORITY
TUESDAY, APRIL 12, 2005**

Mr. Chairman, we meet for the third time in the last two years to explore the issue of regulating credit rating agencies. As I have regularly noted during our past examinations, entities like Moody's, Standard and Poor's, and Fitch have long published their views on the creditworthiness of the issuers of debt securities. The significance of these opinions has also greatly expanded in recent years as a result of increases in the number of issues and issuers, the globalization of our financial markets, and the introduction of complex financial products.

Although rating agencies received some scrutiny after the recent surge of corporate scandals, we have not yet mandated any substantive changes in their practices. One witness at one of our past hearings nevertheless noted that the agencies "played a significant role" in Enron's failure. Additionally, a Senate investigative report determined that the monitoring and review of Enron's finances "fell far below the careful efforts one would have expected from organizations whose ratings hold so much importance."

Outside Enron's auditor, the rating agencies probably had the greatest access to non-public information about the firm's complicated financial arrangements. Even with this data, the agencies exhibited a disappointing reliability in the accuracy of their coverage. In fact, the three existing Nationally Recognized Statistical Rating Organizations at the time of Enron's failure rated the company at investment grade until four days before its bankruptcy filing.

The failure of the nationally recognized agencies to lower their credit ratings in a timely manner in this case and other instances -- such as WorldCom's bankruptcy, New York City's debt crisis, Washington Public Power Supply System's default, and Orange County's collapse -- has resulted in great financial losses for many Americans who little understood the true credit risks of their investments.

This issue is therefore one on which we should focus our attention in the 109th Congress. During our past hearings, it has also become increasingly clear to me that while our capital markets and the ratings industry have evolved considerably in recent years the Commission's rules in this area have changed little, even though it has studied these issues for more than a decade. Additionally, the *Washington Post* late last year in a series of investigative reports on credit ratings concluded that although the agencies with national recognition are the "gatekeepers of capitalism" they have no "commensurate oversight or accountability."

The regulation of rating agencies, I believe, is ripe for examination and action. I know that the Securities and Exchange Commission agrees. Today's witness, Annette Nazareth, the Commission's Director of Market Regulation, has previously observed that while rating agencies have generally performed their work well for nearly a century, they have also missed some "colossal" failures in recent years. She has further described our debt markets as "the dark corner" of the securities industry. The time has come to shine some light into this dimly lit field.

Accordingly, I was pleased that the Commission recently finally put forward for public comment a proposed rule to define what constitutes a Nationally Recognized Statistical Rating Organization and the process for making such a designation. While this proposal is a good step, more still needs to be done in the area of rating agency oversight.

The agencies, as I am aware, are also working with the Commission to establish a voluntary framework to improve transparency. While some hope that this agreement will be effective, many have lingering doubts. After all, Chairman Donaldson has already indicated that he does not have the confidence that these discussions will result in substantive reforms because the existing agencies with national recognition have taken the position that they will not allow the Commission to conduct inspections or take enforcement actions.

As you know, Mr. Chairman, top officials at the Commission have also regularly suggested that additional legislative authority may be needed in the area of rating agencies. Consequently, I have now come to conclude that it is time for us to ask the Commission what specific authorities it believes it needs to effectively oversee rating agencies. I will therefore be sending a letter to the Commission after today's hearing to request this technical assistance.

The Congress will ultimately decide whether to consider a bill related to these issues, but obtaining the insights of the experts at the Commission will help us in crafting an appropriately balanced piece of legislation that addresses First Amendment concerns. Learning of the Commission's views now on the needed statutory authority will also help us to expedite future action if the voluntary framework negotiations break down or result in a flawed product.

In closing, Mr. Chairman, we must act to ensure the continued integrity of the rating agencies and the credit rating process. I also look forward to hearing from our witness today and to moving forward prudently and promptly on these important matters.



**TESTIMONY
OF**

**ANNETTE L. NAZARETH
DIRECTOR OF MARKET REGULATION
U.S. SECURITIES AND EXCHANGE COMMISSION**

**CONCERNING
CREDIT RATING AGENCIES**

**BEFORE THE SUBCOMMITTEE ON CAPITAL MARKETS,
INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES**

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

APRIL 12, 2005

**U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549**

TESTIMONY CONCERNING CREDIT RATING AGENCIES

**ANNETTE L. NAZARETH, DIRECTOR
DIVISION OF MARKET REGULATION
U.S. SECURITIES AND EXCHANGE COMMISSION**

**BEFORE THE SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND
GOVERNMENT SPONSORED ENTERPRISES**

COMMITTEE ON FINANCIAL SERVICES

UNITED STATES HOUSE OF REPRESENTATIVES

April 12, 2005

Chairman Baker, Ranking Member Kanjorski and Members of the Subcommittee:

Thank you for the opportunity to testify before you today on behalf of the Securities and Exchange Commission ("SEC" or "Commission"). Today I plan to provide you with an overview of the SEC's recent work concerning credit rating agencies. I'll begin with a brief history of the SEC's involvement in this area, and then I'll discuss recent SEC initiatives regarding credit rating agencies.

Background

Since 1975, the SEC has relied on credit ratings by market-recognized rating agencies for distinguishing among grades of creditworthiness in various rules under the federal securities laws. These "nationally recognized statistical rating organizations," or "NRSROs," have received no-action letters from the SEC staff. To date, nine firms have received such no-action letters. However, during the 1990s, several NRSROs consolidated so that there are currently five such NRSROs: A.M. Best Company, Inc.; Dominion Bond Rating Service Limited; Fitch, Inc; Moody's Investors Service, Inc.; and the Standard & Poor's Division of the McGraw Hill Companies, Inc.

The term "NRSRO" was originally adopted by the Commission solely for determining capital charges on different grades of debt securities under the Commission's net capital rule for broker-dealers. Over time, however, the NRSRO concept has been incorporated into a number of additional SEC rules and regulations, including rules issued under the Securities Act of 1933, the Securities Exchange Act of 1934, and the

Investment Company Act of 1940. Congress, too, has used the NRSRO concept in legislation, as have other regulatory bodies, including banking regulators both at home and abroad.

Recent Commission Initiatives Relating to Rating Agencies

During the past few years, the Commission has pursued several approaches, on its own and at the direction of Congress, to conduct a thorough and meaningful study of credit rating agencies and the use of credit ratings under the federal securities laws. For example, approximately two years ago the SEC responded to a Congressional directive under the Sarbanes-Oxley Act of 2002 (“Sarbanes-Oxley”) by issuing a report on the role of credit rating agencies in the securities markets. To assist in preparing the report, the SEC held two full days of public hearings. Hearing participants included representatives from credit rating agencies, broker-dealers, buy-side firms, issuers, and the academic community.

The Sarbanes-Oxley report identified a number of substantive issues that the Commission planned to explore in more depth, including (1) improved information flow in the credit rating process; (2) potential conflicts of interest; (3) alleged anticompetitive or unfair practices; (4) potential regulatory barriers to entry into the credit rating business, and (5) ongoing regulatory oversight of credit rating agencies.

On June 4, 2003, the SEC issued a concept release (the “2003 Concept Release”) seeking public comment on the issues raised in the Sarbanes-Oxley report. Generally, the SEC sought comment on whether credit ratings should continue to be used for regulatory purposes under the federal securities laws and, if so, the process of determining whose credit ratings should be used. The Commission also sought comment on the appropriate level of oversight that should be applied to credit rating agencies. Forty-six commenters responded to the concept release.

Most of the 46 commenters supported retention of the NRSRO concept. Many represented that eliminating the concept would be disruptive to the capital markets and would be costly and complicated to replace. Only four commenters supported elimination of the concept, and there was a very limited discussion of regulatory alternatives.

Generally, commenters supported improving the clarity of the process for identifying NRSROs to the extent credit ratings continue to be relied upon in Commission rules and regulations. Specifically, commenters generally supported the Commission's suggestions to specify in more detail what credit rating agencies need to provide to obtain an NRSRO no-action letter. With respect to ongoing oversight, a number of commenters recommended that the Commission enhance the staff's ability to verify whether an NRSRO continues to meet the minimum standards that led to its designation. However, a number of commenters, including each of the current NRSROs, also raised concerns about the extent of the Commission's authority to impose requirements on NRSROs. These commenters argued that the SEC does not have explicit regulatory authority over NRSROs and that NRSRO rating activities are journalistic and are afforded a high level of protection under the First Amendment.

Proposal to Define the Term "NRSRO"

More recently, the Commission, on March 3, 2005, voted to issue a rule proposal that would define the term "NRSRO" for purposes of Commission rules. The proposal builds on earlier Commission work relating to credit rating agencies. The goal of the proposal is to provide greater clarity and transparency to the process of determining whether a credit rating agency's ratings should be relied on as NRSRO ratings for purposes of Commission rules. The proposed definition and the interpretations thereof are intended to provide credit rating agencies with a better understanding of whether they qualify as an NRSRO.

The proposed definition of the term "NRSRO" is composed of three components, which the Commission believes to be the most important criteria in determining whether an entity's ratings should be relied upon for purposes of Commission rules and regulations. Specifically, the Commission is proposing to define the term "NRSRO" as an entity: (1) that issues publicly available credit ratings that are current assessments of the creditworthiness of obligors with respect to specific securities or money market instruments; (2) 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 (3) uses systematic procedures designed to ensure credible and reliable ratings, manage potential conflicts of interest, and prevent the

misuse of nonpublic information, and has sufficient financial resources to ensure compliance with those procedures.

The First Component of the Proposed NRSRO Definition

Under the first component of the proposed definition, to be an NRSRO an entity would have to issue publicly available credit ratings that are current assessments of the creditworthiness of obligors with respect to specific securities or money market instruments. The proposed requirement that an NRSRO make its credit ratings publicly available is consistent with the views of the majority of commenters to the 2003 Concept Release. Most commenters believed that it would be inappropriate to require regulated entities to pay for ratings through subscription services in order to satisfy regulatory requirements.

If adopted, the first component of the proposed definition would also require a credit rating agency to issue credit ratings that are “current assessments” of the creditworthiness of specific securities or money market instruments. The proposal states the belief that this component is necessary so that anyone relying on a rating for regulatory purposes in Commission rules and regulations would have confidence, at any given time, that the rating reflects the credit rating agency’s current view. Under the proposed definition, the Commission would interpret “current assessments” to mean that a credit rating agency’s published credit ratings should not only reflect its opinion as to the creditworthiness of a security or money market instrument as of the time the rating was issued, but that, until the rating is changed or withdrawn, it continues to represent the rating agency’s view as to the creditworthiness of such security or money market instrument.

Because the Commission’s regulatory use of the term “NRSRO” primarily relates to credit ratings on specific securities or obligations, the Commission, in its proposed definition, would limit the availability of the NRSRO concept to entities that issue such ratings. The Commission clarifies this element in the proposed NRSRO definition because credit rating agencies that do not issue credit ratings on specific securities, but instead issue credit ratings on the general creditworthiness of specific entities, have requested NRSRO no-action relief. The risk of loss on different debt instruments of the same issuer can vary considerably depending on the terms written into a security’s legal

documentation. Therefore, applying a single “issuer” rating to all of an issuer’s outstanding debt instruments could be misleading, in the context of the regulatory use of NRSRO ratings, and have adverse regulatory implications.

The Second Component of the Proposed NRSRO Definition

As discussed above, the notion that a credit rating agency be “nationally recognized” for purposes of the NRSRO concept was designed to ensure that credit ratings used for regulatory purposes are credible and reliable, and are reasonably relied upon by the marketplace. Responding to most commenters to the 2003 Concept Release that NRSRO status should be based primarily on a credit rating agency’s wide acceptance in the marketplace, the second proposed component of the “NRSRO” definition focuses on whether a credit rating agency is generally accepted in the financial markets as an issuer of credible and reliable ratings by the predominant users of securities ratings.

The second component of the NRSRO definition requires a credit rating agency to be generally accepted in the financial markets. The proposal states the belief that 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. Further, the proposal states the belief that linking the evaluation of a credit rating agency’s ratings to the views of the predominant users of securities ratings is 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. 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 proposal notes that incorporating market participant views into the definition of NRSRO provides a certain level of credibility and reliability to NRSRO ratings.

Commenters at the Commission’s credit rating agency hearings and to the 2003 Concept Release generally supported the idea that the definition of the term “NRSRO” could 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. Based on these comments, and the staff’s experience in issuing no-action letters to credit rating agencies,

the Commission has proposed that a credit rating agency that has developed a general acceptance in the financial markets for a limited sector of the debt market or a limited geographic area could meet the NRSRO definition. I note that NRSRO no-action letters have been provided to such firms in the past. In these instances, even though the credit rating agencies were generally accepted in the financial markets for a limited sector of the debt market or a limited geographic area, their market acceptance was based on the credibility and reliability of their ratings. Accordingly, the regulatory use of those ratings in Commission rules and regulations is appropriate and consistent with the purposes underlying the NRSRO concept.

The Third Component of the Proposed NRSRO Definition

The third component of the proposed NRSRO definition is designed to ensure that, to meet the definition of the term “NRSRO,” a credit rating agency uses systematic procedures designed to ensure credible and reliable ratings, manage conflicts of interest, and prevent the misuse of nonpublic information. It also addresses the need for credit rating agencies to have sufficient financial resources to ensure compliance with such procedures, if they are to meet the definition. 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 proposal solicits comment on whether the following would be important for assessing whether a credit rating agency meets the third component of the proposed definition:

- (1) The experience and training of a firm’s rating analysts (pertaining to the analysts’ ability to understand and analyze relevant information);
- (2) 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);
- (3) 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);

- (4) 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 credibility of an issuer's management and to attempt to better understand the issuer's financial and operational condition);
- (5) 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);
- (6) How the credit rating agency identifies and manages or proscribes conflicts of interest affecting its ratings business;
- (7) How the credit rating agency monitors and enforces compliance with its procedures designed to prohibit the misuse of material, nonpublic information; and
- (8) 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).

No-Action Letter Process

The proposal states the belief that while adopting a definition of NRSRO would help address commenters' concerns regarding transparency, credit rating agencies might desire to continue to seek staff no-action letters in order to clarify the ability of third parties to rely on their ratings for regulatory purposes. As such, and in light of the long-standing reliance by broker-dealers, issuers, investors and others on the existing staff no-action process, the Commission states in the proposal that, if it were to adopt a definition of NRSRO, it plans to continue to make Commission staff available to provide no-action letters as appropriate to those entities that choose to seek it. No-action letters would be granted for a specific period of time after which the relief would need to be reconsidered.

Commission Authority over NRSROs

As I mentioned previously, a number of commenters to the 2003 Concept Release recommended that the Commission enhance the staff's ability to verify whether an NRSRO continues to meet the minimum standards that led to its designation. Due to apparent limits on the Commission's authority in this area, the Commission staff has worked with the current NRSROs during the past six months to craft a framework for voluntary oversight by the Commission. At this time, our dialogue with the industry has not resulted in an agreed-upon voluntary oversight framework. Nonetheless, I believe a strong and effective industry-led regime could prove to be a constructive and reasonable approach to address a number of concerns involving the credit rating industry that have been raised in recent years by Congress, the Commission, and others, such as the International Organization of Securities Commissions.

That said, the Commission believes that to conduct a rigorous program of NRSRO oversight, more explicit regulatory authority from Congress is necessary. The Commission has not taken a formal position on whether additional legislation should be forthcoming, but it does believe that Congressional hearings on this issue are useful to ensure that this important question is properly vetted. A well-thought out regulatory regime could provide significant benefits in such cases as record-keeping and addressing conflicts of interest in the industry. As Chairman Donaldson said last month before the Senate Committee on Banking, Housing, and Urban Affairs – the Commission welcomes Congressional attention and, of course, would stand ready to work with Congress on crafting appropriate legislation if Congress determines such legislation is necessary.

Thank you again for inviting me to testify. I would be happy to answer any questions you may have.

PAUL E. KANJORSKI
11TH DISTRICT, PENNSYLVANIA
COMMITTEE ON
FINANCIAL SERVICES

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April 12, 2005

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The Honorable William H. Donaldson
Chairman
U.S. Securities and Exchange Commission
450 Fifth Street, NW, Room 6000
Washington, DC 20549

Dear Mr. Chairman:

As you know, the House Financial Services Capital Markets Subcommittee is very interested in the activities of U.S. Securities and Exchange Commission regarding Nationally Recognized Statistical Rating Organizations. Accordingly, to facilitate possible legislative action on these matters in the 109th Congress, this letter requests your technical assistance in providing greater detail about the specific statutory authorities that the Commission may need to improve regulatory oversight of all credit-rating institutions generally and nationally recognized agencies specifically.

Like many of my colleagues, I want to ensure that rating agencies operate effectively, efficiently, and ethically, in order to ensure that Americans understand the real credit risks of their investments. In your recent testimony before the Senate Banking Committee you also noted that “a well-thought-out regulatory regime could provide significant benefits [for investors] in such areas as record-keeping and addressing conflicts of interest in the industry.” I agree with these assessments.

You additionally indicated in this testimony that “legislation may be needed” in this area, even if the Commission and the nationally recognized rating agencies do develop and implement a voluntary framework to improve industry oversight. You further commented that the Commission “would stand ready to work with Congress on crafting appropriate legislation if Congress determines that such legislation is necessary.”

As you know, I have previously called on the Commission to take “prompt and prudent action” to address long-lingering questions related to the supervision of credit-rating agencies. Based on your recent comments before the Senate Banking Committee, several similar public statements made by other senior officials at the Commission, and the limited, but useful, regulatory proposal recently released by the Commission, I have concluded that it is now time to ask what specific legal authority would be needed to effectively oversee rating agencies. Consistent with all applicable law and regulation, I would therefore appreciate receiving your

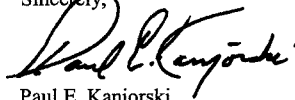
technical assistance in providing draft legislative language that Congress could use if it ultimately determined that it was appropriate to create a comprehensive oversight regime for credit-rating agencies.

Obtaining your insights at this time will help us in crafting an appropriately balanced piece of legislation should we decide to take action on these matters during the 109th Congress. Learning of your views now on any needed statutory enhancements will additionally help us to expedite future legislative action if the voluntary framework negotiations should break down or result in a flawed product. It will also ensure that we address First Amendment considerations, legal precedents, and the specific issues raised in the two concept releases previously issued on these matters.

In addition to providing technical assistance, please continue to keep me informed of the Commission's progress with respect its recent rule proposal related to Nationally Recognized Statistical Rating Organizations and its negotiations with interested parties over a voluntary framework. As for myself, I have not yet concluded the most appropriate way to resolve this problem. It is nonetheless my expectation that the Commission and Congress will eventually act in a way that protects investors without imposing unnecessary regulatory burdens on the securities industry.

In closing, I look forward to receiving your response and request that it be forwarded to my office by June 6, 2005.

Sincerely,



Paul E. Kanjorski
Member of Congress

PEK/tmh

