
Annual Report on Nationally Recognized Statistical Rating Organizations

As Required by Section 6 of the
Credit Rating Agency Reform
Act of 2006



U.S. Securities and Exchange Commission

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ANNUAL REPORT ON NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATIONS

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I. INTRODUCTION

The U.S. Securities and Exchange Commission (“Commission”) is providing this report under Section 6 of the Credit Rating Agency Reform Act of 2006 (“Rating Agency Act”).¹ Section 6 of the Rating Agency Act requires the Commission to submit an annual report to the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Financial Services of the House of Representatives that, with respect to the year to which the report relates:

- Identifies applicants for registration as nationally recognized statistical rating organizations (“NRSROs”) under Section 15E of the Securities Exchange Act of 1934 (“Exchange Act”);
- Specifies the number of and actions taken on such applications; and
- Specifies the views of the Commission on the state of competition, transparency, and conflicts of interest among NRSROs.

This report relates to the period from June 26, 2010 to June 25, 2011.² The report provides an overview of Commission rulemaking and other actions relating to NRSROs

¹ Pub. L. 109-291, 120 Stat. 1327, S. 3850 (Sept. 29, 2006). The Rating Agency Act, among other things, added Section 15E to the Exchange Act (15 U.S.C. 78o-7) to establish self-executing requirements on NRSROs and provide the Commission with the authority to implement a registration and oversight program for NRSROs. On June 5, 2007, the Commission approved rules implementing such a program. See Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 55857, 72 FR 33564 (Jun. 18, 2007) (“June 2007 Adopting Release”). The implementing rules were Form NRSRO (17 CFR 249b.300) and Rules 17g-1 through 17g-6 (17 CFR 240.17g-1 through 17g-6). The Commission has twice adopted amendments to some of these rules. See Amendments to Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 59342 (Feb. 2, 2009), 74 FR 6456 (Feb. 9, 2009) (“February 2009 Adopting Release”) and Amendments to Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 61050 (Nov. 23, 2009), 74 FR 63832 (Dec. 4, 2009) (“November 2009 Adopting Release”). The Commission has also adopted new Rule 17g-7 (17 CFR 240.17g-7). See Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Securities Act of 1933 Release No. 9175; Exchange Act Release No. 63741 (Jan. 20, 2011), 76 FR 4515 (Jan. 26, 2011).

² The first annual report, which was published in June 2008, related to the period from June 26, 2007, the effective date of the Rating Agency Act, to June 25, 2008. See <http://www.sec.gov/divisions/marketreg/ratingagency/nrsroannrep0608.pdf>. Subsequent annual reports are on the NRSRO page of the Commission’s website: <http://www.sec.gov/divisions/marketreg/ratingagency.htm#nrsroannreps>.

and addresses the items specified in Section 6 of the Rating Agency Act for the current period.

On July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”)³ was enacted. The NRSRO provisions in the Dodd-Frank Act substantially augment the Rating Agency Act. In particular, Title IX, Subtitle C, consisting of Sections 931 through 939H of the Dodd-Frank Act, “Improvements to the Regulation of Credit Rating Agencies,” amended the Exchange Act to impose new self-executing requirements with respect to NRSROs, requires that the Commission adopt rules applicable to NRSROs in a number of areas, and requires the Commission to conduct certain studies.⁴

Further, Section 939A of the Dodd-Frank Act requires each Federal agency to: review its regulations that require the use of an assessment of the credit-worthiness of a security or money market instrument and any references to or requirements regarding credit ratings; modify its regulations to remove references to or requirements of reliance on credit ratings and substitute the standard of creditworthiness the agency determines is appropriate; and transmit a report to Congress describing any modifications to the regulations.⁵ As described below in Section II of this report, the Commission has proposed and adopted rules and rule amendments in response to the “reference removal” mandate of the Dodd-Frank Act.⁶

³ Pub. L. 111-203, 124 Stat. 1376, H.R. 4173.

⁴ The Commission has taken certain actions in accordance with these provisions. See Section II of this report.

⁵ The Commission issued this report on July 21, 2011, subsequent to this reporting period. See Report on Review of Reliance on Credit Ratings As Required by Section 939A(c) of the Dodd-Frank Wall Street Reform and Consumer Protection Act, July 2011. In Section III of the report, the Commission described certain rules and forms that Commission staff is continuing to consider how best to address in light of Section 939A of the Dodd-Frank Act.

⁶ The Commission took action prior to the enactment of the Dodd-Frank Act regarding the removal of references to credit ratings in Commission rules. In 1994, the Commission issued a concept release addressing this issue. See Concept Release: Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 34616 (Aug. 31, 1994), 59 FR 46314 (Sep. 7, 1994). In 2003, the Commission again sought comment on whether it should eliminate the NRSRO designation from Commission rules, and, if so, what alternatives could be adopted to meet the Commission’s regulatory objectives. See Concept Release: Rating Agencies and the Use of Credit Ratings under the Federal Securities Laws, Exchange Act Release No. 47972 (Jun. 4, 2003), 68 FR 35258 (Jun. 12, 2003). In July 2008, the Commission proposed removing references in certain of its rules to ratings by NRSROs. See Proposed Rule: References to Ratings of Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 58070 (Jul. 1, 2008), 73 FR 40088 (Jul. 11, 2008). In response, the Commission received many comments that raised serious concerns about the proposals. See www.sec.gov/comments/s7-17-08/s71708.shtml. In October 2009, the Commission adopted several of the proposed amendments and re-opened for comment the remaining proposals. See References to Ratings of Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 60789 (Oct. 5, 2009), 74 FR 52358 (Oct. 9, 2009) (amending Exchange Act Rule 3a1-1 (17 CFR 240.3a1-1), Exchange Act Rules 300, 301(b)(5) and 301(b)(6) of Regulation ATS (17 CFR 242.300, 242.301(b)(5) and 242.301(b)(6)), Form ATS-R (17 CFR 249.638) and Form PILOT (17 CFR 249.821); and Rules 5b-3 and 10f-3 under the Investment Company Act of 1940 (17 CFR 270.5b-3 and 17 CFR 270.10f-3). The

Sections 932(a)(8) and (a)(4) of the Dodd-Frank Act, respectively, also amended Section 15E of the Exchange Act to add paragraphs 15E(p)(3)⁷ and 15E(h)(4)(B),⁸ which relate to Commission examinations and reviews of NRSROs. Section 15E(p)(3)(A) requires the Commission to conduct an examination of each NRSRO at least annually. Under Section 15E(p)(3)(B), the examination must include a review of: (i) whether the NRSRO conducts business in accordance with the policies, procedures, and rating methodologies of the NRSRO; (ii) the management of conflicts of interest by the NRSRO; (iii) implementation of ethics policies by the NRSRO; (iv) the internal supervisory controls of the NRSRO; (v) the governance of the NRSRO; (vi) the activities of the designated compliance officer of the NRSRO; (vii) the processing of complaints by the NRSRO; and (viii) the policies of the NRSRO governing the post-employment activities of former staff of the NRSRO (“look-back policies”). In addition, Section 15E(p)(3)(C) requires that the Commission make available to the public an annual report summarizing (i) the essential findings of all examinations conducted under Section 15E(p)(3)(A) as deemed appropriate by the Commission; (ii) the responses by the NRSROs to any material regulatory deficiencies identified by the Commission; and (iii) whether the NRSROs have appropriately addressed the recommendations of the Commission contained in previous annual reports. Section 15E(h)(4)(B)(i) requires that the Commission conduct periodic reviews of NRSROs’ look-back policies and the implementation of the policies at each NRSRO “to ensure they are reasonably designed and implemented to most effectively eliminate conflicts of interest.” Section 15E(h)(4)(B)(ii) requires that the Commission review the code of ethics and conflict of interest policies of each NRSRO at least annually and whenever the policies are materially modified. The Commission has completed the first cycle of such examinations and reviews with respect to each of the NRSROs.⁹

II. COMMISSION RULEMAKING AND OTHER ACTIONS RELATING TO NRSROs

The Commission issued the following releases relating to NRSROs during the reporting period:

- Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 64514 (May 18, 2011), 76 FR 33420 (Jun. 8, 2011) (“May 2011 Proposing

Commission stated that the amendments were designed, among other things, to address concerns that the inclusion of requirements relating to credit ratings in Commission rules could create the appearance that the Commission had, in effect, given its “official seal of approval” to the ratings, which could adversely affect the quality of due diligence and investment analysis and lead to undue reliance on NRSRO ratings. See 74 FR 52358.

⁷ 15 U.S.C. 78o-7(p)(3).

⁸ 15 U.S.C. 78o-7(h)(4)(B).

⁹ The Commission issued its examination report on September 30, 2011, subsequent to this reporting period. See 2011 Summary Report of Commission Staff’s Examinations of Each Nationally Recognized Statistical Rating Organization As Required by Section 15E(p)(3)(c) of the Securities Exchange Act of 1934, www.sec.gov/news/studies/2011/2011_nrsro_section15e_examinations_summary_report.pdf.

Release”). The Commission proposed for comment rule amendments and new rules in accordance with the Dodd-Frank Act and to enhance oversight that would require NRSROs to, among other things: report on internal controls; protect against conflicts of interest; establish professional standards for credit analysts; publicly provide—along with the publication of a credit rating—disclosure about the credit rating and the methodology used to determine it; enhance their public disclosures about the performance of their credit ratings; and make certain submissions to the Commission electronically. The proposal also would require disclosures concerning third-party due diligence reports for asset-backed securities.

- Solicitation of Comment to Assist in Study on Assigned Credit Ratings, Exchange Act Release No. 64456 (May 10, 2011). The Commission requested comment to assist it in carrying out a study on, among other matters, the feasibility of establishing a system in which a public or private utility or a self-regulatory organization assigns NRSROs to determine credit ratings for structured finance products. The study, as well as a resulting report to Congress, is required by Section 939F of the Dodd-Frank Act.
- Removal of Certain References to Credit Ratings Under the Securities Exchange Act of 1934, Exchange Act Release No. 64352 (Apr. 27, 2011), 76 FR 26550 (May 6, 2011). The Commission proposed for comment amendments to Exchange Act Rules 15c3-1, 15c3-3, 17a-4, 101 and 102 of Regulation M, and 10b-10, and one Exchange Act form (Form X-17A-5, Part IIB) to remove references to credit ratings and, in certain cases, substitute alternative standards of creditworthiness as required by Section 939A of the Dodd-Frank Act. The Commission also requested public comment on potential standards of creditworthiness for purposes of Exchange Act Sections 3(a)(41) and 3(a)(53), which define the terms “mortgage related security” and “small business related security,” respectively.
- References to Credit Ratings in Certain Investment Company Act Rules and Forms, Securities Act of 1933 (“Securities Act”) Release No. 9193, Investment Company Act of 1940 (“Investment Company Act”) Release No. 29592 (Mar. 3, 2011), 76 FR 12896 (Mar. 8, 2011). The Commission proposed for comment a new rule and amendments to two rules and four forms under the Securities Act and the Investment Company Act that contain references to credit ratings. The Commission proposed amendments to Rule 2a-7, Rule 5b-3, and Form N-MFP under the Investment Company Act and Forms N-1A, N-2, and N-3 under the Securities Act and the Investment Company Act. The Commission also proposed a new rule under the Investment Company Act to establish a credit-worthiness standard to replace a statutory reference to credit ratings in the Investment Company Act removed by Section 939(c) of the Dodd-Frank Act.
- Security Ratings, Securities Act Release No. 9186, Exchange Act Release No. 63874 (Feb. 9, 2011), 76 FR 8946 (Feb. 16, 2011). The Commission proposed for

comment rule amendments to remove credit ratings as eligibility criteria for companies seeking to use “short form” registration when registering securities for public sale. Under the Securities Act, the Commission proposed amending Rules 134, 138, 139, 168, Form S-3, Form S-4, Form F-3, and Form F-4. The Commission further proposed rescinding Form F-9 and amending the Exchange Act forms and rules that refer to Form F-9 to eliminate those references. The Commission also proposed amending Schedule 14A under the Exchange Act.¹⁰

- Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Securities Act Release No. 9175; Exchange Act Release No. 63741 (Jan. 20, 2011), 76 FR 4515 (Jan. 26, 2011). The Commission adopted new rules pursuant to Section 943 of the Dodd-Frank Act related to representations and warranties in asset-backed securities offerings, including new Rule 17g-7, which requires NRSROs to include information regarding the representations, warranties, and enforcement mechanisms available to investors in any report accompanying a credit rating for an offering of asset-backed securities.
- Credit Rating Standardization Study, Exchange Act Release No. 63573 (Dec. 17, 2010). The Commission requested comment to help inform its study pursuant to Section 939(h) of the Dodd-Frank Act on the feasibility and desirability of: standardizing credit ratings terminology, so that all credit rating agencies issue credit ratings using identical terms; standardizing the market stress conditions under which ratings are evaluated; requiring a quantitative correspondence between credit ratings and a range of default probabilities and loss expectations under standardized conditions of economic stress; and standardizing credit rating terminology across asset classes, so that named ratings correspond to a standard range of default probabilities and expected losses independent of asset class and issuing entity.
- Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Securities Act Release No. 9148; Exchange Act Release No. 63029 (Oct. 4, 2010), 75 FR 62718 (Oct. 13, 2010). The Commission proposed new rules pursuant to Section 943 of the Dodd-Frank Act related to representations and warranties in asset-backed securities offerings, including new Rule 17g-7. (The Commission issued the related adopting release on January 20, 2011. See the description of Securities Act Release No. 9175, Exchange Act Release No. 63741 above.)
- Removal From Regulation FD of the Exemption for Credit Rating Agencies, Securities Act Release No. 9146; Exchange Act Release No. 63003; Investment Company Act of 1940 Release No. 29448 (Sep. 29, 2010), 75 FR 61050 (Oct. 4, 2010). The Commission implemented Section 939B of the Dodd-Frank Act,

¹⁰ The Commission adopted final rules on July 27, 2011, subsequent to this reporting period. See Security Ratings, Securities Act Release No. 9245, Exchange Act Release No. 6497, 76 FR 46603 (Aug. 3, 2011).

which requires that the Commission “revise Regulation FD (17 CFR 243.100) to remove from such regulation the exemption for entities whose primary business is the issuance of credit ratings (17 CFR 243.100(b)(2)(iii))” within 90 days after the date of enactment.

III. STATUS OF REGISTRANTS AND APPLICANTS

Section 3(a)(62) of the Exchange Act¹¹ defines a “nationally recognized statistical rating organization” as a credit rating agency that issues credit ratings certified by qualified institutional buyers, in accordance with Section 15E(a)(1)(B)(ix) of the Exchange Act, with respect to: (i) financial institutions, brokers, or dealers; (ii) insurance companies; (iii) corporate issuers; (iv) issuers of asset-backed securities (as that term is defined in 17 CFR 229.1101(c)); (v) issuers of government securities, municipal securities, or securities issued by a foreign government; or (vi) a combination of one or more categories of obligors described in any of clauses (i) through (v); and that is registered under Exchange Act Section 15E.

The Commission has granted registration as an NRSRO under Section 15E to ten credit rating agencies. One of these credit rating agencies has recently withdrawn from registration as an NRSRO.¹² The registered credit rating agencies, dates of initial registration, categories of credit ratings described in clauses (i) through (v) of Exchange Act Section 3(a)(62) in which they are registered, and locations of their principal offices are, as of the date of this report:¹³

NRSRO/ Categories of Credit Ratings	Registration Date	Principal Office
A.M. Best Company, Inc. (“A.M. Best”) Categories (ii), (iii), and (iv) ¹⁴	September 24, 2007	U.S.
DBRS, Inc. (“DBRS”) Categories (i) through (v)	September 24, 2007	U.S.
Egan-Jones Ratings Co. (“EJR”) Categories (i) through (v)	December 21, 2007	U.S.
Fitch, Inc. (“Fitch”) Categories (i) through (v)	September 24, 2007	U.S.

¹¹ 15 U.S.C. 78c(a)(62).

¹² On October 13, 2011, Rating and Investment Information, Inc., which had been registered with the Commission as an NRSRO since September 24, 2007, furnished the Commission with a notice of withdrawal from registration as an NRSRO. The withdrawal became effective on November 27, 2011. See <http://www.sec.gov/news/digest/2011/dig112811.htm>.

¹³ See the current Form NRSRO for each firm for any updates of this information.

¹⁴ A.M. Best withdrew from registration in category (i) (financial institutions, brokers, or dealers) during the reporting period. The withdrawal became effective on May 13, 2011, 45 calendar days after the notice of withdrawal was furnished to the Commission.

Japan Credit Rating Agency, Ltd. (“JCR”) Categories (i), (ii), (iii), and (v) ¹⁵	September 24, 2007	Japan
Kroll Bond Rating Agency, Inc. (“KBRA”) Categories (i) through (v)	February 11, 2008	U.S.
Moody's Investors Service, Inc. (“Moody’s”) Categories (i) through (v)	September 24, 2007	U.S.
Morningstar Credit Ratings, LLC (“Morningstar”) Category (iv)	June 23, 2008	U.S.
Standard & Poor's Ratings Services (“S&P”) Categories (i) through (v)	September 24, 2007	U.S.

During the reporting period, there were changes in the names of several of the NRSROs. KBRA changed its name from LACE Financial Corp. on November 12, 2010.¹⁶ LACE Financial Corp. was purchased on August 23, 2010 and is currently owned by KBRA Holdings, Inc.; K-2 Global Partners, LLC has a controlling ownership interest in KBRA Holdings, Inc.¹⁷ Morningstar changed its name from Realpoint LLC.¹⁸ Realpoint LLC was purchased on May 3, 2010 by Morningstar, Inc., and the NRSRO is now a wholly-owned subsidiary of Morningstar, Inc.¹⁹ In addition, DBRS, Inc., the entity previously identified in Item 3 of Form NRSRO as a credit rating affiliate is now identified in Item 1 of Form NRSRO as the NRSRO; DBRS Limited, the entity previously identified in Item 1 of Form NRSRO as the NRSRO is now identified in Item 3 of Form NRSRO as a credit rating affiliate.²⁰

As reported in last year’s annual report, Dagong Global Credit Rating Co., Ltd. (“Dagong”), a credit rating agency based in Beijing, China, submitted its application for registration as an NRSRO to the Commission on December 24, 2009. Dagong subsequently consented to two extensions of time for the Commission to act on the application. On April 14, 2010, the Commission instituted proceedings to determine whether Dagong’s application for registration as an NRSRO should be denied.²¹

¹⁵ JCR withdrew from registration in category (iv) (issuers of asset-backed securities) during the reporting period. The withdrawal became effective on December 2, 2010, 45 days after the notice of withdrawal was furnished to the Commission.

¹⁶ See Item 1 of KBRA’s Form NRSRO, as of KBRA’s update of registration dated November 16, 2010.

¹⁷ See Exhibit 4 to KBRA’s Form NRSRO, as of KBRA’s annual certification dated March 30, 2011 for the year ended December 31, 2010.

¹⁸ See Item 1 of Morningstar’s Form NRSRO in an update of registration dated June 10, 2011.

¹⁹ See Exhibit 4 to Morningstar’s Form NRSRO, in an update of registration dated June 10, 2011.

²⁰ See Items 1 and 3 of DBRS’s annual certification dated March 31, 2011 for the calendar year ended December 31, 2010.

²¹ Order Instituting Administrative Proceedings Pursuant to Section 15E(2)(A)(ii) of the Securities Exchange Act of 1934 and Notice for Hearing, Exchange Act Release No. 61906 (Apr. 14, 2010), 75 FR 20645 (Apr. 20, 2010).

Potential grounds for denial included whether Dagong: (1) had a sufficient connection with U.S. interstate commerce to register as an NRSRO and thereby invoke the regulatory and oversight authority of the Commission; and (2) would be subject to having its registration suspended or revoked because of requirements in its home jurisdiction preventing it from complying with U.S. securities laws and rules. On September 22, 2010 the Commission issued an order denying Dagong's application for registration as an NRSRO.²² The Commission found that Dagong was "currently unable" to comply with the Exchange Act's recordkeeping, document production, and examination requirements. Because of this finding, the Commission did not determine whether Dagong had a sufficient connection with U.S. interstate commerce.

The Commission received no complete initial applications for registration as an NRSRO during the reporting period.

IV. COMMISSION'S VIEW ON COMPETITION

A. Select NRSRO Statistics

The following sections summarize certain information reported by NRSROs registered with the Commission on Form NRSRO and Commission analyses of that information.

1. NRSRO Credit Ratings Outstanding

The table below provides the number of credit ratings outstanding reported by each NRSRO in its annual certification for the calendar year ending December 31, 2010 in each of the five categories identified in Section 3(a)(62) of the Exchange Act for which the NRSRO is registered.

²² Order Denying Application for Registration as a Nationally Recognized Statistical Rating Organization, Exchange Act Release No. 62968 (Sep. 22, 2010).

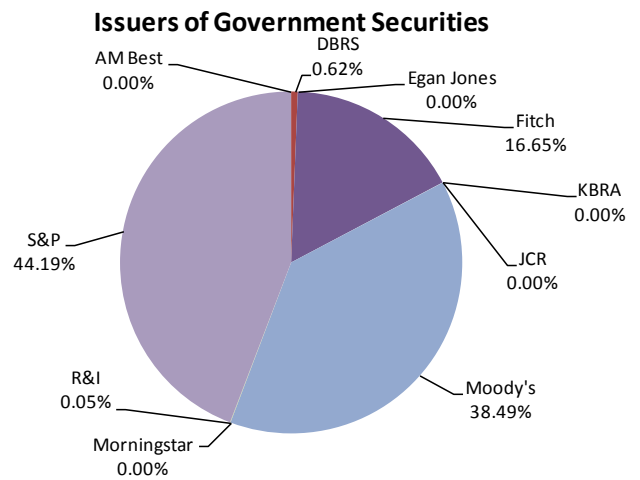
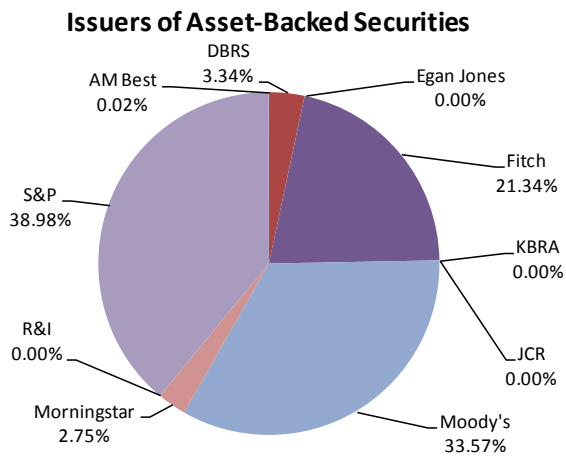
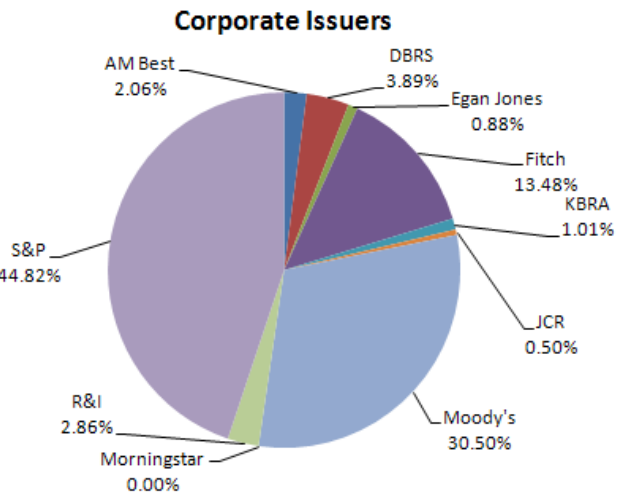
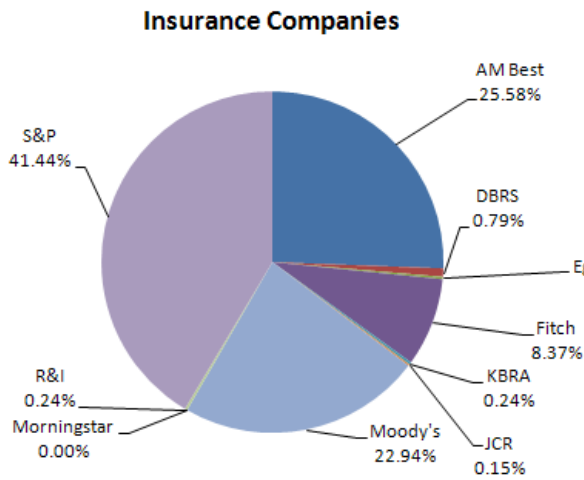
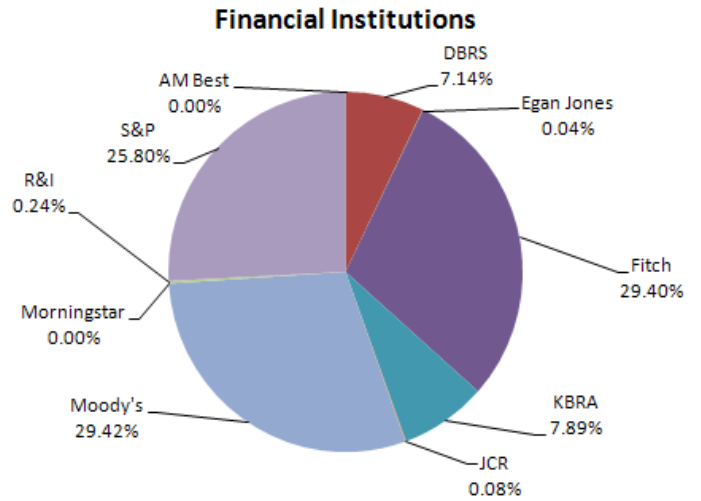
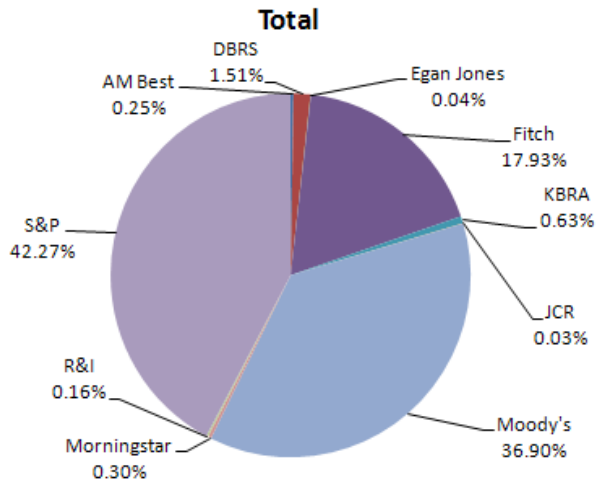
Number of Credit Ratings Outstanding by Category of Credit Rating
Source: NRSRO Annual Certifications for the Year Ended December 31, 2010

	Financial Institutions	Insurance Companies	Corporate Issuers	Issuers of Asset-Backed Securities	Issuers of Government Securities	Total Ratings
A.M. Best	N/R	5,062	2,043	54	N/R	7,159
DBRS	14,941	156	3,863	10,091	13,533	42,584
EJR	89	47	877	13	19	1,045
Fitch	61,550	1,657	13,385	64,535	363,897	505,024
JCR	159	30	495	N/R*	52	736
KBRA	16,515	48	1,002	0**	59	17,624
Moody's	61,581	4,540	30,285	101,546	841,235	1,039,187
Morningstar	N/R	N/R	N/R	8,322	N/R	8,322
R&I	503	48	2,836	N/A	1,031	4,418
S&P	54,000	8,200	44,500	117,900	965,900	1,190,500
Total	209,338	19,788	99,286	302,461	2,185,726	2,816,599

*N/R indicates the NRSRO is not registered for that category of securities.

**KBRA is registered in the asset-backed securities category, although it reported no outstanding ratings in this category as of December 31, 2010.

The pie charts below depict the percent of the total credit ratings outstanding in total and in each category reported by all NRSROs as of December 31, 2010 that were attributable to each NRSRO. For example, per the above table, A.M. Best reported that it had 5,062 insurance company credit ratings outstanding, and the total of the credit ratings outstanding in that category reported by all NRSROs was 19,788. Dividing 5,062 by 19,788 = (approximately) 0.2558 (the proportion of NRSRO insurance company ratings attributable to A.M. Best), and $0.2558 = 25.58\%$.



Moody's and S&P were the two largest NRSROs based on the number of credit ratings outstanding as of December 31, 2010, with approximately 1 million and 1.2 million ratings outstanding, respectively, and Fitch was the third largest with approximately 500,000 ratings outstanding. However, concentration was not consistent across rating classes. Moody's and S&P had the largest number of outstanding credit ratings of corporate issuers, asset-backed securities, and government securities. For credit ratings of financial institutions, Fitch and Moody's had substantially more ratings outstanding than S&P, although the difference has decreased in recent years. S&P had the largest number of outstanding credit ratings of insurance companies, with A.M. Best and Moody's providing most of the remaining ratings in that class.

Three NRSROs (Fitch, Moody's, and S&P) accounted for approximately 97% of all outstanding credit ratings (no change from last year's report). The concentration of outstanding ratings for these three NRSROs is high across all five categories but does vary across those categories. For instance, Fitch, Moody's, and S&P account for over 99% of all outstanding NRSRO ratings for government, municipal and sovereign securities²³, but less than 73% of all outstanding NRSRO ratings for insurance companies.²⁴ For various reasons, including those discussed below, market concentration must be considered together with other factors to identify the level of competition in a given market.

Some of the smaller NRSROs concentrate more on particular sectors or regions. For example, A.M. Best primarily rates insurance companies. Morningstar rates only asset-backed securities ("ABS"). KBRA primarily rates financial institutions. JCR and R&I are based in Japan and issue ratings primarily on Japanese issuers and securities.

Among the smaller NRSROs, KBRA and DBRS reported having the largest number of outstanding ratings of financial institutions (16,515 and 14,941, respectively, or approximately 8% and 7%, respectively, of all outstanding ratings in this category). A.M. Best reported the largest number of ratings of insurance companies among the smaller NRSROs (5,062, or about 26%, of all outstanding ratings in this category) and DBRS reported the largest number of outstanding ratings of corporate issuers among the smaller NRSROs (3,863, or about 4% of all outstanding ratings in this category).

Of the 302,461 outstanding credit ratings of ABS, all but 18,480 (approximately 6%) were attributable to Fitch, Moody's, and S&P. Among the smaller NRSROs, DBRS reported having the largest number of outstanding ratings of ABS (10,091, or approximately 3.34%, of all ratings in this category).

Of the ten NRSROs, seven operate primarily under the "issuer-pay" model.²⁵ Two NRSROs, KBRA and Morningstar, operate primarily under the "subscriber-pay"

²³ Fitch, Moody's, and S&P together accounted for 2,171,032 of the 2,185,726 outstanding NRSRO credit ratings in this category as of December 31, 2010.

²⁴ Fitch, Moody's, and S&P together accounted for 14,397 of the 19,788 outstanding NRSRO credit ratings in this category as of December 31, 2010.

²⁵ A.M. Best, DBRS, Fitch, JCR, Moody's, R&I, and S&P. See Section VI of this report.

model but have recently begun issuing ratings paid for by the rated entity or issuer of the rated security.²⁶ Only EJR operates fully under the subscriber-pay model. The NRSROs operating primarily under the issuer-pay model account for approximately 99% of the total outstanding NRSRO credit ratings reported by NRSROs as of December 31, 2010.

Market concentration is generally measured using the Herfindahl-Hirschman Index (“HHI”), which is a measure of the size of firms in relationship to the industry and is an indicator of the amount of competition among them. It is calculated by taking the market share²⁷ of each firm competing in the market, multiplying that proportion by 100 and squaring the result, and then summing the resulting numbers. The HHI is measured on a scale of 0 to 10,000²⁸ points and approaches zero when a market consists of a large number of firms of relatively equal size.²⁹ The HHI increases both as the number of firms in the market decreases and as the disparity in size between those firms increases.³⁰ According to the U.S. Department of Justice, markets in which the HHI is between 1,000 and 1,800 points are considered to be moderately concentrated, and those in which the HHI is in excess of 1,800 points are considered to be concentrated.³¹ The inverse of the HHI (“HHI Inverse”) is an approximation of the number of equally sized firms which would constitute an equivalent level of concentration for a given HHI, and is calculated by dividing 10,000 by the HHI.

The HHI for all NRSROs based on the number of credit ratings outstanding as of December 31, 2010 is 3,472 (a “concentrated” market), which is the equivalent of approximately 2.88 equally sized firms.³² In last year’s report, the Commission calculated an HHI based on credit ratings outstanding of 3,495, the equivalent of approximately 2.86 equally sized firms, indicating that the level of market concentration based on ratings outstanding is essentially unchanged.

²⁶ See Exhibit 2 to KBRA’s Form NRSRO, as of its annual certification dated March 30, 2011, in which KBRA states that it offers issuer-paid ratings as well as subscriptions to its ratings and describes its process for determining each type of rating; Exhibit 2 to Morningstar’s Form NRSRO, as of its update of registration dated June 6, 2011, in which Morningstar states that it generally issues ratings either as a rating agency selected and paid by the arranger or as a non-selected rating agency providing a final rating and surveillance to subscribers on a subscription-pay basis.

²⁷ For NRSROs, one way of determining market share is by dividing an NRSRO’s outstanding ratings by the aggregate of outstanding ratings issued by all NRSROs.

²⁸ If there is only one firm with 100% of the market, the HHI would be 100 times 100, or 10,000 points.

²⁹ For example, if there are 1,000,000 firms, each with an equal share (.0001%) of the market, the HHI would be .0001 squared (= .00000001) times 1,000,000 = .01 points.

³⁰ For example, if there are five firms, one with 80% of the market and the remaining four each with 5% of the market, the HHI would be 6500 points (80 x 80 = 6400; 5 x 5 = 25; 6400 + (4 x 25) = 6500).

³¹ <http://www.usdoj.gov/atr/public/testimony/hhi.htm>.

³² If the ten firms each had an equal share (10%) of the market, the HHI would be 10 squared (= 100) times 10 = 1,000 points.

The table below reports the HHI Inverse statistic calculated for the ratings outstanding in each class of ratings and in total for the years 2008 through 2010.

HHI Inverse for Each Class of Ratings

Year	Financial Institutions	Insurance Companies	Corporate Issuers	Issuers of Asset-Backed Securities	Issuers of Government Securities	Total
2008	3.72	4.05	3.79	2.82	2.83	2.99
2009	3.85	3.84	3.18	3.18	2.65	2.86
2010	3.99	3.37	3.17	3.20	2.69	2.88

The class of government, municipal and sovereign securities was the most concentrated class of ratings in 2010 with an HHI Inverse of 2.69. The class of financial institutions was the least concentrated with an HHI Inverse of 3.99. The largest annual change in 2010 occurred in the class of insurance companies where the HHI Inverse dropped from 3.84 in 2009 to 3.37 in 2010, indicating a higher level of concentration. The change appears to have resulted primarily from a decline in the number of outstanding insurance company ratings reported by Fitch. Fitch reported 1,657 outstanding ratings of insurance companies in 2010, which was a decrease of approximately 64% from the 4,599 ratings it reported in the category in 2009.

Between 2008 and 2010, the HHI Inverse for the ABS sector increased from 2.82 to 3.20, indicating a lower level of concentration. All NRSROs, except DBRS, reported a decline in the number of ABS ratings outstanding during this period. S&P reported the largest decline, from 198,200 ratings in 2008 to 117,900 outstanding ratings in 2010, a decline of approximately 40%. S&P issued about 49% of all ABS ratings outstanding in 2008. By 2010, this percentage had decreased to 39%. During the same time period, the combined percentage of outstanding ABS ratings of Moody's and Fitch increased from approximately 46% in 2008 to approximately 55% in 2010. Overall, the market share of ABS ratings of the largest three NRSROs decreased from approximately 96% in 2008 to approximately 94% in 2010. Additionally, the percentage of ratings outstanding for DBRS increased from 1.86% in 2008 to 3.34% in 2010. The percentage of ratings outstanding for Morningstar increased from 2.29% to 2.75% during the same period.

2. Number of Credit Analysts

The table below provides the total number of credit analysts and credit analyst supervisors reported by each NRSRO in Exhibit 8 of its most recent Form NRSRO during the reporting period.

Credit Analysts and Credit Analyst Supervisors

NRSRO	Credit Analysts	Credit Analyst Supervisors*
A.M. Best	77	43
DBRS	75	20
EJR	2	3
Fitch	712	337
JCR	27	30
KBRA	9	4
Moody's	1,088	116
Morningstar	17	7
R&I	74	4
S&P	1,109	236
Total	3,190	800

*Some credit analyst supervisors may also have analytical responsibilities.

The three largest NRSROs report having 2,909 credit analysts, or approximately 91% of the total number of credit analysts of the ten NRSROs. Among the other NRSROs, A.M. Best and DBRS reported the largest number of credit analysts (77 and 75, respectively, or approximately 5% each, of the total number of credit analysts).

3. NRSRO Financial Results

Section 15E(k) of the Exchange Act³³ requires each NRSRO to file, on a confidential basis, such financial statements and information concerning its financial condition as the Commission may prescribe by rule. Exchange Act Rule 17g-3³⁴ requires each NRSRO to provide the Commission with annual financial reports not more than 90 calendar days after the end of its fiscal year. In particular, Rule 17g-3(a)(1) requires NRSROs to provide audited financial statements, which must include a balance sheet, an income statement and statement of cash flows, and a statement of changes in ownership equity.

The total revenue reported by all of the NRSROs for the most recent financial report made in the reporting period was approximately \$4.2 billion, up from approximately \$3.7 billion reported last year.³⁵ The HHI based on total revenue reported by NRSROs is 3,326 points, the equivalent industry concentration of approximately 3 equally sized firms. The HHI based on net income reported by NRSROs is 3,573 points, the equivalent industry concentration of approximately 2.8 equally sized firms. The HHI based on net income is higher than the HHI based on revenue because the firms which

³³ 15 U.S.C. 78o-7(k).

³⁴ 17 CFR 240.17g-3.

³⁵ Seven NRSROs have fiscal years ending on December 31; others have fiscal years ending on March 31, September 30, or November 30.

reported the largest amounts of revenue also tended to have higher after-tax profit margins. The net income amounts reported by the three largest NRSROs made up approximately 97% of the total net income reported by all of the NRSROs.

B. Demand for Ratings

Investors, both individual and institutional, look to credit rating agencies to provide an independent assessment of the relative or absolute credit risk of a particular debt obligation or obligor. Credit ratings also provide rated issuers with less costly access to debt markets.³⁶ Furthermore, parties can write contracts that create obligations based on a change in credit ratings—the use of so-called “ratings triggers.”³⁷ In many cases, investment managers and financial institutions have been required by regulations, including Commission rules, to use credit ratings to establish investment risk standards for their portfolio holdings.³⁸ However, as noted above, Section 939A of the Dodd-Frank Act requires federal agencies to modify their regulations to remove requirements of reliance on credit ratings and for each rule to substitute an alternative standard of creditworthiness.³⁹

In addition to NRSROs and other credit rating agencies, there are other providers of credit research and analysis.⁴⁰ Credit models and assessments by third-party providers may be used by investors as indicators of value or price for a given debt obligation. Where available, third-party providers of credit analytics and internal models are natural competitors to NRSROs for all non-regulatory uses and may serve as a check on NRSRO ratings quality or substitutes for non-regulatory uses if they provide more accurate or useful ratings.

³⁶ See, e.g., Michael Faulkender and Mitchell A. Petersen, “Does the Source of Capital Affect Capital Structure?” *Review of Financial Studies*, 9(1), 45-79 (2006). Frank Partnoy, “The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Ratings Agencies,” *Washington University Law Quarterly*, 77 (3), 619-714 (1999); Arnoud W.A. Boot, Todd T. Milbourn and Anjolein Schmeits, “Credit Ratings as Coordination Mechanisms,” *Review of Financial Studies*, 19 (1), 81-118 (2006); Deiter Kerwer, “Ratings Agencies: Setting a Standard for Global Financial Markets,” *Economic Sociology European Electronic Newsletter*, 3 (3), 40-46 (2002); Timothy J. Sinclair, “Reinventing Authority: Embedded Knowledge Networks and the New Global Finance,” *Environment and Planning C: Government and Policy*, 18 (4), 487-502 (2000) (these articles, among other things, argue that credit rating agencies create value through standardizing the credit assessment process).

³⁷ See additional discussion in Section IV.C. of this report.

³⁸ See, Joint Forum Report, “Stocktaking on the Use of Credit Ratings,” June 2009 (available at <http://www.bis.org/publ/joint22.pdf?noframes=1>) (shorten link) (discussing, among other things, the use of credit ratings in “(a) determining capital requirements; (b) identifying or classifying assets, usually in the context of eligible investments or permissible asset concentrations; (c) providing a credible evaluation of the credit risk associated with assets purchased as part of a securitization offering or a covered bond offering; (d) determining disclosure requirements; and (e) determining prospectus eligibility”).

³⁹ The Commission has taken certain actions in response to the “reference removal” mandate. See Section II of this report.

⁴⁰ See, e.g., Arturo Estrella, “Credit Ratings and Complementary Sources of Credit Quality Information,” *Basel Committee on Banking Supervision Working Papers*, Aug. 2000.

Economists point to several factors that have increased the demand for credit ratings over the years.⁴¹ Structural changes in financial markets increased the number of participants, their anonymity, and the complexity of their investment strategies. Credit ratings have offered a time-saving and comparative tool to evaluate the growing number of debt issues. Also, financial disintermediation and an increase in the proportion of credit supplied by capital markets rather than banks has been accompanied by the creation of increasingly complex securitization instruments. This increasing complexity likely contributed to additional demand from investors for NRSRO credit ratings as they provided a single summary measure of the credit risks of difficult to evaluate financial instruments.

As noted above, NRSROs are one type of entity providing third-party credit assessments to the market. When users of credit assessments for non-regulatory purposes also need NRSRO credit ratings for regulatory purposes, they may choose to purchase only NRSRO credit ratings to avoid purchasing both. The economic case for purchasing a non-NRSRO credit assessment may be even more difficult if the entity is a newer entrant to the third-party credit assessment field, without the same established level of reputation as more well-known entities, even when that assessment is valuable to the investor. However, there are a number of credit rating agencies operating in the U.S. that have not registered as NRSROs.

C. Regulatory and Economic Factors that Potentially Affect Competition in the Credit Rating Industry

In enacting the Rating Agency Act, Congress found that “the 2 largest credit rating agencies [Moody’s and S&P] serve the vast majority of the market, and additional competition is in the public interest.”⁴² Further, the Senate Report accompanying the Rating Agency Act quoted witnesses testifying before Congress as describing the largest two NRSROs as a “partner-monopoly” and an “oligopoly.”⁴³ Information obtained from NRSROs about the number of ratings they have outstanding, the number of credit analysts, and their financial results, as presented above, suggests that, in combination with Fitch, these entities are the dominant market players.

Economists note that the credit rating industry has exhibited a high level of concentration throughout much of its history, dating from the early twentieth century.⁴⁴ Analysts have cited the regulatory use of ratings as a factor that has created barriers to

⁴¹ See, e.g., Fabian Dittrich, 2007, “The Credit Rating Industry: Competition and Regulation,” Doctoral Dissertation, Universität zu Köln, Köln, Germany; Isabelle Gras, “The Power to Rate,” REGEM Analysis No. 6 (2003).

⁴² See Section 2 of the Rating Agency Act.

⁴³ See Report of the Senate Committee on Banking, Housing, and Urban Affairs to Accompany S. 3850, Credit Rating Agency Reform Act of 2006, S. Report No. 109-326, 109th Cong., 2d Sess. (Sep. 6, 2006) (“Senate Report”), p.5.

⁴⁴ See, e.g., Richard Sylla, “A Historical Primer on the Business of Credit Ratings” and Lawrence J. White, “The Credit Rating Industry: an Industrial Organization Analysis” both papers in Ratings, Rating Agencies and the Global Financial System (2002).

entry and led to concentration in the credit rating industry.⁴⁵ Financial regulators including the Federal Reserve Banks, the Office of the Comptroller of the Currency, and state banking and insurance departments have used credit ratings to assist them in their oversight of financial institutions since the 1930s. Early ratings-dependent rules included requirements to mark-to-market lower rated bonds and restrictions on the purchase of speculative securities. In the 1950s, the National Association of Insurance Companies increased capital requirements on lower rated bonds held by insurance companies.⁴⁶

The Commission first used the term NRSRO in 1975 in the net capital rule for broker-dealers as an objective benchmark to prescribe capital charges for different types of debt securities. Since then, the Commission has used the designation in a number of regulations. Although the use of the term NRSRO was originated for a narrow purpose in the Commission's own regulations, ratings by NRSROs have come to be used widely as benchmarks in federal and state legislation as well as in rules issued by other financial regulators.

Congress incorporated the NRSRO concept into other pieces of financial legislation. For example, when Congress defined the term “mortgage related security” in Section 3(a)(41) of the Exchange Act as part of the Secondary Mortgage Market Enhancement Act of 1984, it required that such securities be rated in one of the two highest rating categories by at least one NRSRO.⁴⁷ Further, in 1989, Congress added the NRSRO concept to the Federal Deposit Insurance Act, prescribing that corporate debt securities are not “investment grade” unless they are rated in one of the four highest categories by at least one NRSRO.⁴⁸

Finally, a number of other federal and state laws and regulations employed the NRSRO concept. For example, the U.S. Department of Education used ratings from NRSROs to set standards of financial responsibility for institutions that wish to participate in student financial assistance programs under Title IV of the Higher Education Act of 1965, as amended. In addition, several state insurance codes relied, directly or indirectly, on NRSRO ratings in determining appropriate investments for insurance companies. More recently, credit ratings were used to determine the eligibility of assets for a number of the programs established by the Federal Reserve and the Department of the Treasury in response to the credit crisis.⁴⁹

⁴⁵ See, e.g., Partnoy (1999), White (2001).

⁴⁶ See, e.g., Richard Cantor and Frank Packer, “The Credit Rating Industry,” FRBNY Quarterly Review, Summer-Fall, 1994.

⁴⁷ Section 939(e) of the Dodd-Frank Act amended Section 3(a)(41) and Section 3(a)(53) (the definition of “small business related security”) of the Exchange Act to replace the words “is rated in one of the two highest rating categories by at least one [NRSRO]” with the words “meets standards of credit-worthiness as established by the Commission.”

⁴⁸ See “Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets As Required by Section 702(b) of the Sarbanes-Oxley Act of 2002” (2003), <http://www.sec.gov/news/studies/credratingreport0103.pdf>.

⁴⁹ See, e.g., “Term Asset-Backed Securities Loan Facility: Terms and Conditions,” (2009), http://www.newyorkfed.org/markets/talf_terms.html.

As discussed above, however, the Dodd-Frank Act requires every federal agency to review rules that use credit ratings as an assessment of credit-worthiness, modify its regulations to remove references to or requirements of reliance on credit ratings, and for each rule, substitute an alternative standard of creditworthiness.

Credit ratings are used widely by financial regulators outside the United States.⁵⁰ According to a Basel Committee on Banking Supervision (BCBS) study published in 2000, eleven out of twelve countries that are members of the BCBS used the ratings of credit rating agencies in financial regulatory supervision.⁵¹ The Basel II framework, which has been implemented by members of the European Union, relies on the ratings of credit rating agencies recognized as External Credit Assessment Institutions to calculate bank capital requirements within its standardized approach for credit risk measurement.⁵²

Economies of scale, sunk costs, and access to a historical default distribution may be economic factors which may favor the larger, more established rating agencies. Large rating agencies can allocate the costs of, among other things, analytical software, administrative, legal, compliance, marketing and support staff across a wider range of ratings, providing a more efficient cost base. In addition, these rating agencies have, over the years, used substantial resources to, for example, develop ratings methodologies and procedures.⁵³ A long history of providing credit risk assessment is also important in credit rating agencies' ability to develop statistical models that rely on historical default probability distribution.

The importance of reputation is another economic factor that is often cited by analysts.⁵⁴ When the quality of a firm's product is difficult to assess at the time of purchase, consumers often use the quality of prior products produced by the firm as a benchmark for their purchasing decision.⁵⁵ A firm that has a long history of producing quality products develops a reputational asset which allows it to command a higher price. The value of this reputational asset can provide an incentive for the firm to continue to produce high quality products.⁵⁶

Credit ratings are an example of a product whose quality, at time of issuance or purchase, is particularly difficult to evaluate. In most cases, credit ratings are estimates about the probability of default or expected loss for a given debt obligation or obligor.

⁵⁰ See The Joint Forum, "Stocktaking on the Use of Credit Ratings," (June 2009) <http://www.bis.org/publ/joint22.pdf>.

⁵¹ See Arturo Estrella, "Credit Ratings and Complementary Sources of Credit Quality Information," Basel Committee on Banking Supervision Working Papers No. 3 (Aug. 2000).

⁵² See Basel Committee on Banking Supervision, "International Convergence of Capital Measurement and Capital Standards: A Revised Framework - Comprehensive Version," (June 2006).

⁵³ See, e.g., Herwig M. Langohr, "The Credit Rating Agencies and Their Credit Ratings," address given to the Bond Market Association (Feb. 2006).

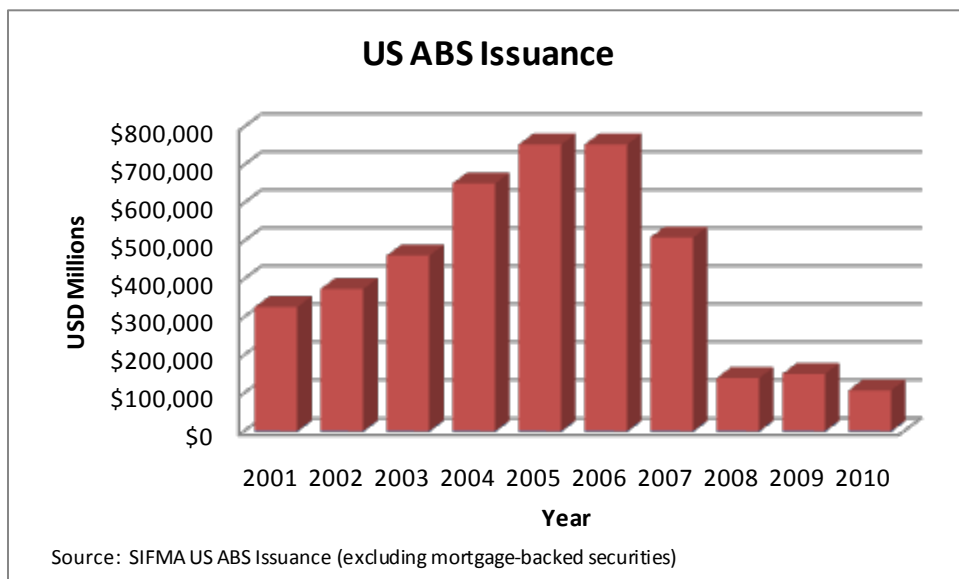
⁵⁴ See, e.g., Dittrich (2007).

⁵⁵ See, e.g., Carl Shapiro, "Premiums for High Quality Products as Returns to Reputations," *Quarterly Journal of Economics* 98(4): 659-79 (Nov. 1983).

⁵⁶ See, e.g., Benjamin Klein and Keith Leffler, "The Role of Market Forces in Assuring Contractual Performance," *Journal of Political Economy*, Vol. 89, No. 41 (1981).

Defaults are expected to occur rarely at the higher rating levels and are highly sensitive to macroeconomic forces which may be difficult to forecast. The accuracy and consistency of ratings produced by a given rating agency may only be revealed over an extended period. Because it is difficult to evaluate a particular credit rating easily, establishing and maintaining a reputation for ratings accuracy, a process which can take years, is very important for any credit rating agency.

A rating agency’s reputation can be damaged by a failure to continue to assign ratings accurately. The assignment of high credit ratings to many residential mortgage-backed securities (“RMBS”) and collateralized debt obligations (“CDOs”) in recent years, followed by the scope and magnitude of subsequent downgrades during the current credit crisis, appears to have resulted in a loss of confidence among at least some investors in the reliability of credit ratings issued by the largest NRSROs in this sector. Ratings on these RMBS and CDOs did not measure up to similarly rated obligors and securities, with respect to rating transitions and defaults, within and among the asset classes. There had also been a broader dislocation in the credit markets, to which any loss of confidence could have contributed. The integrity of all ABS ratings has been questioned and the uncertainty around ABS credit quality has increased, contributing to the decline in investors’ willingness to purchase ABS. This is consistent with the dramatic drop-off in ABS issuances since mid-2007. ABS issuance increased slightly in 2009, but decreased again in 2010, remaining far below pre-crisis levels (see the chart below).



In the wake of these events, the NRSROs that rated ABS have come under intense scrutiny and criticism. However, their overall market share does not seem to have been affected within this asset class as reflected in the number of ABS ratings each of their

Form NRSROs. However, some of the smaller NRSROs appear to have increased their market share in new issue ratings for some types of ABS.⁵⁷

Network externalities, or a “network effect,” may also play a role in the credit rating industry. Network externalities, which are often considered in connection with such products as computer operating systems or video recorders, exist when the value of a product increases as more people use it.⁵⁸ Network externalities can create a significant obstacle to entry for a new entrant in an industry where these effects are strong. In these types of industries, a company may make a product which has superior attributes to an entrenched competitor and still fail to win market share. The procedures and methodologies of a rating agency create a standardized way of looking at credit risk, and one function of the rating is to facilitate communication about credit risk among market participants.⁵⁹ Another function of credit ratings is to facilitate comparisons among credit instruments within a sector and potentially across sectors. Market participants may consider how widely the ratings of a particular rating agency are used by other investors and the breadth of coverage a rating agency provides as factors in determining the usefulness of its ratings.⁶⁰

A wide range of private contractual agreements which reference the ratings of particular rating agencies create another barrier to entry for new entrants.⁶¹ These include, for example, minimum ratings requirements that specify the ratings of specific rating agencies in the investment management contracts of institutional fund managers and the investment guidelines of fixed income mutual fund managers, pension plan sponsors, and endowment fund managers. In addition, fixed income indices used to evaluate the performance of investment managers often have inclusion characteristics which refer to the ratings of specific rating agencies. The effect of these contractual agreements can be to increase the demand and liquidity for securities bearing the ratings of specific providers.

In addition, ratings triggers are commonly found in bank loan agreements, guaranteed investment contracts, and the credit support annexes and other provisions of

⁵⁷ Asset-Backed Alert “Rating-Agency Shares of US ABS and MBS Issuance in 2010” (Dec. 31, 2010); Commercial Mortgage Alert “Rating Agencies for CMBS Issued in First Half” (June 30, 2011).

⁵⁸ See, e.g., Michael L. Katz and Carl Shapiro, “Network Externalities, Competition, and Compatibility,” The American Economic Review, Vol. 75, No. 3, pp. 424-440, (June 1985). For application to credit rating industry see Jerome S. Fons, “White Paper on Rating Competition and Structured Finance,” (Jan. 2008).

⁵⁹ See, e.g., Kerwer (2002).

⁶⁰ See, e.g., Fons (2008).

⁶¹ See, e.g., Richard Cantor, Owain ap Gwilym, Stephen Thomas, “The Use of Credit Ratings in Investment Management in the U.S. and Europe,” The Journal of Fixed Income, Vol. 17, No. 2 (Fall 2007); H. Kent Baker and Sattar A. Mansi, “Assessing Credit Rating Agencies by Bond Issuers and Institutional Investors,” Journal of Business Finance & Accounting, Vol. 29, Numbers 9-10 (November/December 2002); G. Timothy Haight, George Engler and Kenneth J. Smith, “An Examination of the Characteristics of College Endowment Funds,” Journal of Investing (Fall 2006).

derivatives contracts.⁶² When ratings triggers are present, a decline in the rating of an issuer or obligor below a certain level can alter the obligations of parties to an agreement. For example, a ratings trigger can provide a counterparty to a derivatives contract the right to demand collateral or lenders with the right to demand repayment of a loan. The ratings of specific rating agencies are often specified in such agreements.

Barriers that prevent some NRSROs from obtaining information needed to assign ratings may also limit competition, particularly with respect to structured finance products. Generally, when the issuer-paid model is employed, much of the information relied on by the hired NRSROs to rate structured finance products is non-public. In the past, this made it difficult for other NRSROs to rate these securities. As a result, the products frequently were issued with ratings from only one or two NRSROs and only by NRSROs that are hired by the issuer, sponsor, or underwriter. In addition, investors may also have tended to place greater weight on an opinion that is based, in part, on access to privileged information.⁶³ The Commission's November 2009 amendments to Rule 17g-5 were designed to reduce these barriers by prohibiting an NRSRO from issuing an issuer-paid rating on a structured finance product unless certain information about the transaction is disclosed to other NRSROs.⁶⁴

D. The State of Competition among NRSROs

As discussed above, since the enactment of the Rating Agency Act and the adoption of the Commission's rules under the Rating Agency Act, ten firms have registered as NRSROs with the Commission. The first seven firms applied for registration as NRSROs in June of 2007 under the new registration and oversight program adopted by the Commission that month and were granted registration on September 24, 2007. By June 23, 2008, the Commission had granted three additional credit rating agencies NRSRO registration. As of December 31, 2010, these three NRSROs accounted for approximately 27,000 credit ratings, slightly less than 1% of the total outstanding NRSRO ratings. In addition, these three NRSROs operated primarily under the subscriber-pay compensation model at the time of initial registration, providing users of ratings an alternative to the issuer-pay model employed by the seven NRSROs that applied for registration in June 2007. However, as mentioned above, two of these agencies which had previously operated primarily under the subscriber-pay compensation model have recently introduced an issuer-pay compensation model for part of their business.

Although the credit ratings of the two largest NRSROs now represent a slightly smaller proportion of all NRSRO ratings, the Commission is unable to discern from this data the impact of NRSRO registration on the demand for or the provision of credit ratings for several reasons. First, the registration and oversight program implemented by

⁶² See, e.g., Moody's Special Comment, "2008 Rating Trigger Trends in the U.S. Life (Re) Insurance Industry," (Jan. 2009).

⁶³ See, e.g., Philippe Jorion, Zhu Liu, and Charles Shi, "Informational Effects of Regulation FD: Evidence from Rating Agencies," *Journal of Financial Economics*, (May 2005).

⁶⁴ See Rule 17g-5(a)(3) (17 CFR 240.17g-5(a)(3)).

the Commission under the Rating Agency Act that requires disclosure of information about outstanding ratings for NRSROs has been in existence only since the third quarter of 2007. In addition, the recent credit crisis, while potentially creating additional long term demand for providers of credit assessment tools, also reduced debt issuance in a number of sectors. Issuance levels have recovered in some sectors, such as corporate debt, but remain well below levels prior to the crisis in other areas, notably for ABS. Consequently, there is insufficient historical data to evaluate the impact that being registered as an NRSRO has had on obtaining additional business, particularly for the newer NRSROs.

Second, comparing the number of ratings outstanding for large, established NRSROs and newly registered NRSROs may not provide a complete picture. The large NRSROs have a significantly longer history of issuing ratings and their ratings include those for debt obligations (and obligors) that were rated long before the establishment of the newer entrants. Consequently, a comparison of the number of ratings issued on more recent issuances may provide a better gauge of how well newer entrants are competing with more established firms.

Third, as noted above, all seven of the NRSROs which applied for registration in June 2007 operate primarily on an issuer-pay compensation model, whereas the three more recently registered NRSROs, at the time of their registration, relied primarily on a subscriber-pay compensation model. For the earlier-registered NRSROs, outstanding ratings were solicited from a paying client (the issuer) for that individual rating. Increases and decreases in the total number of outstanding ratings reflect trends in securities issuances and the demand for ratings by clients of that NRSRO. For subscriber-pay NRSROs, on the other hand, investors and other market participants purchase the right to access the pool of credit ratings issued by the NRSRO, and are not necessarily users of all credit ratings issued by the NRSRO. Thus, a reported increase in the number of securities rated by the NRSRO as part of its regulatory filings does not necessarily demonstrate that those additional credit ratings are being widely relied upon by market participants.

E. Assessing the Impact of Additional Competition

The Senate Report accompanying the Rating Agency Act stated that the statute's purpose was to "improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency, and competition in the credit rating industry."⁶⁵ The Senate Report also noted that competition would "provide investors with more choices, higher quality ratings, and lower costs."⁶⁶ Competition can lead to credit ratings that are of higher value to investors along one or more dimensions (for example, greater accuracy or timeliness) or ratings that are of equivalent value at a lower cost. Competition may also lead to improved management of conflicts of interest, to the

⁶⁵ See Senate Report, p. 1.

⁶⁶ See Senate Report, p. 7.

extent investors can discern whether rating agencies are properly managing these conflicts.⁶⁷

It should be noted, however, that increasing the number of entities that are treated as NRSROs, in itself, may not have a significant effect on competition. The newer NRSROs, by providing ratings that are superior in either quality or price, could create additional competition. Nevertheless, it may take time before the impact of increased competition can be observed because of the importance of reputation, the difficulty in establishing a reputation quickly, and various economic factors. Gaining acceptance in the market for a new NRSRO may be even more difficult when investors and their agents rely upon written policies and procedures requiring the use of ratings provided by the large well-established NRSROs. Altering such policies and procedures would require proactive steps on the part of investors.

F. The Potential Impact on Competition of NRSRO Rules

The Rating Agency Act and the registration and oversight program for NRSROs implemented by the Commission pursuant to authority granted by the Rating Agency Act are designed, among other things, to promote competition. For example, the registration process prescribed by the Rating Agency Act and Rule 17g-1 were designed to make it easier for credit rating agencies to become NRSROs as compared to the process in place before the enactment of the Rating Agency Act.⁶⁸ In addition, the disclosure requirements of Form NRSRO are intended to make it easier for users of credit ratings to compare NRSROs and, therefore, for an NRSRO to distinguish itself from its peers. For example, the disclosure of performance statistics and the methodologies and procedures for determining credit ratings provides a means for assessing the accuracy of an NRSRO's credit ratings and how well its procedures and methodologies are designed to achieve accuracy. Moreover, the disclosures of conflicts, the procedures for managing conflicts, and the procedures for protecting material, nonpublic information allow users of credit ratings to assess the steps an NRSRO has taken to ensure the integrity of its credit rating processes.

Other Commission rules for NRSROs also contain provisions that were designed to promote competition. For example, Rule 17g-2(d)(3) requires NRSROs to publicly provide ratings histories for all credit ratings initially determined on or after June 26, 2007. Further, as discussed below, the Commission's May 2011 proposal, if adopted, would expand and enhance these disclosure requirements. These enhanced disclosures with respect to the performance of NRSROs' credit ratings are designed to foster greater comparability and accountability of NRSROs with respect to their credit ratings as well as competition among NRSROs by making it easier for users of credit ratings to assess the performance of NRSROs' credit ratings. Ultimately, if adopted, these changes could make it easier for a smaller, newer NRSRO to demonstrate that it produces more accurate ratings.

⁶⁷ As discussed in section VI, some analysts believe that competition can lead to "ratings shopping", which can result in ratings of lower credit quality.

⁶⁸ See Senate Report p. 6-7.

As discussed above, NRSROs competing in the structured finance sector will potentially be affected by the November 2009 amendments to Rule 17g-5 prohibiting an NRSRO from issuing an issuer-paid rating on a structured finance product unless certain information about the transaction is disclosed to other NRSROs.⁶⁹ An NRSRO may then be able to provide unsolicited ratings on these securities and establish itself as a provider of high quality ratings of structured finance products.⁷⁰

The Commission is aware of concerns that increased regulatory burdens on NRSROs could decrease competition in the credit rating industry by unduly burdening smaller NRSROs or deterring new entrants. In proposed rules implementing the NRSRO mandates of the Dodd-Frank Act, the Commission has made every effort to avoid impeding competition and has sought out comments regarding the effect that the proposals would have on competition. In addition, in the past, the Commission has granted exemptive relief from certain rules on a temporary basis to smaller NRSROs.⁷¹ The fact that two of the smaller NRSROs (KBRA and Morningstar) were purchased by larger non-NRSRO entities suggests that participants in the credit rating industry continue to value the NRSRO designation.

V. COMMISSION'S VIEW ON TRANSPARENCY

Congress described the Rating Agency Act as an act to improve ratings quality “by fostering accountability, transparency, and competition in the credit rating agency industry.”⁷² Similarly, Section 932 of the Dodd-Frank Act is titled “Enhanced regulation, accountability, and transparency of [NRSROs].” Both Acts contain various provisions to increase the transparency—through clear disclosure open to public scrutiny—of, among other things, NRSROs’ credit rating procedures and methodologies, business practices, and credit ratings performance.

⁶⁹ See Rule 17g-5(a)(3) (17 CFR 240.17g-5(a)(3)).

⁷⁰ Commenters have stated that some provisions of the rule have acted as a deterrent to its use and have suggested revisions to the rule to increase the issuance of unsolicited ratings. See, e.g., September 13, 2011 letter to Elizabeth Murphy, Secretary, U.S. Securities and Exchange Commission from The Securities Industry and Financial Markets Association, <http://www.sec.gov/comments/4-629/4629-9.pdf>; and September 12, 2011 letter to Securities and Exchange Commission from The American Securitization Forum, <http://www.sec.gov/comments/4-629/4629-12.pdf>, in response to the Commission’s request for comment to assist it in carrying out a study required by Section 939 of the Dodd-Frank Act on, among other matters, the feasibility of establishing a system in which a public or private utility or a self-regulatory organization assigns NRSROs to determine credit ratings for structured finance products, Solicitation of Comment to Assist in Study on Assigned Credit Ratings, Exchange Act Release No. 64456 (May 10, 2011), <http://www.sec.gov/rules/other/2011/34-64456.pdf>.

⁷¹ See, e.g., Order Granting Temporary Exemption of Kroll Bond Rating Agency, Inc. from the Conflict of Interest Prohibition in Rule 17g-5(c)(1) of the Securities Exchange Act of 1934, Exchange Act Release No. 65339 (Sept. 14, 2011).

⁷² See the preamble to the Rating Agency Act.

The Rating Agency Act added Section 15E(a)(3) of the Exchange Act,⁷³ which requires the Commission to issue rules requiring an NRSRO to make certain information publicly available on its website or through another comparable, readily accessible means. Exchange Act Rule 17g-1(i)⁷⁴ specifies that the information consists of the NRSRO's current Form NRSRO and Exhibits 1 through 9 to Form NRSRO. These exhibits contain information about each NRSRO's performance statistics; procedures and methodologies for determining credit ratings; procedures to prevent the misuse of material, non-public information; organizational structure; code of ethics (or explanation of why it does not have a code of ethics); conflicts of interest; procedures to manage conflicts of interest; credit analysts; and designated compliance officers.⁷⁵

The following is a list of the Internet website links where Form NRSRO and Exhibits 1 through 9 for each NRSRO currently can be obtained:⁷⁶

A.M. Best

<http://www.ambest.com/nrsro/index.html>

DBRS

<http://dbrs.com/about/regulatoryAffairs>

EJR

<http://www.egan-jones.com/nrsro.aspx>

Fitch

<http://www.fitchratings.com/jsp/corporate/PolicyRegulation.faces?context=3&detail=4>

JCR

<http://www.jcr.co.jp/english/nrsro/index.html>

KBRA

<http://www.krollbondratings.com/regulatory.php>

Moody's

<http://v3.moodys.com/Pages/reg001002.aspx>

Morningstar

<https://www.realpoint.com/PublicDocs/NRSRO%20Application.pdf>

⁷³ 15 U.S.C. 78o-7(a)(3).

⁷⁴ 17 CFR 240.17g-1(i).

⁷⁵ The Commission's examination staff focuses on the quality and accuracy of an NRSRO's disclosures during an examination of an NRSRO. Prior to the implementation of the NRSRO registration and oversight program, certain credit rating agencies disclosed some of this information, particularly with respect to credit rating performance statistics and their procedures and methodologies for determining credit ratings.

⁷⁶ These links were current as of October 2011.

R&I

<http://www.r-i.co.jp/eng/rating/nrsro/nrsro.html>

S&P

<http://www.standardandpoors.com/regulatory-affairs/ratings/en/us>

The Dodd-Frank Act contains a number of provisions relating to NRSRO transparency.⁷⁷ Section 943, for example, requires the Commission to prescribe rules on the use of representations and warranties in the market for ABS that, among other things, require NRSROs to include in any report accompanying a credit rating a description of the representations, warranties, and enforcement mechanisms available to investors and how they differ from the representations, warranties, and enforcement mechanisms in issuances of similar securities. In January 2011, the Commission adopted new rules related to representations and warranties in ABS offerings, including new Rule 17g-7, which tracks the statutory language.⁷⁸ In addition, Section 938(a) of the Dodd-Frank Act, among other things, requires the Commission to adopt rules requiring NRSROs to have procedures to clearly define the meaning of symbols used to denote credit ratings and to apply those symbols consistently.

Section 932(a)(8) of the Dodd-Frank Act added Sections 15E(q), (r), and (s) to the Exchange Act.⁷⁹ Section 15E(q)(1) requires the Commission to issue rules to require an NRSRO to publicly disclose certain information on its initial credit ratings and any subsequent changes to the credit ratings, for the purpose of allowing users of credit ratings to evaluate the accuracy of ratings and compare the performance of ratings by different NRSROs. Section 15E(q)(2) requires that the disclosures are comparable among NRSROs, are clear and informative for investors having a wide range of sophistication, include performance information over a range of years and for a variety of types of credit ratings, are published and made freely available by the NRSRO on an easily accessible portion of its website, and in writing, when requested, are appropriate to the business model of a NRSRO, and that an NRSRO include an attestation with any credit rating it issues affirming that no part of the rating was influenced by any other business activities, that the rating was based solely on the merits of the instruments being rated, and that such rating was an independent evaluation of the risks and merits of the instrument.

Currently, the Commission's rules require NRSROs to publish two types of information about the performance of their credit ratings: (1) performance statistics⁸⁰ and

⁷⁷ See Section VI of this report for a discussion of the disclosure requirements in Section 15E(h)(4) of the Exchange Act, added by Section 932(a)(4) of the Dodd-Frank Act, and proposed Rule 17g-8(c), which relate to "look-back" reviews.

⁷⁸ Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Securities Act of 1933 Release No. 9175; Exchange Act Release No. 63741 (Jan. 20, 2011), 76 FR 4515 (Jan. 26, 2011).

⁷⁹ 15 U.S.C. 78o-7(q), (r), and (s).

⁸⁰ See the instructions for Exhibit 1 to Form NRSRO. This type of disclosure shows the performance of an NRSRO's credit ratings in the aggregate. Performance statistics consist of the percent of rated obligors, securities, and money market instruments in each category of credit

(2) ratings histories.⁸¹ The Commission has proposed to implement the rulemaking mandated in Section 15E(q) of the Exchange Act, in substantial part, by significantly enhancing the requirements for generating and disclosing this information by amending the instructions for Exhibit 1 to Form NRSRO and amending Rule 17g-1, Rule 17g-2, and Rule 17g-7.⁸²

The Commission has proposed amending the instructions for Exhibit 1 to standardize the production and presentation of the transition and default statistics. The Commission has also proposed amending paragraph (i) of Rule 17g-1 to require an NRSRO to make Form NRSRO and Exhibits 1 through 9 freely available on an easily accessible portion of its website, removing the option to make it available through “another comparable, readily accessible means,” and freely available in writing when requested. In addition, the Commission has proposed adding new paragraph (b) to Rule 17g-7. This proposed amendment would implement rulemaking mandated in Section 15E(q) of the Exchange Act by: (1) re-codifying in paragraph (b) of Rule 17g-7 requirements currently contained in paragraph (d)(3) of Rule 17g-2 (the “100% Rule”); and (2) substantially enhancing those requirements. First, new proposed paragraph (b)(1) of Rule 17g-7 would require the NRSRO, among other things, to publicly disclose the ratings history information for free on an easily accessible portion of its corporate Internet website. The second enhancement would broaden the scope of credit ratings subject to the disclosure requirements. The third enhancement would increase the scope of information that must be disclosed about a rating action. The fourth enhancement would be to require that a rating history not be removed from the disclosure until 20 years after the NRSRO withdraws the credit rating assigned to the obligor, security, or money market instrument. In light of these proposed enhancements, as well as the proposed amendments to Exhibit 1 to Form NRSRO, the Commission has proposed repealing paragraph (d)(2) of Rule 17g-2 (the “10% Rule”).

Section 15E(r) of the Exchange Act requires the Commission to issue rules that require an NRSRO to have procedures: (1) to ensure that credit ratings are determined using procedures and methodologies, including qualitative and quantitative data and models, that are approved by the board of the NRSRO and are in accordance with the policies and procedures of the NRSRO for the development and modification of credit rating procedures and methodologies; (2) to ensure that when material changes to credit rating procedures and methodologies are made, that the changes are applied consistently

rating in the NRSRO’s rating scale that, over a given time period, were downgraded or upgraded to another credit rating category or went into default. The goal is to provide a mechanism for users of credit ratings to compare the performance of credit ratings across NRSROs.

⁸¹ See Rule 17g-2(d). This type of disclosure consists of the credit rating history of an obligor, security, or money market instrument rated by an NRSRO. A credit rating history includes the initial credit rating and all subsequent modifications to the credit rating (such as upgrades, downgrades, and placements on watch) and the dates of such actions. The goal is to allow users of credit ratings to compare how different NRSROs rated an individual obligor, security, or money market instrument and how and when those ratings were changed over time. The disclosure of ratings histories also is designed to provide “raw data” that can be used by third parties to generate independent performance statistics such as transition and default rates.

⁸² See May 2011 Proposing Release, 76 FR 33433-33452.

to all credit ratings to which the changed procedures and methodologies apply, to the extent that changes are made to credit rating surveillance procedures and methodologies, the changes are applied to then-current credit ratings by the NRSRO within a reasonable time period determined by the Commission, by rule, and the NRSRO publicly discloses the reason for the change; and (3) to notify users of credit ratings of the version of a procedure or methodology used with respect to a particular credit rating, when a material change is made to a procedure or methodology, when a significant error is identified in a procedure or methodology that may result in credit rating actions, and of the likelihood of a material change resulting in a change in current credit ratings.

To implement Section 15E(r), the Commission has proposed paragraph (a) of new Rule 17g-8.⁸³ Proposed Rule 17g-8(a) would require an NRSRO to have policies and procedures with respect to the procedures and methodologies the NRSRO uses to determine credit ratings that are reasonably designed to ensure that: the procedures and methodologies are approved by its board of directors and are developed and modified in accordance with the policies and procedures of the NRSRO; material changes to the procedures and methodologies are applied consistently to all credit ratings to which the changed procedures or methodologies apply; material changes to the procedures and methodologies are, to the extent that the changes are to surveillance or monitoring procedures and methodologies, applied to then-current credit ratings within a reasonable period of time taking into consideration the number of ratings impacted, the complexity of the procedures and methodologies used to determine the credit ratings, and the type of obligor, security, or money market instrument being rated; the NRSRO promptly publishes on an easily accessible portion of its corporate Internet website material changes to the procedures and methodologies, the reason for the changes, and the likelihood the changes will result in changes to any current ratings; the NRSRO promptly publishes on an easily accessible portion of its corporate Internet website significant errors identified in a procedure or methodology that may result in a change in current credit ratings; and it discloses the version of a credit rating procedure or methodology, used with respect to a particular credit rating.

Section 15E(s)(1) of the Exchange Act requires the Commission to issue rules requiring an NRSRO to accompany the publication of each credit rating with a form that discloses: information relating to the assumptions underlying credit rating procedures and methodologies, the data that was relied on to determine the credit rating, how the NRSRO used servicer or remittance reports, and with what frequency, to conduct surveillance of the credit rating, and information that can be used by investors and other users of credit ratings to better understand credit ratings issued by the NRSRO. Section 15E(s)(2) of the Exchange Act requires that the form be easy to use and helpful for users of credit ratings to understand the information contained in the report, require the NRSRO to provide the content in a manner that is directly comparable across types of securities, and be made readily available to users of credit ratings, in electronic or paper form, as the Commission may, by rule, determine. Section 15E(s)(3) of the Exchange Act requires that the form contain nine enumerated types of qualitative information and four enumerated types of quantitative information. Section 15E(s)(4) of the Exchange Act

⁸³ See May 2011 Proposing Release, 76 FR 33452.

requires that the issuer or underwriter of any ABS make publicly available the findings and conclusions of any third-party due diligence report obtained by the issuer or underwriter, in any case in which third-party due diligence services are employed by a NRSRO, an issuer, or an underwriter, the person providing the due diligence services provide to any NRSRO that produces a rating to which such services relate, written certification, in a form that the Commission must establish. In addition, the Commission must adopt rules requiring a NRSRO, at the time at which the NRSRO produces a rating, to disclose the certification to the public in a manner that allows the public to determine the adequacy and level of due diligence services provided by a third party.

The Commission has proposed adding new paragraphs (a)(1) and (2) to Rule 17g-7 to implement rulemaking mandated in Sections 15E(s)(1), (2), (3), and (4)(D) of the Exchange Act. Proposed new paragraphs (a)(1) and (2) of Rule 17g-7 would require, respectively, an NRSRO when taking a rating action to publish a form containing information about the credit rating resulting from or subject to the rating action; and any certification of a provider of third-party due diligence services received by the NRSRO that relates to the credit rating.

Section 938(a) of the Dodd-Frank Act requires the Commission to issue rules requiring NRSROs to have policies and procedures with respect to the symbols, numbers, or scores it uses to denote credit ratings reasonably designed to: assess the probability that an issuer of a security or money market instrument will default, fail to make timely payments, or otherwise not make payments to investors in accordance with the terms of the security or money market instrument; clearly define the meaning of each symbol, number, or score in the rating scale used by the NRSRO to denote a credit rating category; and apply any such symbol, number, or score in a manner that is consistent for all types of obligors, securities and money market instruments for which the symbol, number, or score is used.

The Commission has proposed paragraph (b) of new Rule 17g-8⁸⁴ to implement rulemaking mandated in Section 938(a) of the Dodd-Frank Act. Proposed Rule 17g-8(b) would closely track the statutory text.

An NRSRO currently submits the Form NRSROs required under Rule 17g-1 and the annual reports required under Rule 17g-3 to the Commission in paper form. As part of the May 2011 Proposing Release,⁸⁵ the Commission proposed amending Rule 17g-1, the Instructions to Form NRSRO, Rule 17g-3, and Regulation S-T⁸⁶ to require an NRSRO to use the Commission's Electronic Data Gathering, Analysis, and Retrieval (EDGAR) system to: (1) electronically file or furnish, as applicable, Form NRSRO and the information and documents contained in Exhibits 1 through 9 of Form NRSRO if the submission is made pursuant to paragraph (e), (f), or (g) of Rule 17g-1 (that is, an update

⁸⁴ See May 2011 Proposing Release, 76 FR 33480.

⁸⁵ See May 2011 Proposing Release, 76 FR 33482-33484.

⁸⁶ 17 CFR 232 et seq.

of registration, an annual certification, or a withdrawal from registration, respectively)⁸⁷ and (2) electronically file or furnish, as applicable, the annual reports required by Rule 17g-3.⁸⁸

One of the primary goals of the EDGAR system is to facilitate the rapid dissemination of financial and business information in connection with filings the Commission receives. Although paragraph (i) of Rule 17g-1 currently requires NRSROs to make the public portions of their current Form NRSROs publicly available on its website or through another comparable, readily accessible means within 10 business days after submission to the Commission, if adopted, the amendments would make such information available immediately in one location.

VI. COMMISSION'S VIEW ON CONFLICTS OF INTEREST

Credit rating agencies operate under one of two business models (or a combination of them), and there are potential conflicts of interest inherent in both. As discussed above, the business model of the largest NRSROs is an “issuer pay” business model, which means that, for example, an issuer of bonds pays the rating agency to rate its bonds. This “issuer-pay” model is subject to a potential conflict in that, if the bond issuer can “shop” for another rating by a different rating agency, the NRSRO, in order to gain favor with the issuer and retain its business, may issue a credit rating that is higher than the NRSRO’s objective analysis would otherwise determine. This conflict could be broader if, for example, the fact that an NRSRO issues higher credit ratings with respect to a class of issuers results in the NRSRO retaining or attracting business across all issuers in that class.

The other business model is the “subscriber-pay” model, which means that investors pay the rating agency a subscription fee to access its ratings. This model also is subject, albeit perhaps to a lesser degree, to potential conflicts of interest. For example, the NRSRO may be aware that an influential subscriber holds a securities position (long or short) that could be advantaged if a credit rating upgrade or downgrade causes the market value of the security to increase or decrease; or that the subscriber invests in newly issued bonds and would obtain higher yields if the bonds have lower ratings. In another example, the NRSRO may be aware that a subscriber wishes to acquire a particular security but is prevented from doing so because its credit rating is lower than internal investment guidelines or an applicable contract permit. An upgrade of the credit rating of the security by the NRSRO could remove this impediment to investing in the security. These potential conflicts are mitigated, however, to the extent that subscribers have different interests with respect to an upgrade or downgrade of a particular security.

⁸⁷ See 17 CFR 240.17g-1(e), (f), and (g). The electronic submissions of Form NRSRO and Exhibits 1 through 9 of Form NRSRO would be made available to the public immediately upon filing.

⁸⁸ See 17 CFR 240.17g-3. An NRSRO is not required to make the Rule 17g-3 annual reports publicly available and the reports would not be available to the public on EDGAR. The information collected pursuant to Rule 17g-3 is, and would continue to be, kept confidential to the extent permitted by the Freedom of Information Act (15 U.S.C. 552 *et seq.*).

Other potential conflicts are common to both business models. For example, an employee of the NRSRO may have an ownership interest in an issuer that is subject to a credit rating of the NRSRO.⁸⁹ Another potential conflict, which, as discussed below, was addressed by the Dodd-Frank Act, may arise when a credit analyst who participated in rating an issuer was also seeking employment with the issuer.

A number of studies have attempted to identify cases of “ratings shopping” behavior, where, under the issuer-pay model, issuers seek to hire rating agencies that provide more favorable ratings. For example, according to one study of RMBS transactions in the early to mid 1990s, rating agencies whose rating methodologies required lower levels of credit enhancement than competitors tended to increase their market share.⁹⁰ A more recent study of corporate ratings concluded that the presence of a new entrant could result in more “issuer-friendly” ratings.⁹¹ Other analysts, however, have argued that the incentives for a rating agency to maintain its reputation outweigh the short term gain which can be achieved by issuing ratings of lower quality.⁹²

The potential for conflicts of interest may be particularly acute in the structured product area, including, among other instruments, RMBS and CDOs, where issuers are separate legal entities created and operated by a relatively concentrated group of sponsors, underwriters and managers (collectively “arrangers”). These products are highly complex and require specific and technical knowledge of financial engineering and valuation of the underlying assets. But the complexity of the products and the issuers’ ability to control the flow of information about the underlying assets may lead to an outcome where the arranger has more or better information about the transaction than the investor.⁹³ This informational imbalance, combined with very high concentration in NRSRO credit raters, increases the potential for conflicts of interest to impair market integrity. As discussed above, however, reputational risk provides incentives for firms to produce high quality ratings.

The Dodd-Frank Act contains several provisions that address conflicts of interest. Section 932(a)(4) of the Dodd-Frank Act added new subparagraph (3) (“Separation of ratings from sales and marketing”) to Exchange Act Section 15E(h) (“Conflicts of interest”).⁹⁴ Section 15E(h)(3) requires the Commission to issue rules to prevent the

⁸⁹ Rule 17g-5(c)(2) (17 CFR 240.17g-5(c)(2)) prohibits an NRSRO from issuing or maintaining a credit rating with respect to an issuer where the NRSRO, a credit analyst who participated in determining the rating, or a person responsible for approving the rating has any direct ownership interest in the issuer.

⁹⁰ See Cantor and Packer (1994).

⁹¹ See Bo Becker, and Todd Milbourn. "How Did Increased Competition Affect Credit Ratings?" *Journal of Financial Economics* 101, no. 1 (July 2011): 2011-2012.

⁹² See, e.g., Steven L. Schwarcz, “Private Ordering of Public Markets: The Rating Agency Paradox,” *University of Illinois Law Review*, Vol. 2002, No. 2 (Feb. 2002); Daniel M. Covitz and Paul Harrison, "Testing Conflicts of Interest at Bond Ratings Agencies with Market Anticipation: Evidence that Reputation Incentives Dominate," FEDS Working Paper No. 2003-68 (Dec. 2003).

⁹³ Economists typically refer to this outcome as the existence of information asymmetries. See, e.g., George A. Akerlof, "The Market for 'Lemons': Quality Uncertainty and the Market Mechanism," *Quarterly Journal of Economics* 84(3): 488–500 (1970).

⁹⁴ 15 U.S.C. 78o-7(h).

sales and marketing considerations of an NRSRO from influencing the production of credit ratings by the NRSRO. Section 15E(h)(3) requires that the rules provide for exceptions for small NRSROs where the Commission determines that the separation of ratings production and sales and marketing activities is not appropriate, and for suspension or revocation of an NRSRO's registration if the Commission finds, on the record, after notice and opportunity for a hearing, that the NRSRO has violated a rule issued "under this subsection" and the violation affected a rating.

The Commission has proposed to implement this provision by amending Rule 17g-5.⁹⁵ New Rule 17g-5(c)(8) would prohibit an NRSRO from issuing or maintaining a credit rating where an employee of the NRSRO who participates in the sales or marketing of a product or service of the NRSRO or of a person associated with the NRSRO also participates in determining or monitoring a credit rating or developing or approving procedures used for determining a credit rating. New paragraph (f) of Rule 17g-5 would provide that, upon written application by an NRSRO, the Commission may exempt it from Rule 17g-5(c)(8) if the Commission finds that due to the small size of the NRSRO it is not appropriate to require the separation of the production of ratings from sales and marketing activities. New paragraph (g) of Rule 17g-5 would provide that in a proceeding pursuant to Section 15E(d) or 21C of the Exchange Act, the Commission shall suspend or revoke the registration of an NRSRO if it finds that the NRSRO has violated a rule issued under Section 15E(h), that the violation affected a rating, and that suspension or revocation is necessary for the protection of investors and in the public interest.

Section 932(a)(4) of the Dodd-Frank Act also added new paragraph (h)(4), a "Look-back requirement," to Section 15E of the Exchange Act.⁹⁶ Section 15E(h)(4) requires an NRSRO to have policies and procedures reasonably designed to ensure that in the case in which a former employee who participated in determining a credit rating, and was subsequently employed – within one year – by an entity or issuer, underwriter, or sponsor of a security subject to that credit rating, the NRSRO will conduct a "look-back" review to determine whether any conflicts of interest influenced the credit rating and take action to revise the rating, if appropriate, in accordance with such rules as the Commission shall prescribe.

To implement this provision, the Commission has proposed paragraph (c) of new Rule 17g-8,⁹⁷ which would require that the NRSRO have such policies and procedures that include, at a minimum, those reasonably designed to ensure that if the "look-back" review determined that a conflict influenced a rating, the NRSRO would: immediately place the credit rating on a credit watch and include, among other things, an explanation that the reason for the action is that the rating was influenced by a conflict of interest; promptly determine whether the credit rating must be revised so it no longer is influenced by a conflict of interest; and promptly publish a revised credit rating or an affirmation of the credit rating, if appropriate.

⁹⁵ See May 2011 Proposing Release, 76 FR 33426.

⁹⁶ 15 U.S.C. 78o-7(h)(4).

⁹⁷ See May 2011 Proposing Release, 76 FR 33429.

VII. CONCLUSION

As described above, the Commission took a number of actions during the reporting period with respect to NRSROs. The Commission will continue to engage in rulemaking and other initiatives with respect to NRSROs to implement mandates of the Dodd-Frank Act and to otherwise enhance its oversight of NRSROs.