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BY ELECTRONIC MAIL

Ms. Nancy M. Morris
Secretary
United States Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Re: *File No. S7-04-07*
Proposed Rule: Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations

Dear Ms. Morris:

This letter is submitted by Fitch, Inc. ("Fitch") in response to the request for comments of the Securities and Exchange Commission ("SEC" or the "Commission") to the rules proposed in *Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations* (Release No. 34-55231; File No. S7-04-07, the "Proposed Rules"). Fitch was first recognized as a nationally recognized statistical rating organization (a so-called "NRSRO") by the SEC in 1975, and is currently one of the five NRSROs.

Set forth below are our comments on the Proposed Rules, other than Proposed Rule 17g-6(a)(4) that prohibits the practice commonly known as "notching," which we address in a separate comment letter, and answers to those questions raised by the Commission for which we believe we have useful observations and comments. For the convenience of the Commission, we have set forth our comments below in order of impact on Fitch's business.

1. Issues Relating to Prohibited Acts and Practices Concerning Unsolicited Ratings

Relevant Proposed Rule: 17g-6(a)(5)

We understand, and agree with the underlying principle, that the Credit Rating Agency Reform Act of 2006 (the "Credit Rating Act") makes it unlawful for a rating organization to coerce a person, with respect to whom an unsolicited credit rating has been issued by such rating organization, into paying for the unsolicited credit rating or other service.[1] We also understand

[1] We understand an "unsolicited credit rating" to be a rating of an entity that has not assented to the issuance of the rating. Under Fitch's policy, the decision to issue these ratings must meet the same standards for information

the Commission's concern that a rating organization may exercise a degree of influence on issuers, and that a rating organization should not engage in "strong-arm" tactics to induce payment for an unsolicited credit rating, as such behavior would be unfair, coercive or abusive. However, the blanket prohibition set forth in Proposed Rule 17g-6(a)(5) is overbroad, and we request the Commission consider revising it in light of the reasons submitted herein.

As drafted, Proposed Rule 17g-6(a)(5) sweeps within its mandate non-coercive as well as coercive communications between rating organizations and such rated persons. For example, under Proposed Rule 17g-6(a)(5), rating agencies would be prohibited from contacting such rated persons and soliciting purchase of other rating organization services even years after the unsolicited rating was issued. In addition, under the Proposed Rule a rating organization might not be able to cease rating an entity on an unsolicited basis for any reason, as such action may be construed as an attempt to induce payment. This Proposed Rule could also prevent such rated person from voluntarily availing itself of a service offered by the rating organization that would require payment. These are day-to-day business decisions of rating organizations (or of the rated entities themselves) that have no relationship to the coercive behavior Proposed Rule 17g-6(a)(5) prohibits.

Therefore, while Fitch agrees in principal with the proposed rule, we suggest revising Proposed Rule 17g-6(a)(5) as follows: "Issuing an unsolicited credit rating and communicating with the rated person to induce or *coerce* the rated person to pay for the credit rating or any other service or product of the rating organization or a person associated with the rating organization. *Notwithstanding the foregoing, the rating organization or person associated with the rating organization is not prohibited from (i) ceasing to provide an unsolicited credit rating at any time for any legitimate business purpose; (ii) requiring or receiving payment for services related to the credit rating after a reasonable period of time following issuance of the credit rating; or (iii) seeking payment or business from such rated person for services unrelated to the credit rating. Moreover, nothing in this provision shall prohibit such rated person from voluntarily paying for services unrelated to the credit rating offered on a fee-basis by the rating organization or a person associated with the rating organization.*"

2. Financial Statements

a. Issues Relating to Meeting Initial Application Deadline

Relevant Proposed Exhibits: 10, 11, 12, 13

Form NRSRO requires certain exhibits requesting financial information that Fitch will not be able to submit by the initial application deadline. The information requested by the Commission in these exhibits each raises a different issue for Fitch.

Proposed Exhibit 10 to Form NRSRO's request for a list of the largest issuer and subscriber customers is burdensome as drafted. First, it would appear that this list would need to

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and analysis as the decision to issue solicited credit ratings. Since 2001, Fitch has publicly disclosed such ratings as having been initiated by Fitch.

include information with respect to the customers of the NRSRO's affiliates. We do not currently have a consolidated revenue/billing system which includes our affiliates' information, and thus we would be unable to provide this information by the initial application deadline. Next, it is unclear whether the information provided for any one customer is intended to include all affiliates of that customer. If so, this is unduly burdensome as an ongoing requirement and one that Fitch will be unable to comply with at all by the initial application deadline. Fitch does not maintain its records on a basis that ties together affiliated issuers and subscribers, but rather maintains them by payor under the relevant fee arrangement. Similarly, we do not maintain records by obligor or underwriter that used credit rating services. We will be able to provide this information by payor only (both for the initial application and for the annual certification) under our current system, and we respectfully request that we not be required to change our practices in order to track the specific information the Commission seeks. We also request clarification as to whether Proposed Exhibit 10 attached to the initial application must be audited, as the Proposed Rules are silent on this issue. To the extent Proposed Exhibit 10 must be audited for the initial application (or for that matter the annual certification), Fitch will be unable to comply by the deadline as this information would not be auditable by our auditors due to the manual intensive data gathering process to produce this list and the subjectivity used to aggregate the data. Please note that if the list does not have to be aggregated by issuer or subscriber, but only by payor as suggested below on page 4, it can be audited. The burden associated with producing the information requested by Proposed Exhibit 10 is discussed more fully on pages 4.

While Fitch is able to provide audited U.S. GAAP financial statements for the past three years as requested under Proposed Exhibit 11 by the initial application deadline, it can do so only if the statements do not need to comply with Regulation S-X. Fitch currently does not prepare financial statements in compliance with Regulation S-X. In the event Proposed Exhibit 11's audited financial statements must comply with Regulation S-X, it will be a very lengthy and costly process and such financial statements will not be available by the deadline. We believe that the Proposed Rules do not require that the initial application include financial statements audited in compliance with Regulation S-X, but we would appreciate the Commission's clarification that this is the case.

Fitch will be able to supply most of the revenue information requested by Proposed Exhibit 12 by the initial application deadline because the Commission has explicitly stated that the information need not be audited. Proposed Rules at 62. We do not, however, track "[r]evenue from determining credit ratings that are not made readily accessible (private ratings)," and therefore cannot supply such information at this time. Our inability to provide information on private ratings is discussed in more detail on page 5.

Finally, since we do not currently maintain compensation data at the level requested by Proposed Exhibit 13, we will not be able to provide the requested information by the initial application deadline. As discussed in more detail on page 6, we believe we will be able to supply this information for fiscal year 2008.

b. Issues Relating to Disclosure of Large Fee-Paying Issuers and Subscribers

Relevant Proposed Rule: 17g-3(b)(3) Relevant Proposed Exhibit: 10

1. 20 largest issuers and subscribers

As discussed briefly above, we do not currently have a system that aggregates our revenue sources with those of our affiliates. Also, Fitch currently tracks revenue only through subscription agreements and fee letters. For example, Fitch may rate several subsidiaries of a large financial institution, and the several ratings each correspond to a different fee letter. As Fitch currently does not maintain records of the corporate relationships of the entities it rates or to whom it provides subscription services, if required, it would need to manually produce the requested lists by aggregating the individual fees based on our belief of who was an affiliate of whom – a process that is time consuming and prone to inaccuracies. Moreover, given our manual process of gathering such information, we have been told by our external auditors that the results would not be deemed auditable. We have looked into the cost of enhancing our existing systems to capture this data and produce the relevant reports that can be audited and we estimate it will take approximately 2.5 years and cost approximately $6 million to $8 million to complete. This is impractical and very costly, and we respectfully request the Commission not require us to provide this information. Instead, we believe it would be more practical, as well as advance the Commission's goal, for credit rating agencies to be required to submit revenue information of the *50 largest payors*, as it would greatly decrease the burden of providing such information, and yet still enable the Commission to perceive patterns of revenue received.

2. Large underwriters and obligors

Fitch does not currently track revenue according to underwriter. Because, as explained above, Fitch tracks such revenue only through fee arrangements, it would not be possible for Fitch to provide information on the largest underwriters. Further, we do not believe such a requirement would advance the Commission's goal of detecting undue influence. Even though underwriters regularly refer issuers to the rating agencies, the underwriters do not make the decision as to which rating agency will be asked to rate the issuer and/or issuance. We request that the requirement for large underwriter information be eliminated and that Fitch not be made to undertake the burdensome task of tracking revenue by underwriter.

Fitch also does not currently track revenue according to obligor, unless the obligor enters into a fee arrangement. For example, structured finance transactions can often involve situations where the obligor is not yet known at the time Fitch enters into a fee arrangement. Moreover, because of our practice, as with issuers and subscribers, of maintaining revenue information on the basis of fee arrangements, we cannot at present determine which obligors are related and thus aggregate the information in the way the Commission may be suggesting. We therefore request that the requirement for large obligor information be eliminated and Fitch not be required to maintain revenue data by obligor.

c. Problems with Regulation S-X Compliance

Relevant Proposed Rules: 17g-3(a), (c)

As mentioned above, Fitch does not currently prepare financial statements in compliance with Regulation S-X. In order to do so, we will need to reformat our financial statements and make additional disclosures. We also seek clarification as to whether Proposed Rule 17g-3(a) would require us to submit two years of audited consolidated balance sheets and three years of audited income statements as provided in Regulation S-X at 17 C.F.R. §§ 210.3-01, 02. While we have implemented systems that would enable our compliance, we would not be able to submit Regulation S-X-compliant financial statements until fiscal year 2008. This limitation is due to the Regulation S-X requirement for prior years of financials and our inability to reformat information prior to 2006 as a result of new system implementation. We therefore request that this requirement not be applied to us until fiscal year 2008.

d. Problems with Assembling Revenue from Private Ratings

Relevant Proposed Rule: 17g-3(b)(1)(iv) Relevant Proposed Exhibit: 12

While we are willing to provide any relevant information the Commission, as authorized under the Credit Rating Act, requires, our current accounting systems simply do not allow us to comply with Proposed Exhibit 12 and Proposed Rule 17g-3(b)(1)(iv). Fitch does not distinguish between publicly available and private ratings when recording revenue from its credit rating services. To either go back and differentiate between public and private ratings or overhaul Fitch's existing tracking systems to make such distinctions would be time consuming and financially prohibitive. We believe, therefore, that this requirement is impractical and request that it be eliminated. In the alternative, given the burdens associated with recreating this information and overhauling Fitch's system to maintain it going forward, we request we not be required to maintain such information and that the rule provide an exception if such information is not available.

e. <u>Analyst Compensation</u>

Relevant Proposed Rule 17g-3(b)(2) Relevant Proposed Exhibit: 13

Fitch seeks clarification that the definition of "credit analyst" found in the Proposed Form NRSRO instructions (the "Instructions") on Proposed Exhibit 8 applies also to Proposed Rule 17g-3(b)(2) and Proposed Exhibit 13. Such a clarification both would aid Fitch in providing the required compensation information as well as address the Commission's purpose of monitoring the adequacy of an NRSRO's managerial and financial resources. Fitch also seeks clarification on how deferred compensation should be treated for purposes of the annual certification and the initial application. In addition, we suggest elimination of the Proposed Rule 17g-3(b)(2) requirement that the statements on analyst compensation be audited. We believe that requiring such an audit would be unduly burdensome and unnecessary because the accuracy of the information is subject to our strong internal control environment. We believe that an audit of this selected non-financial data will add cost and time, provide no value to the accuracy of the information and is not necessary to achieve the objectives of the Credit Rating Act. Finally, since we do not currently track our compensation at this level, we would request that the Commission grant us sufficient time to capture and produce this information. We anticipate that Fitch would be able to provide this information for fiscal year 2008.

f. <u>Objection to Requirement Relating to General Ledger Records and Records of Original Entry</u>

Relevant Proposed Rule: 17g-2(a)(1)

We do not believe the requirement to make and retain records of original entry into the accounting system and records reflecting entries to and balances in all general ledger accounts is necessary to the Credit Rating Act's objective of monitoring the adequacy of an NRSRO's financial resources, although Fitch does maintain such records for appropriate periods of time. As the Commission stated in its explanatory notes, such records are necessary for the preparation of the audited financial statements and the schedules required under other rules. As such, we believe audited financial statements are sufficient to consider an NRSRO's financial adequacy. We therefore request that Proposed Rule 17g-2(a)(1) be eliminated.

g. <u>Objection to Making and Retaining Records of Information Underlying Annual Audited Financials</u>

Relevant Proposed Rule: 17g-2(b)(1)

Proposed Rule 17g-2(b)(1) is redundant with the requirement that NRSROs provide audited financial statements to the Commission under Proposed Rule 17g-3 and we respectfully suggest that it be eliminated. Although Fitch currently retains such records for appropriate lengths of time, we do not believe there should be a need to make such underlying records readily available to the Commission because we will be producing audited financial statements.

3. Issues Concerning Non-Manageable Conflicts of Interest

a. Issues Concerning Proposed Non-Manageaeble Conflicts of Interest Arising From Securities Ownership and Lending Transactions

Relevant Proposed Rule: 17g-5(c)(2)

Proposed Rule 17g-5(c)(2) appears to overreach its stated objective. It is our view that this proposed rule, which the Commission believes is appropriate in the public interest and for the protection of investors, prohibits conduct that should raise no conflicts of interest and proscribes conduct that is part of the ordinary course of any business. We believe that the Commission needs to balance its desire to protect investors with the realities of the business world by revising this provision as outlined below. Moreover, in accordance with the Credit Rating Act, the recitation that the proposal is "appropriate in the public interest and for the protection of investors," Proposed Rules at 92, seems inadequate to justify the proposal. To serve the objective of the Credit Rating Act to promote competition, the Credit Rating Act requires that the proposed regulation not achieve the Act's objectives in an unduly burdensome way.

Read literally, Proposed Rule 17g-5(c)(2), providing that a rating organization, credit analyst responsible for the credit rating or a person associated with the NRSRO responsible for approving the credit rating[2] shall not own "securities of, or [have] any other ownership interest in" the rated entity, prevents a credit analyst from investing in mutual funds or other collective investment schemes that may invest in a rated entity. In keeping with Fitch's current policy, we request that the Commission include a carve-out exception for investments in mutual funds or other collective investment schemes.[3] This exception would not apply to credit analysts responsible for the credit rating of mutual funds or persons associated with the rating organization responsible for approving the credit rating of mutual funds to the extent that such

[2] The Commission's use of the phrase "approving the credit rating" does not accord with our practice. A rating committee decides a rating or a rating action; no one separately or subsequently "approves" the rating. We therefore understand the phrase "approving the credit rating" to include all those involved in the committee's determination of the rating/rating action.

[3] This exception would also apply to Proposed Rule 17g-4(b), which seeks to "prevent a person associated with the rating organization or any member of an associated person's household from purchasing, selling, or otherwise benefiting from any transaction" when the "person possesses or has access to material nonpublic information obtained in connection with the performance of credit rating services that affects the securities or money market instruments." This rule likewise unnecessarily prevents individuals from investing in mutual funds or other collective investment schemes that may own a security rated by Fitch. This is overreaching, and Fitch respectfully requests that the Commission include an exception for investments in mutual funds or other collective investment schemes. As is Fitch's current practice, however, this exception would not apply to credit analysts (or their households) that rate mutual funds to the extent that they may not invest in the specific funds or collective investment schemes they are involved in rating.

persons would not be able to invest in the specific mutual funds they are involved in rating or are involved in approving.

Proposed Rule 17g-5(c)(2) also prohibits credit analysts responsible for the credit rating or a person associated with the NRSRO responsible for approving the credit rating from being a "borrower or lender with respect to the rated person," and, accordingly, such individuals would be prevented from having bank accounts, loans or mortgages from any bank they are involved in rating. Credit analysts in Fitch's insurance group essentially would not be permitted to own insurance from any company they are involved in rating. This cannot be the outcome the Commission intends, and Fitch does not have the desire or the infrastructure to track and police its employees' personal bank accounts, mortgages and insurance. Fitch therefore requests the Commission revise the proposed rule to account for the reasonable acts individuals engage in in the ordinary course.

Finally, the prohibition that a rating organization shall not be a "borrower or lender with respect to the rated person" should, similarly, be amended. Fitch and the other rating organizations operate like any other business, in that they must hold bank accounts, take out loans, have insurance policies and otherwise engage in business with entities that Fitch rates. This behavior is in the ordinary course of any business, and yet it is prohibited under Proposed Rule 17g-5(c)(2) as written. We request that the Commission clarify in its rules that the day-to-day running of a business, particularly with regard to borrowing or lending or entering into insurance contracts, should not be considered a conflict under the Credit Rating Act.

On a related note, the Commission asks "whether proposed Rule 17g-5 should contain materiality thresholds insomuch as some conflicts may be inconsequential." Proposed Rules at 94. While Fitch would not impose materiality thresholds, we believe the regulations should reflect the general understanding that procuring goods and services in the ordinary course of business is not a conflict. For example, Fitch may procure computers, electricity or telephone services from entities that are subject to issued or pending credit ratings. Given that the individuals at Fitch who negotiate these contracts associated with running our business are not the same individuals responsible for making credit rating determinations, Fitch does not think this situation requires disclosure of policies or procedures for conflict management. Rather, Fitch requests that the Commission include a provision in the rules that reflects the understanding that any transactions with vendors entered into in the ordinary course of business are not conflicts under the rules and that therefore Proposed Rule 17g-5 would not apply.

b. <u>Lack of Need for Proposed Rule 17g-5(b)(2)</u>

Relevant Proposed Rule: 17g-5(b)(2)

Fitch believes that Proposed Rule 17g-5(b)(2) should be eliminated because it is not a conflict and is redundant of Proposed Rule 17g-5(c)(2). Proposed Rule 17g-5(b)(2) creates the inference that an employee not involved in determining the credit rating or responsible for approving the credit rating may not own securities or money market instruments of a person subject to a pending or issued credit rating of the rating agency. That cannot be the case, as there is no conflict inherent in owning a rated security and working at the rating organization. A conflict arises only if the owner of the rated security has responsibility and oversight of the rating, as addressed under Proposed Rule 17g-5(c)(2). We note that our policy is to prohibit credit analysts who participate in proposing the credit rating and/or who vote on the rating committee for an entity from owning securities or money market instruments of such rated entity (other than through mutual funds or other collective investment schemes, as described above).

c. Suggestion that Proposed Non-Manageable Conflict Relating to Net Revenue Contribution Be Made a Managed Conflict

Relevant Proposed Rule: 17g-5(c)(1)

Any conflict related to the rating organization's issuing or maintaining a credit rating solicited by a person that provided the rating organization and its affiliates with net revenue equaling or exceeding 10% of the total net revenue of the rating organization and its affiliates for the year can be disclosed and managed. Although Fitch currently rates no entity that provides Fitch and its affiliates with net revenue equaling or exceeding 10% of their total net revenue, it is plausible that such situation could arise at some point. This may be an issue especially for smaller rating organizations that issue fewer ratings, and for which it is more likely that one single rating may make up over 10% of its total net revenue. Such a requirement would arguably forestall the Credit Rating Act's objective of safeguarding a competitive market of participants. We believe this conflict could be effectively managed under Proposed Rule 17g-5(b) through disclosing the person whose fees equal or exceed 10% of the total net revenue and implementing policies and procedures to address any potential concern over the rating organization's independence.

We also suggest that this conflict be edited to substitute the term "*paid*" for "solicited." Fitch does not maintain revenue information based on which entity solicits a credit rating. Recreating records on the basis of who solicited a credit rating or developing a way to track this information in the future is unduly burdensome and not practical. Rather, as discussed above, Fitch maintains records based on payment and therefore can track percentage of net revenue only by payor. We request that the Commission not require rating organizations to begin to maintain (or recreate) records based on who solicited credit ratings for the sake of complying with this Proposed Rule, and instead permit this data to be collected based on payor.

4. Issues of Identifying Applicant

Proposed Form NRSRO Item 1

Fitch seeks confirmation of our interpretation that when a parent company submits an initial application to be recognized as an NRSRO, it applies for registration also on behalf of its subsidiaries, including minority-owned subsidiaries where it has full control over the rating process. We believe it is the Commission's intention to ensure that oversight covers all affiliated entities conducting a common credit rating agency business.

5. Issues Relating to Procedures and Methodologies

a. Issue Relating to Burden of Attaching Voluminous Documents to Form NRSRO

Relevant Proposed Exhibit: 2

We believe that if the first sentence of the Instructions for Proposed Exhibit 2 is intended to require that a rating organization provide literally "the procedures and methodologies that the credit rating agency uses to determine credit ratings, including unsolicited credit ratings," the requirement is unduly burdensome. Such a requirement would mean that Fitch must attach to its initial application tens of thousands of pages of documents that are otherwise publicly available, as Fitch publishes its procedures and methodologies on its free web site. We believe that incorporating by reference these publicly available procedures and methodologies would be sufficient to the Commission's purposes of determining whether to grant a rating agency NRSRO status and of providing information to the public.

While we agree that users and potential users of credit ratings should be informed of an NRSRO's rating methodologies in order to understand the rating process, we believe the requirements under Proposed Exhibit 2 as written are broader than what is needed to achieve the Credit Rating Act's stated goal of providing information to the public and oversight of compliance. Congress's prohibition on the Commission's regulation of the substance of procedures and methodologies restricts the Commission in its requirements for the level of detail in rating agencies' procedures and methodologies that differs from the level of detail in fact adopted by the credit rating agency. See Securities Exchange Act of 1934 ("Exchange Act") § 15E (c)(2). We believe our procedures and methodologies as currently published on Fitch's web site provide the Commission and the general public with a sufficient level of detail.

We note, however, that Fitch also maintains analyst reference guides ("ARGs"), which are not publicly available as they contain instructional materials for Fitch analysts and which are proprietary to Fitch. We do not believe these proprietary training materials should be published, as they do not provide the kind of information useful to users and potential users of credit ratings. If necessary, we would be willing to provide these ARGs on a confidential basis to the Commission. If the Commission, however, requires the rating organizations to publish the ARGs (or documents similar to the ARGs) with the initial application, we will need more time to prepare the ARGs to omit the proprietary instructional portions. We would appreciate the Commission's guidance on this issue.

b. Issue of Regulation of Procedures as Applied to Record Making

Relevant Proposed Rule: 17g-2(a)(2)(iii)

Fitch observes that Congress's prohibition on the Commission's regulation of the substance of procedures and methodologies restricts the Commission from regulating the records made in accordance with an NRSRO's procedures and methodologies. That is, if an NRSRO's procedures do not prescribe that it make a record of procedures and methodologies used, we believe that the Credit Rating Act makes clear that the NRSRO may not be required to do so.

6. Issues Relating to Record Making, Retention and Examination

a. Clarification of Dates Triggering Record Retention Periods

Relevant Proposed Rule: 17g-2(c)

Fitch believes that the record retention requirements under Proposed Rule 17g-2(c) would be clearer and less burdensome to implement if there was a more succinct policy that took into account the ongoing nature of the rating agency business.. We therefore suggest that records referred to in Proposed Rules 17g-2(a)(1), (a)(2), (a)(5) and (b) "*be retained for three years after the date the record was made or received.*" We do recognize that a slightly different standard may be more appropriate for the records referred to in 17g-2(a)(3) and (4) and therefore suggest that they "*be retained for three years after the date the record ceases to be in effect*."

As currently drafted, Proposed Rule 17g-2(c)(1) is ambiguous in requiring record retention for "three years after the date the record is replaced with an updated record." We suggest it be consolidated under the "made or received" standard in Proposed Rule 17g-2(c)(3). Proposed Rule 17g-2(c)(2) does not take into account that Fitch, like other rating organizations, has continuing business relationships with many rated issuers and that such relationships may never actually "end." As drafted, Proposed Rule 17g-2(c)(2) is unclear and would require an NRSRO to retain records in perpetuity or to retain records that have ceased to be effective for a long period of time, which would be burdensome and unnecessary in light of the Commission's purpose of monitoring NRSROs' compliance with internal policies and procedures.

Accordingly, we suggest that Proposed Rule 17g-2(c) read as follows: "The records required to be retained pursuant to paragraphs *(a) and (b)* of this section must be retained for three years after the date the record *was made or received, provided that records required to be retained pursuant to paragraphs (a)(3) and (a)(4) must be retained for three years after the date the record ceases to be in effect.*" Please note that we would also be willing to retain records for longer than three years if necessary.

b. Non-Resident Undertaking Issue

Relevant Proposed Rule: 17g-2(f)

The proposed non-resident undertaking set forth in Proposed Rule 17g-2(f) imposes an undue burden on non-resident NRSROs. It is our view that it is a financial hardship and burden for non-resident NRSROs to translate and provide documents to the United States upon any Commission request. In addition, many non-resident NRSROs, including those related to Fitch, are constrained by local privacy laws.

We understand, however, that the Commission may in certain circumstances require inspection of records maintained overseas without having to travel to the location. We suggest that the undertaking be narrowed to Commission requests that are "reasonable" and that the demand for materials be limited to the "extent permitted by local law." Accordingly, we suggest that the first sentence of Proposed Rule 17g-2(f) be revised to state: "A non-resident rating organization, as defined in paragraph (h) of this section, must undertake to provide books and records to the Commission upon a *reasonable* demand *and to the extent permitted by local law*."

The proposed form of the undertaking the Commission requests non-resident rating organizations to submit should likewise be amended to include our proposed language.

c. Problems with Making a Record for Each Person That Solicits the Rating Organization

Relevant Proposed Rule: 17g-2(a)(3)

As drafted, the requirement that rating organizations "make and retain" a record for each person "that solicits the rating organization to determine or maintain a credit rating," Proposed Rule 17g-2(a)(3), is overly intrusive and burdensome. As previously mentioned, Fitch tracks contact information by the person that pays the relevant fee; credit ratings are tracked by issuer/issuance. Fitch does not maintain this information by solicitor, as such information is not relevant to the rating organization's business. Creating new internal procedures to track this information would be time consuming and expensive and is unnecessary as such information is not relevant to determine Fitch's financial adequacy or to identify conflicts of interest. Instead, we believe that records maintained by payor would be sufficient to achieve the Commission's objectives and comply with the Credit Rating Act.

Accordingly, we suggest that Proposed Rule 17g-2(a)(3) be revised as follows: "A record for each person (for example, an obligor, issuer, underwriter, or other user) that *pays* the rating organization to determine or maintain a credit rating indicating: (i) The identity and principal business address of the person; and (ii) The credit rating(s) *requested by such person*."

d. Problems with Making Records Describing Each Type of Service and Product Offered Required to Be Made and Retained

Relevant Proposed Rule: 17g-2(a)(5)

It is overly burdensome for Fitch to "make and retain" "[a] record describing each type of service and product offered." Proposed Rule 17g-2(a)(5). Tracking "services and products offered" is nearly impossible, as "offers" may be made in countless ways, including through telephone calls and mailings. However, Fitch makes and retains a record describing each type of service and product "requested" through its fee letters and subscription agreements. We believe such information is sufficient to serve the public interest, protect investors and assist the Commission to monitor whether rating organizations are complying with the Credit Rating Act and the rules thereunder, and we therefore request the Commission not require us to keep records of all "services and products offered."

Accordingly, we suggest that the Commission revise Proposed Rule 17g-2(a)(5) as follows: "A record describing each type of service and product *requested from* the rating organization."

e. Clarification of "Work Papers"

Relevant Proposed Rules: 17g-2(b)(2), (3)

Fitch requests clarification that "work papers" as used in Proposed Rules17g-2(b)(2), (3) does not include drafts of documents.

f. Problems with Retaining Records of External and Internal Communications

Relevant Proposed Rule: 17g-2(b)(7)

We suggest that the phrase "*that are material to the credit rating*" be added to the end of Proposed Rule 17g-2(b)(7). This would clarify that extraneous communications that do not form the basis of the rating or any change to the rating need not be retained. Without this revision, the requirement of retaining all external and internal communications "received and sent by the rating organization and its employees relating to initiating, determining, maintaining, changing, or withdrawing a credit rating" is overbroad as it will capture immaterial exchanges. In addition, Fitch reminds the Commission that, like any business, Fitch has constraints in terms of physical and electronic storage space. We request that the Commission avoid requiring the retention of communications extrinsic to what is material to the credit rating.

g. Third-Party Record Custodian Undertaking

Relevant Proposed Rule: 17g-2(e)

We suggest that the undertaking required of third-party record custodians be amended as follows: ". . . upon the *reasonable request* of the Commission *and to the extent permitted by local law and in accord with local custom or practice* it will promptly permit examination by the Commission and its representatives of the records at any time or from time to time during business hours . . . ."

7. Issues Relating to Requirements for Personal Employee Information

a. Objection to Providing Analyst Information

Relevant Proposed Exhibit: 8

The information required by Proposed Exhibit 8 appears to exceed the Commission's statutory mandate, which authorizes the Commission to deny NRSRO registration upon determining that a credit rating agency does not have "adequate financial and managerial resources to consistently produce credit ratings with integrity." Exchange Act § 15E(a)(2)(C)(ii)(I). Requiring the name, title and description of responsibilities, employment history, education and employment status of each credit analyst does not relate to an NRSRO's managerial resources. Such a requirement also would be unduly burdensome, in that Fitch would need to request that over 1,000 employees create current *curriculum vitae* for attachment to its Form NRSRO. Further, certain European Union laws on privacy restrict Fitch from disseminating personal information about its employees. We propose instead that such detailed information be required only for senior management personnel and that, in addition, NRSROs submit the numbers of analysts who work on full-time and part-time bases. We believe that such a requirement keeps to the statutory bounds while providing relevant information useful to investors.

b. Objection to Providing Compliance Officer Assistant Information

Relevant Proposed Exhibit: 9

The Instructions to Proposed Exhibit 9, in requiring the name, title and description of responsibilities, employment history, education and employment status of "any other persons that assist the designated compliance officer," also appear to go beyond the Credit Rating Act's statutory bounds. The Credit Rating Act mandates the designation of a compliance officer, Exchange Act § 15E(j), but it does not specifically provide for the appointment of any compliance officer assistant. As explained above, under the discussion of Proposed Exhibit 8, such detailed information is not relevant to a determination of managerial adequacy. We therefore propose that the requirement as to assistants be eliminated.

8. Timing of Compliance Issues Relating to Form NRSRO and Annual Certification

a. Problems with Timing of Public Availability of Form NRSRO

Relevant Proposed Rule: 17g-1(d)

The Commission's proposal under 17g-1(d) that rating organizations have "5 business days" to "make the current Form NRSRO and non-confidential exhibits publicly available by posting them on its Web site or by another comparable and readily accessible means" as of "the date of the Commission order granting the application" or "furnishing an amendment or annual certification" is too short. Fitch has made inquiry of its Information Technology department, and we have concluded that it is not possible to make this volume of information accessible within 5 business days. We therefore request that the period of "5 business days" be revised to "*15 business days*," which we believe is a more practical time period and one that rating organizations will be able to meet.

b. Problems with Timing of Updating Form NRSRO

Relevant Proposed Rule: 17g-1(f)

Fitch agrees that a rating organization amending its application should "promptly furnish the Commission with the amendment on Form NRSRO that follows all applicable instructions for the Form." Proposed Rule 17g-1(f). However, the Commission's belief that updating Form NRSRO "promptly" means to do so within two business days is unrealistic. There are many components involved in updating Form NRSRO, including completing Form NRSRO, attaching the amended information and submitting the amendment package to the Commission, and two days is insufficient to ensure that it would be done properly. Fitch believes that "promptly" should be understood to mean ten business days, which is a reasonable time period to update Form NRSRO, and that rating agencies should have little problem meeting this deadline in most circumstances.

c. Problems with Annual Certification Deadline

Relevant Proposed Rule: 17g-1(g)

The timing the Commission proposes for the rating organizations to submit annual certifications as not later than 90 days after the end of each calendar year is not practical for rating organizations that operate with non-traditional fiscal year dates. Fitch's fiscal year ends in September. Under Proposed Rule 17g-3(a), we would have to file our audited annual financial statements "not more than 90 calendar days after the end of the fiscal year," that is by the end of December, but file our annual certification with audited financials by the following March. This timing would create duplicative work. As it is outside the Commission's mandate to change Fitch's fiscal year (nor do we believe the Commission would want to), we suggest that this rule be amended to include "*an option*" for an NRSRO to submit its annual certification "*not later than 90 days after the end of its fiscal year*."

Thank you for giving us the opportunity to provide our comments. We hope you find them useful, and that you will give them due consideration. Please call me at (212) 908-0626 with any questions that you might have on our comments or to discuss this matter further at your convenience.

Very truly yours,

Charles D. Brown

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March 12, 2007

BY ELECTRONIC MAIL

Ms. Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-0609

Re: *File No. S7-04-07*
Proposed Rule: Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations

Dear Ms. Morris:

We write to comment on the Securities and Exchange Commission's ("Commission") proposed rules implementing the provisions of the Credit Rating Agency Reform Act of 2006 (the "Act") concerning unfair, coercive and abusive conduct. In particular, this letter addresses Proposed Rule 17g-6(a)(4), which prohibits the practice commonly known as "notching." This is the practice by which rating agencies such as Moody's Investor Services, Inc. ("Moody's") and Standard & Poor's, Inc. ("S&P"), as a condition of rating securities or money market instruments issued by an asset pool (such as a money market mutual fund or a pooled investment vehicle), or as part of any asset-backed or mortgage-backed securities transaction (such as a collateralized debt obligation or structured investment vehicle) (collectively, a "Portfolio Product"), insist on rating most, if not all, of the assets underlying the portfolio, and on reducing ratings that other NRSROs have assigned to collateral in the portfolio that they themselves have not rated. We are separately submitting comments on the Commission's proposed rules implementing other provisions of the Act.

We believe that Proposed Rule 17g-6(a)(4) is critical to achieving the Act's objective of greater accountability, transparency, and competition in the credit ratings market. We also believe it has wide-ranging implications for the capital markets. Among its other pernicious effects, notching:

- distorts capital flows and risk-adjusted returns;
- impedes the issuer community's ability to structure transactions freely;

- reduces the predictability and comprehensiveness of available information by, among other things, reducing the number of credit opinions available;
- decreases rating agencies' responsiveness to the needs of financial market participants;
- permits the largest rating agencies to charge excessive fees;
- restricts competition in the ratings markets for Portfolio Products and the securities that comprise them;
- constrains the purchasing choices of issuers of Portfolio Products by forcing them to buy securities that carry Moody's and S&P ratings;
- compels issuers of securities comprising, or purchased by, Portfolio Products to buy ratings from the agencies that practice notching (i.e. Moody's and S&P);
- limits competition in the ratings markets for securities wrapped by financial guaranty insurers and reinsurers;
- potentially makes credit markets more pro-cyclical and subject to greater event risk.

Although we fully agree with the Commission's preliminary determination that notching is unfair, coercive and abusive, we believe Proposed Rule 17g-6(a)(4) does not go far enough to meet the desired goal of a free and fair credit ratings market. As discussed in detail below, we believe:

- the 85% threshold provided under the exception to subsection (a)(4) should be eliminated or reduced;
- the Proposed Rule's safeguards should be extended to financial guaranty insurers and reinsurers of asset-backed and mortgage-backed securities and municipal bonds;
- the Proposed Rule should expressly prohibit NRSROs from refusing to recognize other NRSROs' ratings, or reducing other NRSROs' ratings, or using any other direct or indirect means, including but not limited to, insisting on shadow ratings or credit assessments, or adjusting their models, to compel investment portfolios to invest in securities rated by them;
- the Proposed Rule needs to be aligned with the Act to make it clear that the Rule, like the Act, applies to synthetic collateralized debt obligations and derivatives as well as cash transactions.

Changes in the Debt Markets Have Led to Distortions in the Credit Rating Markets

Dramatic changes in the debt markets over the last decade have resulted in the dominant NRSROs being able to suppress competition in the credit rating markets through notching and related unfair, coercive, and abusive practices. Historically, the vast majority of purchasers of bonds, including traditional investors such as insurance companies and mutual funds, invested in debt securities to meet income requirements. In the last decade, a new category of buyers emerged, namely investment vehicles created solely to purchase securities and simultaneously issue debt to fund their purchases. These include structured investment vehicles, asset backed commercial paper programs, and collateralized debt obligations, among others. The enormous size of these vehicles' holdings — asset backed commercial paper programs alone hold in excess of a trillion dollars in assets — has materially altered the composition of virtually every corner of the debt market; the residential mortgage market, student loan market, and corporate debt and loan markets have all been affected.

The changes in the debt markets have enabled the largest NRSROs to restrict competition and bar new entrants from the structured finance credit rating markets. As the structured finance market has grown exponentially in terms of both dollar value and number of market participants, it has become increasingly circular. Most notably, Portfolio Products issuers regularly acquire securities of other Portfolio Products issuers. The circularity of the market, in which large, intertwined investors are each subject to notching guidelines mandated by Moody's and S&P, has allowed Moody's and S&P to extend their partner monopoly in the traditional bond market to the increasingly prominent structured finance market. Therein lies the power of the unfair, coercive, and abusive practice of notching.

Notching Severely Restricts Competition in the Credit Ratings Markets

Notching has two distinct components that operate in tandem to suppress competition in the credit rating markets. As a condition of rating securities or money market instruments issued by a Portfolio Product, Moody's and S&P typically require that they effectively rate each and every investment made by such an entity. Generally, they require that no less than 80% and sometimes as much as 100% of the securities comprising the Portfolio Product bear their public rating, depending on the asset class and composition of the portfolio. At the same time, for the remaining securities, Moody's and S&P insist that they provide a private shadow rating or credit assessment for a fee, or assign a reduced rating based on another NRSRO's public rating. In the latter case, they reduce the other NRSRO's rating by as many as four "notches" or rating categories. For example, in determining the rating to be assigned to a Portfolio Product, Moody's and S&P, without analytic justification, will treat investment grade securities rated "BBB" by any other NRSRO as below investment grade. This anti-competitive conduct applies to cash, synthetic and derivative transactions alike.[1]

Moody's and S&P's insistence on their own ratings as the sole indication of credit quality severely restricts the competition for ratings on the wide range of securities typically purchased by issuers of, and which typically comprise, Portfolio Products. This is because Portfolio Products are burdened with significant additional fees and other costs when securities are subject to shadow ratings, or credit assessments, or when ratings assigned to securities included in the portfolio are reduced or "notched" as a condition of the Portfolio Product obtaining a rating. Even a reduction of one "notch" or grade may prohibitively increase transaction costs depending on the number of underlying securities affected. The cost associated with a reduction by four notches of an investment grade security rated 'BBB' is illustrative. A security rated 'BBB' has a probability of default of approximately 5% over ten years. Notched down to a 'BB-' rating, this same security has a purported probability of default of 25% over ten years. At a probability of default of 25%, this security requires five times the amount of equity capital, or credit enhancement,[2] to be made available. To calculate the total cost burden, this per-security charge must be multiplied by the number of securities in the portfolio subject to notching.

To avoid the burdensome costs associated with notching, issuers of Portfolio Products typically restrict their purchases to securities that will not be subject to notching — in other words, to securities rated by the credit rating agencies that practice notching. This forces issuers of securities included in Portfolio Products to purchase ratings from these same agencies. To do otherwise would mean that the demand for their securities would be severely restricted.

Proposed Rule 17g-6(a)(4) Bans Notching
Without Exception

We understand that Proposed Rule 17g-6(a)(4) bans notching without exception. Under its terms, NRSROs are prohibited from

> issuing or threatening to issue a lower credit rating, or lowering or threatening to lower an existing credit rating, or refusing to

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1 In synthetic and derivative transactions, the Portfolio Product is comprised of "referenced" securities, as distinguished from securities in which the issuer of the Portfolio Product has an ownership interest.

2 Credit enhancement within the structured finance area is defined as any means to improve the credit of a class of bonds, and may be internal to a transaction's capital structure, or external. The most common method of internal credit enhancement is subordination of other classes of bonds to the more senior class, so that the more senior class bears less credit risk and is worthy of a higher credit rating.

> issue a credit rating or withdrawing a credit rating, with respect to securities or money market instruments issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction, unless a portion of the assets which comprise the asset pool or the asset-backed or mortgage-backed securities also are rated by the rating organization

subject to a limited exception affecting only the latter two practices proscribed by the rule – refusing to issue a credit rating or withdrawing a credit rating. Under the exception, a NRSRO may refuse to issue, or withdraw, a rating if the NRSRO has rated less than 85% of the market value of the assets comprising the Structured Product. If a NRSRO chooses not to issue a credit rating or to withdraw a credit rating, as provided for under the exception, under Proposed Rule 17g-6(b), it must document in writing its reasons for doing so.

In recent weeks, Moody's and S&P have publicly floated the notion that the Proposed Rule permits NRSROs to continue to insist on shadow ratings or credit assessments, and to continue to reduce ratings assigned by other NRSROs. However, the Commission made clear that the proposed exception is intended to apply only to the prohibition in paragraph (a)(4) against refusing to rate a security or withdrawing a rating, and not to the prohibition on issuing or threatening to issue a lower credit rating or lowering or threatening to lower an existing credit rating.[3] In line with Congress' goal of ending coercive practices in the credit ratings industry and increasing competition, the ban on notching is purposefully absolute. When rating a Portfolio Product, a NRSRO may not issue or threaten to issue a lower credit rating, or lower or threaten to lower an existing credit rating, as a condition of rating the Product. It may choose only not to rate the product, or to withdraw its rating on the product, provided it has rated less than 85% of the market value of the underlying assets.

We understand that the Proposed Rule is intended to prevent Moody's and S&P from continuing to insist that they rate up to 100% of the securities underlying a Portfolio Product as a condition of rating the Portfolio Product, and from engaging in any unfair, coercive or abusive conduct that directly or indirectly furthers such objective. This includes, but is not limited to, refusing to recognize, or systematically reducing, other NRSROs' ratings, insisting on shadow ratings or credit assessments for securities they do not rate, and adjusting their models to penalize portfolios that include securities they do not rate. In light of non-coercive Moody's and S&P's public statements to the effect that the Proposed Rule does not prohibit a NRSRO from refusing to recognize, or reducing, other NRSROs' ratings, the Rule needs to be modified to make clear that the ban on notching is absolute, and that a NRSRO cannot seek to achieve the same result through other direct or indirect means, including, but not limited to, shadow ratings or credit assessments, or adjustments to models.

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3 Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, SEC Release No. 34-55231, 72 Fed. Reg. 6378, 6402-03 (Feb. 9, 2007) (the "SEC Release").

The Proposed Rule Is a Significant Step Forward But Does Not Go Far Enough in Furthering the Act's Objective of a Competitive Marketplace

The Proposed Rule's ban on notching is an important first step in fostering competition in the structured finance credit ratings markets. But Proposed Rule 17-g(a)(4) does not go far enough to meet the desired goal of a competitive marketplace free of unfair, coercive and abusive conduct. Allowing NRSROs to refuse to rate Portfolio Products if they rate less than 85% of the market value of the underlying assets enables the largest rating agencies to continue to suppress competition by forcing asset managers of Portfolio Products to buy securities that carry their ratings. This means that issuers of bonds or other securities to be purchased by Portfolio Products must purchase credit ratings from the agencies that unfairly, coercively, and abusively notch.

Four key modifications to Proposed Rule 17-g(a)(4) are needed to stimulate competition in the credit ratings markets as Congress has demanded:

<u>First</u>, the 85% threshold provided under the exception to subsection (a)(4) ideally should be eliminated; alternatively, it should be reduced. We believe 66% is most appropriate to balance competing interests.

Credit rating performance data, sensitivity analyses, and comparability studies conducted by Moody's and Fitch show that on average NRSRO ratings are the same. As such, they support the elimination of the 85% threshold exception in favor of a mutual recognition system, as explained more fully below. Historical ratings data show that the ratings performance of the major credit rating agencies are comparable and could reliably form the basis of such a system.

Alternatively, the 85% threshold exception should be revised downward to ensure adequate competitive opportunity among rating agencies. Setting the threshold exception at 85% rewards Moody's and S&P for the notching practices they introduced in 2001 to the detriment of free and fair competition. It also allows them unfairly to suppress competition from existing NRSROs, while fortifying the insurmountable barriers that confront new entrants.

Because regulatory, investor and corporate governance requirements generally mandate that securities be rated by two NRSROs, the market size for credit ratings is effectively 200%. Prior to the introduction of the current form of "notching" into the structured finance market in 2001, no one agency consistently had greater than a 66% share of the credit ratings market for commercial mortgage-backed securities or residential mortgage-backed securities, the most competitive of the structured finance ratings markets. Today, as a result of their unfair, coercive and abusive notching practices, both Moody's and S&P have dramatically increased their market shares. This discussion reflects market dynamics among Moody's, S&P and Fitch because they are the only three NRSROs that currently compete globally. We can only assume that other newcomers will be similarly disadvantaged by Moody's and S&P's anticompetitive conduct.

Second, the Proposed Rule's safeguards should be extended to financial guaranty insurers and reinsurers of asset-backed and mortgage-backed securities and municipal bonds. Rating agency capital adequacy models employed by certain NRSROs when rating financial guaranty insurers typically require that every transaction insured by the financial guaranty insurer be rated, or have a "shadow" rating, by the rating agency that is assessing the insurer's financial strength. If an insured transaction does not carry such a rating or shadow rating, but was rated by another NRSRO, the rating agency will generally "notch" down the rating assigned by the other NRSRO in assessing the financial guaranty insurer's capital adequacy. This practice is similar to the largest NRSROs' unfair, coercive and abusive notching practices concerning structured finance transactions and should not be permitted to continue.

Third, the Commission's intentional limitation of the exception in paragraph (a)(4) to the prohibition in paragraph (a)(4) against refusing to rate a security or withdrawing a rating[4] needs to be expressly reflected in the text of the Proposed Rule. More to the point, it must be made clear that Rule 17g-6(a)(4)'s prohibition on notching is absolute and not subject to any exception. As noted above, in recent weeks, Moody's and S&P have publicly asserted that the Proposed Rule permits NRSROs, when rating a Portfolio Product, to continue to insist on shadow ratings or credit assessments, and to reduce ratings assigned by other NRSROs, on underlying securities not rated by them. The Commission should modify the Proposed Rule to preclude any attempts to (mis)construe the Rule in this manner. The Rule should expressly prohibit NRSROs from refusing to recognize other NRSROs' ratings, or reducing other NRSROs' ratings, or using any other direct or indirect means, including but not limited to, insisting on shadow ratings or credit assessments, or adjusting their models, to compel Portfolio Products to invest in securities rated by them.

Fourth, a technical change is needed to bring the Proposed Rule in line with the Act. As discussed in greater detail below, the text of the Proposed Rule needs to be aligned with the Act to make it clear that the Rule, like the Act, applies to synthetic collateralized debt obligations and derivatives as well as cash transactions.

We discuss each of these proposed modifications in detail below.

I. The Proposed 85% Threshold Exception Is Too High and Should Be Eliminated Or Substantially Revised Downward

Historical credit ratings data, and the public's interest in increased transparency, accountability and competition in the credit ratings market, support eliminating the 85%

4 *See id.* at 6402-03.

threshold exception provided under Proposed Rule 17g-6(a)(4) in favor of a mutual-recognition ratings system.

Historical Ratings Data Show
Comparability of Ratings Among NRSROs

Under the Proposed Rules, NRSROs are required to file with the Commission explanations of their credit ratings, performance measurement statistics showing historical default and downgrade rates within each credit rating notch or grade, including the metrics used to derive the statistics, and information on the procedures and methodologies used to determine credit ratings. These requirements build on credit rating agencies' practices of compiling and maintaining historical default and transition rates within credit rating grades.[5]

There is no statistical or other legitimate basis for a NRSRO to refuse to recognize another NRSRO's ratings without penalty. To the contrary, historical default and transition rates and comparability studies show that a system whereby agencies generally but conservatively accept other agencies' ratings is analytically supported. Indeed, we have cause to believe that Moody's and S&P have waived their notching requirements in transactions sponsored by large financial institutions.

Extensive empirical research on default rates, rating transitions[6] and rating predictability conducted by Moody's, S&P and Fitch show that the global ratings assigned by the three agencies are highly comparable in terms of predicting default over annual and multi-year horizons. For example, Fitch, Moody's and S&P's average cumulative three-year default rates through year-end 2006 for 'BB' rated global corporate borrowers are 5.78%, 6.20% and 5.61%, respectively[7]. Further, Fitch and S&P's average cumulative three-year default rates through year-end 2005 for 'BB' rated global structured finance bonds are 4.97% and 5.07%,

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5 *Id.* at 6387.

6 Rating transitions are expressed as matrices showing upgrades and downgrades of ratings over time. For a comparison of Fitch, Moody's and S&P's rating transitions, see, for example, Fitch, Credit Market Research, *Fitch Ratings 1991-2005 U.S. Structured Finance Transition Study* (July 7, 2006), publicly available at http://www.fitchratings.com; Moody's, Special Comment, *Structured Finance Rating Transitions: 1983-2006* (Jan. 2007); Standard & Poor's, *Rating Transitions 2005: Global Structured Finance Securities Exhibit Solid Credit Behavior* (Mar. 2006).

7 See Fitch, Credit Market Research, *Fitch Ratings Global Corporate Finance 1990-2006 Transition and Default Study* (to be published April 2007); Moody's, Special Comment, *Corporate Default and Recovery Rates, 1920-2006* (Feb. 2007) at Exhibit 25, page 23; Standard & Poor's, *Annual European Corporate Default Study and Rating Transitions* (Feb 2007) at Table 12, page 14.

respectively.[8] In lieu of default rates, Moody's reports cumulative impairment rates. Moody's broadly defines impairment as bonds in payment default or downgraded to 'CC' or lower. The cumulative three-year impairment rate reported by Moody's through year-end 2005 for 'BB' global structured finance bonds is 12.94%.[9] Fitch's comparable cumulative three-year impairment rate for 'BB' rated structured bonds for the same period is 9.0%.[10] Rating migration patterns reported independently by each agency in publicly available research reports also show substantial symmetry. For example, all three agencies show a high degree of rating stability at the investment grade level, especially at the 'AAA' level, and relatively more volatility, including a greater incidence of downgrades further down the rating scale, across the spectrum of non-investment grade ratings. Overall, the share of ratings upgraded and downgraded each year by the agencies is very similar.

The traditional method of analyzing rating performance utilizes default frequencies and rating transition rates. Rating agencies, most notably Moody's, also use an additional measure of rating predictability computed by using the Gini curve[11], which Moody's refers to as the cumulative accuracy profile curve, and the Gini coefficient, which Moody's refers to as the accuracy ratio. The Gini curve is a graphical representation of a cumulative distribution. The Gini coefficient is a measure of the inequality of a distribution.[12] The Gini curve is constructed by first ordering the population of ratings from the worst credit quality

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8 See Fitch, Credit Market Research, *Fitch Global Structured Finance 1991-2005 Default Study* (Nov. 28, 2006) at page 1, publicly available at http://www.fitchratings.com; Standard & Poor's, *Rating Transitions 2005: Global Structured Finance Securities Exhibit Solid Credit Behavior* (Mar. 2006) at Appendix 2, page 16.

9 Moody's, Special Comment, *Default and Loss Rates of Structured Finance Securities: 1993-2005* (Apr. 2006) at Appendix 3, page 30.

10 For comparison purposes, Fitch calculated its impairment rate by adding other securities considered impaired under Moody's definition of impairment to Fitch's reported default rate.

11 A Gini curve is also known as a cumulative accuracy profile, power curve, or Lorenz curve.

12 In the context of assessing the discriminatory power of a rating system, the Gini coefficient (referred to by Moody's as an accuracy ratio) is a ratio with values between 0 and 1: the numerator is the area between the curve graphically depicting the cumulative shares of defaulted or impaired securities relative to the universe of all securities and the 45-degree uniform (perfect) distribution line; the denominator is the maximum possible area above the 45-degree uniform distribution line. The Gini coefficient approaches zero as the Gini curve approaches the 45-degree uniform distribution line, suggesting that all defaulted or impaired securities are randomly distributed without regard to rating and are of low predictability.

('CCC' to 'C') to best credit quality ('AAA') and then plotting the cumulative share of issuer ratings against the cumulative share of defaulted or impaired securities, as the case may be. The Gini coefficient summarizes the results of the Gini curve into a single statistic that ranges between 0% and 100%. If ratings perfectly rank ordered default risk and the associated risk of loss, all defaults would carry the very lowest rating designation. The resulting Gini coefficient would therefore be 100%. Fitch's average one-year Gini coefficient across the agency's global structured finance universe is 87.6%, demonstrating a high level of rating accuracy.[13] In comparison, Moody's reports an average one-year accuracy ratio of 76.6% across its rated universe of structured bonds.[14]

Rating comparability studies conducted in 2006 by Fitch and Moody's on thousands of structured finance bonds show that across multiple combinations of product and rating categories, on seasoned portfolios and on newly issued bonds, average rating differences from a portfolio perspective are small, with the vast majority of ratings across the three agencies are either the same or within one notch. For example, Fitch's review of 34,185 U.S. structured finance bonds with a total value estimated at $3.2 trillion, published March 2006, revealed that on seasoned bonds, 94.3% and 92.3% of the combination of S&P/Fitch and Moody's/Fitch ratings, respectively, were either the same or within one notch. The average rating difference for each group was just 0.02 of a notch for the S&P/Fitch pair and negative 0.18 of a notch for the Moody's/Fitch combination. S&P's ratings were on average just slightly higher than Fitch's ratings, while Moody's were slightly lower.[15] Fitch's global comparability study released May 2006 studies more than 38,500 bonds over a ten-year period representing over $4.2 trillion in securitization; on average, S&P's ratings globally are 0.02 of a notch higher than Fitch's, and Moody's are 0.19 of a notch lower.[16]

Moody's subsequent study, published May 2006,[17] confirmed Fitch's findings. Moody's examined rating comparability on roughly 40,000 bonds, and concluded that, on average, ratings outstanding on jointly rated instruments differed by less than one notch. Specifically, Moody's found the average rating difference across the various rating categories

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[13] Fitch, Credit Market Research, *Fitch Global Structured Finance 1991-2005 Default Study* (Nov. 28, 2006) at page 5, publicly available at http://www.fitchratings.com.

[14] Moody's, Special Comment, *The Performance of Structured Finance Bonds - Mid Year 2006 Report* (Sept. 2006) at page 2.

[15] Fitch, Credit Market Research, *U.S. Structured Finance Rating Comparability Survey* (Mar. 24, 2006) publicly available at http://www.fitchratings.com.

[16] Fitch, Credit Market Research, *International Structured Finance Rating Comparability Survey* (May 16, 2006), publicly available at http://www.fitchratings.com.

[17] Moody's, Special Report, *Comparing Ratings on Jointly-Rated U.S. Structured Finance Securities* (May 25, 2006).

to be negative .21 of a notch for both the Moody's/S&P combination and the Moody's/Fitch group. The Moody's study, similar to Fitch's, confirmed that rating comparability was very high at the investment grade level and modestly declined further down the rating scale. However, even at the non-investment grade level, the majority of ratings were found by both studies to be either the same or within one notch. Moody's study further confirmed Fitch's findings that the broad similarity in ratings consistently held across each of the broad structured finance asset types, including residential mortgage backed securities, collateralized debt obligations, asset backed securities and commercial mortgage backed securities.

As the Senate Committee on Banking, Housing, and Urban Affairs observed in its September 6, 2006 report on the Act, the historic default rate for AAA-rated securities is well under one percent in any given ten-year period. For B-rated securities, the ten-year probability of default is approximately 45 percent.[18] The ratings levels and performance trends that allow these observations are substantially similar among the major NRSROs. Indeed, the market and regulators generally view the major agencies' ratings as equivalent indicators of risk.

To justify their anti-competitive practices, Moody's and S&P often point to limited occurrences of wide rating differences in deep non-investment grade investments, and assert that these differences make it highly risky for any one agency to accept another agency's ratings. This argument is specious. The size and diversity of the total universe of rated bonds, the small number of deeply non-investment grade bonds, and the random distribution of ratings, means that these differences have no practical impact on the creditworthiness of Portfolio Products. Moreover, the ratings assigned to deeply non-investment grade bonds reflect a high likelihood of default; in other words, there are few surprises when they default.

A System of Mutual Recognition of Ratings
Is the Best Approach

The Act and the Proposed Rules "establish a registration and regulatory program for credit rating agencies opting to have their credit ratings qualify for purposes of laws and rules using the term 'nationally recognized statistical rating organization.'"[19] Under this program, the Commission determines whether an applicant for NRSRO status "has adequate financial and managerial resources to consistently produce credit ratings with integrity and to comply with its established policies and methodologies."[20] Credit rating agencies designated as NRSROs have a continuing obligation, among other things, to make and retain certain records relating to the business of issuing credit ratings, including information on credit ratings performance statistics, to furnish the Commission with certain

[18] S. REP. 109-326, at 3.

[19] SEC Release, 72 Fed. Reg. at 6380.

[20] *Id.* at 6384.

financial reports, and to implement policies to manage the handling of material non-public information and conflicts of interest.

Considering the registration and regulatory program established under the Act and Proposed Rules, and the Act's objective of increasing accountability, transparency, and competition in the credit ratings markets, once an agency is recognized as a NRSRO under the Act, its ratings should be entitled to recognition by other NRSROs without penalty. We propose that the Commission modify Proposed Rule 17g-6(a)(4) to mandate, and to provide a transparent system for, recognition of other NRSRO ratings.

Specifically, we propose that the Commission modify Proposed Rule 17g-6(a)(4) by eliminating the proposed exception to that rule, and by providing that if a NRSRO rates a transaction that includes underlying assets that are not rated by that NRSRO, and

> the underlying assets are publicly rated by two other NRSROs, the NRSRO issuing the rating should use the lower rating;
>
> the underlying assets are publicly rated by three other NRSROs, the NRSRO should take the middle rating;
>
> the underlying assets are publicly rated by four or more NRSROs, the NRSRO should take the second lowest rating.

This would provide a conservative and transparent approach to rating pools of assets, while avoiding the unfair, coercive and abusive effect of requiring a percentage of assets be rated by a given agency.

The Basel II Framework developed by the Basel Committee on Banking Supervision to revise the standards governing the capital adequacy of internationally active banks, and to promote greater stability in the financial system, is instructive. Basel II describes comprehensive measures and minimum standards for capital adequacy, and seeks to improve on existing rules by aligning regulatory capital requirements more closely to the underlying risks that banks face. For purposes of calculating credit risks, Basel II allows banks to choose either the "Standardised Approach" or "Internal Ratings-based Approach." The Standardised Approach measures credit risk according to a standardized risk weighting framework supported by ratings from external credit assessment institutions ("ECAIs"), the European designation that is comparable to the United States "NRSRO" designation. The risk weighting framework lays out the appropriate risk weight for various types of claims, and bank supervisors are responsible for deciding which assessment categories correspond to which risk weights. In carrying out this "mapping" exercise, bank supervisors must consistently use the chosen ECAI ratings for each type of claim. In other words, once a credit agency is recognized as an ECAI, its ratings have equal standing for purposes of calculating adherence to minimal capital adequacy requirements.

Similarly, the US proposal for BASEL II implementation does not make distinctions among NRSROs. For example, the joint notice of proposed rulemaking for risk-based capital standards released by the Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of Thrift Supervision in September 2006 explains that in calculating credit risk, reference is to be made to "applicable external ratings," where "applicable external rating" is defined as "the lowest external rating assigned to the exposure by <u>any</u> NRSRO."[21] Also, in explaining the Internal Assessment Approach, the notice of proposed rulemaking requires that a bank's "internal credit assessments of securitization exposures must be based on publicly available rating criteria used by an NRSRO."[22] The Committee of European Banking Supervisors has also found ratings of Moody's, S&P and Fitch to be comparable and does not differentiate among them for regulatory capital purposes, including determining risk weights of credit exposures.[23]

If the Exception is Retained, It Must be Revised Downward
To Stimulate Competition and Avoid Rewarding Past Bad Conduct

If the exception provided under Proposed Rule 17g-6(a)(4) is to be retained, the percentage threshold must be revised downward to achieve the goal of a competitive marketplace. At the level of 85%, the threshold exception provides a target that allows Moody's and S&P to continue their partner monopoly and suppress competition.

During the period before Moody's and S&P introduced notching to the structured finance market, competition in the credit ratings markets for structured finance transactions thrived. In the commercial mortgage backed securities markets, and the mortgage backed securities markets in particular, bond issuers typically submitted preliminary information to three NRSROs, and each would respond with a preliminary quote that included its expected rating. On the basis of these quotes, the issuer would select two agencies to rate the final transaction. In the competitive environment of that period, where three agencies

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[21] Risk-Based Capital Standards: Advanced Capital Adequacy Framework and Market Risk, 71 Fed. Reg. 55830, 55912 (Sept. 25, 2006) (emphasis added). An external rating is defined as "a credit rating that is assigned by an NRSRO to an exposure, provided: (1) The credit rating fully reflects the entire amount of credit risk with regard to all payments owed to the holder of the exposure. . . . and (2) The credit rating is published in an accessible form and is or will be included in the transition matrices made publicly available by the NRSRO that summarize the historical performance of positions rated by the NRSRO." *Id.* at 55917.

[22] *Id.* at 55939.

[23] *See* Press Release, Committee of European Banking Supervisors, European Supervisors Agree on the Outcome of the Informal Joint Assessment Process of Three External Credit Assessment Institutions (Aug. 4, 2006); *see also* Council Directive 2006/48/EC, arts. 80-83, 2006 O.J. (L 1777) 33-35 (EC).

freely competed for two available ratings, no one agency consistently had more than a 66% share of the commercial mortgage-backed and residential mortgage-backed securities markets.

At a minimum, Proposed Rule 17g-6(a)(4) should seek to stimulate the level of competition that existed in the structured finance credit ratings markets before the introduction of notching. Ideally it should foster an even greater degree of competition. Accordingly, we propose that the threshold exception be revised downward, to no higher than 66%.

If a NRSRO Has Rated Two-thirds (66%) of the Assets Comprising a Portfolio Product, There Is No Legitimate Reason It Cannot Rate the Portfolio Product

Analytic studies discussed above at pages 8-10 indicate that NRSROs are able to assess the risk of a Portfolio Product accurately and credibly even where less than 66% of the assets underlying the portfolio are rated by them. Several market participants have already filed comments with the Commission advancing this view.

To test this argument, we conducted an analysis of all jointly rated corporate and structured finance securities, divided into two portfolios, as of January 2006.[24] The first includes a mix of assets of varying credit quality. The second consists of 'AAA' and 'AA' assets only. We believe these two portfolios are reasonable proxies for portfolios held by Portfolio Products. We subjected each portfolio to an increasing exposure of assets rated by another NRSRO, starting at 5% and ending at 50% of the portfolio,[25] and for each case calculated the resulting change in the overall portfolio credit rating. We then determined the maximum percentage of securities rated by another NRSRO that could be included in a portfolio to reach a pre-determined threshold of rating difference of one quarter of a notch.[26]

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[24] The global rated corporate and structured finance universe for this exercise covers about 3,100 and over 50,000 individual entities, respectively.

[25] We started with the universe of jointly rated corporate and structured finance securities bearing at least two NRSRO ratings and then compared the ratings for each agency pairing: Fitch using Moody's' ratings, Fitch using S&P's ratings, Moody's using Fitch's ratings, Moody's using S&P's ratings, S&P using Fitch's ratings and S&P using Moody's ratings.

[26] Across Fitch's global portfolio of structured and corporate finance bonds, Fitch's average rating on outstanding issues is 'A.' Empirical research has shown that the average annual default rate for 'A' rated entities (including 'A+', 'A', and 'A-' rated issues) is approximately five basis points and ranges from one basis point for 'A+' rated bonds to ten basis points for 'A-' rated issues. However, credit ratings are opinions of both default and loss given default. Given a historical average recovery rate of 40% of par on defaulted bonds, the resulting annual loss rates for 'A' rated entities range from a fraction of a basis point for 'A+' rated bonds to six basis points for issues rated 'A-'. Given these historical relationships, a full notch increase in credit risk across a portfolio with an average rating of 'A' would translate into a move from 'A' to 'A-' or an annual increase in expected credit

We found that no matter the pairing of the NRSROs, a portfolio can contain up to 45% of the assets rated by other NRSROs and cause an overall change in the portfolio credit rating of equal or less than a quarter of a notch. In sum, accepting ratings of other NRSROs on as much as 45% of the assets underlying a Portfolio Product results in a *de minimus* change in the expected loss of the portfolio.

Moreover, for purposes of assessing credit and assigning credit ratings, NRSROs regularly rely on professional opinions, and financial and other information that they do not independently verify or audit, including, for example, internal bank assessments of credit risks, information provided by corporate officers, financial statements, auditor opinions, and legal opinions. There is no legitimate reason NRSROs cannot similarly rely on credit opinions of other NRSROs, with appropriate disclaimers as necessary. Further, requiring NRSROs to include opinions of other NRSROs among the wide array of inputs on which they regularly rely neither restricts free speech, nor regulates the substance of credit opinions, as the dominant NRSROs argue.

Finally, while some market participants have expressed concern about a system of mutual-recognition of ratings, or a reduced maximum threshold exception, because new NRSROs are likely to enter the market without published long-term performance data, we believe this is a concern without merit. As a practical matter, it is highly unlikely that the market will accept securities rated by an unestablished new entrant without such securities also bearing a rating from one or more existing NRSROs.

II. Notching within the Financial Guaranty Insurance Industry Is Unfair, Coercive and Abusive and Should Be Prohibited

Financial guaranty insurance serves the interests of public investors in Portfolio Products and municipal bond transactions by irrevocably and unconditionally guaranteeing payments on securities in exchange for premiums. The value of the financial guaranty insurance product is generally a function of the credit rating applied to the obligations insured. As such, financial guaranty insurers are highly dependent on the availability and integrity of credit ratings. Most financial guaranty insurers maintain a financial strength rating of 'AAA' or 'AA' (with one insurer being rated 'A' by design) from multiple nationally recognized statistical rating organizations. These rating agencies regularly review the financial guaranty insurer's business and financial condition, and apply their own capital adequacy models in assessing the financial strength of the financial guaranty insurer.

As the Association of Financial Guaranty Insurers have pointed out in their letter to the Commission dated March 7, 2007, rating agency capital adequacy models

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loss of three basis points. A fractional notch increase in credit risk, in this case, one quarter of a notch, would therefore increase expected credit loss on the full portfolio by less than one basis point.

employed by certain NRSROs typically require that every transaction insured by a financial guaranty insurer be rated, or have a so- called shadow rating or credit assessment, by the rating agency that is assessing the insurer's financial strength. The shadow rating reflects the NRSRO's assessment of the creditworthiness of the transaction without giving effect to the insurance. If an insured transaction does not carry such a rating or shadow rating, but was rated by another NRSRO, the rating agency will generally "notch" down the rating assigned by another NRSRO in assessing the financial guaranty insurer's capital adequacy. This practice is similar to the NRSRO's practices with respect to asset-backed and mortgage-backed pools addressed in paragraph (a)(4) of Proposed Rule 17g-6.

The Commission's proposals in Rule 17g-6 banning coercive and abusive practices in the rating of asset pools, and asset-backed and mortgage-backed transactions are similarly applicable to the financial guaranty insurance industry. If a rating agency requires that each transaction in a financial guaranty insurer's book of business be rated (or shadow rated) by the rating agency in assessing the insurer's financial strength, or else be "notched" downwards, there is significant pressure on the financial guaranty insurer to obtain, from each rating agency that assesses its financial strength and engages in notching, a rating or shadow rating for every transaction it insures. Accordingly, we urge the Commission to modify Rule 17g-6 to extend its safeguards to financial guaranty insurers and reinsurers.

III. To End the Unfair, Coercive and Abusive Practice of Notching within the Structured Finance Industry, Its Prohibition Must Be Made Explicit

Although the Commission Release expressly states that the exception set out in paragraph (a)(4) of Proposed Rule 17g-6 does not apply to the prohibition on notching, Moody's and S&P have publicly taken the position that paragraph (a)(4) caps at 85% the portion of the assets underlying a Portfolio Product that a NRSRO may demand that it rates as a condition of rating the Portfolio Product, but does not limit a NRSRO's ability to insist on shadow ratings or credit assessments or to reduce the ratings assigned by other NRSROs on the portion of the underlying assets that it does not rate. This construction renders paragraph (a)(4) effectively meaningless. Unless NRSROs are prohibited from reducing other agencies' ratings, or using other indirect means to force bond issuers to buy their ratings, Proposed Rule 17g-6 will have minimal, if any, effect on abusive credit ratings practices within the structured finance market.

In light of Moody's and S&P's publicly stated intention to continue their unfair, coercive and abusive practice of notching, we urge the Commission to revise the language of proposed paragraph (a)(4) to reflect the Commission's intentions as stated in the Release: Under the exception set out in paragraph (a)(4), a NRSRO has the right to choose not to rate a Portfolio Product where it has rated less than a specified percentage of the underlying assets, but in rating a Portfolio Product, may not reduce ratings assigned by other NRSROs to underlying assets they have not rated. Additionally, if a NRSRO has rated a specified percentage of the assets underlying the portfolio, it must rate the portfolio if asked to do so, and may not notch.

We also urge the Commission to make it clear that NRSROs may not use any other direct or indirect means, including but not limited to, insisting on shadow ratings or credit assessments, or adjusting their models, to coerce issuers of securities typically included in Portfolio Products to obtain their ratings. Consistent with the Act's objective of greater transparency in the credit ratings markets, the Commission should also require NRSROs to disclose their rating policies relating to Portfolio Products, including money market instruments, and, more particularly, structured investment vehicles, where rating agency policies are often hidden in non-public side letters.

IV. The Rule Should Be Modified to Clarify Its Applicability to Synthetic Portfolio Products as well as Cash Transactions

Proposed Rule 17g-6(a)(4) is promulgated under Section 15E(i)(1)(B) of the Exchange Act (as established by the Act), which provides that the Commission, by rule, shall prohibit the following practices if the Commission determines they are unfair, coercive, or abusive:

> Lowering or threatening to lower a credit rating on, or refusing to rate, securities or money market instruments issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction, unless a portion of the assets <u>within such pool or part of such transaction, as applicable,</u> also is rated by the nationally recognized statistical rating organization. (emphasis added)

Section 15E(i)(1)(B)'s use of the phrase "within such pool or part of such transaction" includes synthetic and derivative Portfolio Products within the Act's scope. Having determined that the conduct described in Section 15E(i)(1)(B) is unfair, coercive and abusive, the Commission has promulgated Proposed Rule 17g-6(a)(4) to prohibit the conduct contemplated by Section 15E(i)(1)(B). In doing so, it departed from the language of the statute with what we believe to be unintended consequences. In relevant part, Proposed Rule 17g-6(a)(4) prohibits NRSROs from

> lowering or threatening to lower an existing credit rating, or refusing to issue a credit rating or withdrawing a credit rating, with respect to securities or money market instruments issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction, unless a portion of the assets <u>which comprise the asset pool or the asset-backed or mortgaged-backed securities</u>, also are rated by the rating organization. (emphasis added)

The differences between the language of Section 15E(i)(1)(B) and Proposed Rule 17-g(a)(4) emphasized above could be construed to make Proposed Rule 17g-6(a)(4) inapplicable to synthetic Portfolio Products and derivates, as distinguished from cash transactions. We do not believe this was the intent, and know of no rationale for applying the Rule to cash transactions, but not synthetic transactions. To make it clear that the Proposed Rule applies to cash and synthetic transactions alike, we propose that the Commission align the Proposed Rule with the Act by substituting "which, by ownership or referred value, comprise the asset pool or transaction, as applicable" in place of the phrase commencing "which" underscored above.

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Thank you for giving us the opportunity to provide our comments. We hope you find them useful, and that you will give them due consideration. Please call me at (212) 908-0626 with any questions that you might have on our comments or to discuss this matter further at your convenience.

Very truly yours,

Charles D. Brown

Charles D. Brown
General Counsel