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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REPORT ON NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATIONS

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

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 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.

The Rating Agency Act became effective on June 26, 2007. Consequently, the year to which this report relates begins on June 26, 2007 and ends on June 25, 2008.

On June 5, 2007, the Commission approved the rules implementing a registration and oversight program for NRSROs under the Rating Agency Act – the rules became effective that same month. During the year ended June 25, 2008, the Commission registered the first 10 NRSROs. Also, in response to the role played by NRSROs in the credit market turmoil, the Commission staff began an examination of the NRSROs' activities in rating residential mortgage-backed securities backed by subprime mortgage loans and collateralized debt obligations linked to such loans. In addition, the Commission expects to release a public report on its exam findings in the very near future. Furthermore, on June 11, 2008, the Commission took two actions by voting to propose amendments to certain of the NRSRO rules and to propose a new NRSRO rule (Rule 17g-7).[2] These rulemaking actions are designed to address concerns about the role

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[1] Pub. L. No. 109-291 (2006).

[2] See Proposed Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 57967 (June 16, 2008), 73 FR 36212 (June 25, 2008) ("Proposing Release").

that NRSROs played in the credit market turmoil and to strengthen the robustness and transparency of their credit rating processes generally.[3]

This report provides an overview of the Rating Agency Act, the Commission's rules adopted under the Rating Agency Act as of the date of this report, the Commission's proposals for new NRSRO requirements, the scope of the Commission's on-going examination of NRSROs, and addresses each of the items specified in Section 6 of the Rating Agency Act.

II. THE RATING AGENCY ACT AND COMMISSION RULES APPLICABLE TO NRSROS

The purpose of the Rating Agency Act is 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."[4] As discussed in more detail below, the Rating Agency Act, among other things, amended Section 3 of the Exchange Act to add certain definitions, added Section 15E to the Exchange Act to implement a registration and oversight program for NRSROs, amended Section 17 of the Exchange Act to provide the Commission with recordkeeping, reporting, and examination authority over NRSROs, and amended Section 21B(a) of the Exchange Act to provide the Commission with authority to assess money penalties against NRSROs in proceedings instituted under Section 15E of the Exchange Act. The operative provisions of the Rating Agency Act became applicable upon the Commission's adoption in June 2007 of a series of rules implementing a registration and oversight program for credit rating agencies that register as NRSROs.[5]

A. Provisions of the Rating Agency Act

The Rating Agency Act added definitions of "credit rating,"[6] "credit rating agency,"[7] "nationally recognized statistical rating organization,"[8] and "qualified

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3 In a related third action, the Commission voted on June 25, 2008 to amend existing Commission rules to reduce undue reliance on NRSRO ratings in the rules.

4 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. (Sept. 6, 2006) ("Senate Report"), p. 1.

5 See Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, Securities Exchange Act of 1934 ("Exchange Act") Release No. 55857 (June 5, 2007), 72 FR 33564 (June 18, 2007) ("Adopting Release").

6 15 U.S.C. 78c(a)(60). The Exchange Act defines a "credit rating" to mean "an assessment of the creditworthiness of an obligor as an entity or with respect to specific securities or money market instruments." Id.

7 15 U.S.C. 78c(a)(61). The Exchange Act defines "credit rating agency" to mean "any person—
(A) engaged in the business of issuing credit ratings on the Internet or through another readily accessible means, for free or for a reasonable fee, but does not include a commercial credit reporting company;

institutional buyer"[9] ("QIB") to Section 3 of the Exchange Act.[10] Taken together, these definitions prescribe the type of entity that can apply to the Commission to be registered as an NRSRO. First, the entity must meet the definition of "credit rating agency" in Section 3 of the Exchange Act, which means, among other things, it must issue "credit ratings" as defined in the Exchange Act (i.e., assessments of the creditworthiness of obligors as entities or with respect to specific securities or money market instruments). Furthermore, to be a "credit rating agency," the entity must be engaged in the business of issuing credit ratings on the internet or through another readily accessible means, for free or for a reasonable fee. In addition, the entity must employ either a quantitative or qualitative model or both to determine credit ratings and receive fees from issuers, investors, or other market participants.

To register with the Commission, a "credit rating agency" must meet the definition of "nationally recognized statistical rating organization." For example, under the Rating Agency Act, the credit rating agency must have been in the business of issuing credit ratings for the three years immediately preceding the date of its application for registration with the Commission.[11] In addition, the credit rating agency must issue credit ratings with respect to one or more classes of specific types of obligors: (1) financial institutions, brokers, or dealers; (2) insurance companies; (3) corporate issuers;

(B) employing either a quantitative or qualitative model, or both, to determine credit ratings; and
(C) receiving fees from either issuers, investors, or other market participants, or a combination thereof." Id.

[8] 15 U.S.C. 78c(a)(62). A "nationally recognized statistical rating organization" is defined as a "credit rating agency that—
(A) has been in the business as a credit rating agency for at least the 3 consecutive years immediately preceding the date of its application for registration under [Section 15E of the Exchange Act];
(B) issues credit rating 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 Section 1101(c) of part 229 of Title 17, Code of Federal Regulations, as in effect on the date of enactment of this paragraph);
(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 the clauses (i) through (v); and
(C) is registered under Section 15E [of the Exchange Act]." Id.

[9] 15 U.S.C. 78c(64).

[10] 15 U.S.C. 78c.

[11] See 15 U.S.C. 78c(a)(62)(A).

(4) issuers of asset-backed securities; and (5) issuers of government securities, municipal securities, or securities issued by a foreign government.[12]

A credit rating agency that meets these statutory definitions can seek to be registered with the Commission as an NRSRO under Section 15E of the Exchange Act. Section 15E(a)(1)(B) of the Exchange Act, prescribes certain minimum information a credit rating agency must provide in its application for registration as an NRSRO.[13] This information is:

- Credit ratings performance measurement statistics over short-, mid-, and long-term periods, as applicable;[14]

- The procedures and methodologies that the applicant uses in determining ratings;[15]

- Policies or procedures adopted and implemented by the applicant to prevent the misuse, in violation of the of the Exchange Act (or the rules and regulations hereunder) of material, nonpublic information;[16]

- The organizational structure of the applicant;[17]

- Whether or not the applicant has in effect a code of ethics, and if not, the reasons therefore;[18]

- Any conflict of interest relating to the issuance of credit ratings by the applicant;[19]

- The categories described in any of clauses (i) through (v) of Section 3(a)(62)(B) of the Exchange Act with respect to which the applicant intends to apply for registration under Section 15E of the Exchange Act (i.e., the classes of obligors identified in the definition of "nationally recognized statistical rating organization");[20]

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12 See 15 U.S.C. 78c(a)(62)(B)(i) – (v).

13 15 U.S.C. 78o-7(a)(1)(B).

14 15 U.S.C. 78o-7(a)(1)(B)(i).

15 15 U.S.C. 78o-7(a)(1)(B)(ii).

16 15 U.S.C. 78o-7(a)(1)(B)(iii).

17 15 U.S.C. 78o-7(a)(1)(B)(iv).

18 15 U.S.C. 78o-7(a)(1)(B)(v).

19 15 U.S.C. 78o-7(a)(1)(B)(vi).

20 15 U.S.C. 78o-7(a)(1)(B)(vii).

- On a confidential basis, a list of the 20 largest issuers and subscribers that use the credit rating services of the applicant, by amount of net revenues received therefrom in the fiscal year immediately preceding the date of submission of the application;[21] and

- On a confidential basis, as to each category of obligor described in clauses (i) through (v) of Section 3(a)(62)(B) of the Exchange Act, written certifications described in Section 15E(a)(1)(C) of the Exchange Act, except as provided in Section 15E(a)(1)(D) of the Exchange Act.[22]

Section15E(a)(2)(A) of the Exchange Act requires the Commission to grant an application for registration as an NRSRO or commence proceedings on whether to deny the application within 90 days from the date the application is furnished to the Commission or a longer period if the applicant consents.[23] Further, if proceedings are commenced, Section 15E(a)(2)(B) of the Exchange Act[24] requires the Commission to conclude them within 120 days of the date the application is furnished to the Commission.[25] Section 15E(a)(2)(C)(i) of the Exchange Act provides that the Commission shall grant a credit rating agency registration if the requirements of Section 15E of the Exchange Act are satisfied.[26] Section 15E(a)(2)(C)(ii) of the Exchange Act provides that the Commission shall deny the application if it finds that the applicant does not have adequate financial and managerial resources to consistently produce credit ratings with integrity and materially comply with the procedures and methodologies disclosed pursuant to Section 15E(a)(1)(B) of the Exchange Act and established pursuant Sections 15E(g), (h), (i) and (j) or if the applicant were so registered, its registration

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21 15 U.S.C. 78o-7(a)(1)(B)(viii).

22 15 U.S.C. 78o-7(a)(1)(B)(ix). Specifically, this provision requires the applicant to provide the certifications from QIBs as specified in Section 15E(a)(1)(C) of the Exchange Act (15 U.S.C. 78o-7(a)(1)(C)). Sections 15E(a)(1)(C)(i) – (iii) of the Exchange Act require an applicant to furnish certifications from a minimum of 10 QIBs, including certifications from no less than two QIBs for each category of obligor for which the applicant intends to be registered. 15 U.S.C. 78o-7(a)(1)(C)(i) – (iii). Section 15E(a)(1)(C)(iv) requires that the certification state that the entity meets the definition of a QIB and has used the credit ratings of the applicant for at least the 3 years immediately preceding the date of the certification in the subject category or categories. 15 U.S.C. 78o-7(a)(1)(C)(iv). Section 15E(a)(1)(D) of the Exchange Act provides an exemption from the furnishing the QIB certifications for any applicant that had received, or been the subject of, a no-action letter provided by Commission staff prior to August 2, 2006. 15 U.S.C. 78o-7(a)(1)(D).

23 15 U.S.C. 78o-7(a)(2)(A).

24 15 U.S.C. 78o-7(a)(2)(B).

25 Under Section 15E(a)(2)(B)(iii) of the Exchange Act, the Commission can extend this period for an additional 90 days for good cause or for such other period as the applicant consents (15 U.S.C. 78o-7(a)(2)(B)(iii)).

would be subject to suspension or revocation under Section 15E(d) of the Exchange Act.[27]

After registration, a credit rating agency – now an NRSRO – becomes subject to certain provisions in Section 15E of the Exchange Act. Some of these provisions require the NRSRO to keep the information provided in its registration application up-to-date. For example, Section 15E(b)(1) of the Exchange Act requires an NRSRO to promptly update its application for registration if, after registration, any information or document provided as part of the application becomes materially inaccurate.[28] The statute further provides that the information on credit ratings performance statistics required pursuant to Section 15E(a)(1)(B) of the Exchange Act must be updated only on an annual basis and that the certifications from the QIBs are not required to be updated.[29] In addition, Section 15E(b)(2) of the Exchange Act requires an NRSRO to furnish the Commission with an amendment to its registration not later than 90 days after the end of each calendar year (the "annual certification").[30] This section further provides that the amendment must (1) certify that the information and documents provided in the application for registration (except the QIB certifications) continue to be accurate and (2) list any material change to the information and documents during the previous calendar year.[31]

Other provisions of Section 15E of the Exchange Act require an NRSRO to implement certain types of controls to manage its activities. For example, Section 15E(g)(1) of the Exchange Act[32] requires an NRSRO to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the misuse of material, nonpublic information in violation of the Exchange Act.[33] Additionally, Section 15E(h)(1) of the Exchange Act requires an NRSRO to establish, maintain, and enforce policies and procedures reasonably designed, taking into consideration the nature of its business, to address and manage conflicts of interest.[34] And, Section 15E(j) of the Exchange Act requires an NRSRO to designate an individual responsible for administering the policies and procedures of the NRSRO to prevent the misuse of nonpublic information, to manage conflicts of interest, and to ensure compliance with the

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[26] 15 U.S.C. 78o-7(a)(2)(C)(i).

[27] 15 U.S.C. 78o-7(a)(2)(C)(ii).

[28] 15 U.S.C. 78o-7(b)(1).

[29] Id.

[30] 15 U.S.C. 78o-7(b)(2).

[31] Id.

[32] 15 U.S.C. 78o-7(g)(1).

[33] 15 U.S.C. 78a et seq.

[34] 15 U.S.C. 78o-7(h)(1).

securities laws and the rules and regulations under those laws ("designated compliance officer").[35]

Section 15E of the Exchange Act also provides the Commission with authority to take actions against an NRSRO. For example, Section 15E(d) of the Exchange Act provides that the Commission shall, by order, censure, place limitations on the activities, functions or operations of, suspend for a period not exceeding 12 months, or revoke the registration of an NRSRO if, among other things, the NRSRO fails to maintain adequate financial and managerial resources to consistently produce credit ratings with integrity.[36] The Commission also can take such action if the NRSRO or an associated person: (1) has committed or omitted any act, or has been subject to an order or finding, enumerated in subparagraphs (A), (D), (E), (G), or (H) of section 15(b)(4) of the Exchange Act, has been convicted of any offense specified in section 15(b)(4)(B) of the Exchange Act , or has been enjoined from any action, conduct, or practice specified in section 15(b)(4)(C) of the Exchange Act of; (2) has been convicted of any crime that is punishable by imprisonment for 1 or more years, and that is not described in section 15(b)(4) of the Exchange Act, or has been convicted of a substantially equivalent crime by a foreign court of competent jurisdiction; or (3) is subject to any order of the Commission barring or suspending the right of the person to be associated with an NRSRO.[37]

B. Commission's NRSRO Rules

By adding Section 15E and amending Section 17 of the Exchange Act, the Rating Agency Act provided the Commission with rulemaking authority in a variety of areas. The Commission adopted six rules in June 2007.

1. Rule 17g-1 and Form NRSRO

Rule 17g-1 prescribes, among other things, how an NRSRO must apply to be registered with the Commission, keep its registration up-to-date, and comply with the statutory requirement to furnish the Commission with an annual certification.[38] Specifically, all of these actions must be accomplished by furnishing the Commission with a Form NRSRO. As described below, the Form NRSRO elicits information about the credit rating agency applying for registration and, after registration about the NRSRO, including the information required under 15E(a)(1)(B) of the Exchange Act.[39] Rule 17g-1(i) requires an NRSRO to make its current Form NRSRO and information and documents submitted in Exhibits 1 though 9 (described below) publicly available within

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35 15 U.S.C. 78o-7(j).

36 15 U.S.C. 78o-7(d).

37 Id.

38 See 17 CFR 240.17g-1.

39 15 U.S.C. 78o-7(a)(1)(B).

10 business days of being granted an initial registration or registration in an additional class of credit ratings and within 10 business days of furnishing an update to amend information on the form, to provide the annual certification, and to withdraw a registration.[40]

Form NRSRO contains 8 line items and 13 Exhibits. The line items elicit information about the applicant credit rating agency or NRSRO such as: its address; corporate form; credit rating affiliates that would be, or are, a part of its registration; the classes of credit ratings for which it is seeking, or is, registered as an NRSRO; the number of credit ratings it has issued in each class and the date it began issuing credit ratings in each class; and whether it or a person associated with it has committed or omitted any act, been convicted of any crime, or is subject to any order identified in Section 15(d) of the Exchange Act. Form NRSRO also directs an applicant credit rating agency, if not exempt from the requirement, to submit a minimum of 10 QIB certifications, of which at least two must address each class of credit rating the applicant is seeking to be registered in, and prescribes the form of the QIB certification.

The 13 Exhibits to Form NRSRO elicit the information required under Sections 15E(a)(1)(B)(i) through (ix) of the Exchange Act and additional information the Commission prescribed under authority in Section 15E(a)(1)(B)(x) of the Exchange Act.[41] As noted above, an NRSRO must make Exhibits 1 through 9 publicly available after it is registered. Exhibits 10 through 13 do not need to be publicly disclosed pursuant to Rule 17g-1(i) and need to be furnished only when applying for registration. These Exhibits elicit financial information about the applicant credit rating agency that the Commission uses in making the finding required under Section 15E(a)(2)(C)(ii) of the Exchange Act[42] that the applicant has adequate financial and managerial resources to consistently produce credit ratings with integrity and materially comply with the procedures and methodologies disclosed pursuant to Section 15E(a)(1)(B) of the Exchange Act[43] and established pursuant Sections 15E(g), (h), (i) and (j) of the Exchange Act.[44] After registration, an NRSRO is required to furnish financial information to the Commission in an annual report required by Rule 17g-3 (discussed below) that is similar to the information elicited in Exhibits 10 through 13.[45] The NRSRO rules do not require that the annual reports furnished to the Commission pursuant to Rule 17g-3 be made publicly available by the NRSRO.[46]

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40 See 17 CFR 240.17g-1(i).

41 15 U.S.C. 78o-7(a)(1)(B)(i) – (x).

42 15 U.S.C. 78o-7(a)(2)(C)(ii).

43 15 U.S.C. 78o-7(a)(1)(B).

44 15 U.S.C. 78o-7(g), (h), (i) and (j).

45 See 17 CFR 240.17g-3.

46 See Adopting Release, 72 FR at 33590.

Exhibit 1 elicits the information required by Section 15E(a)(1)(B)(i) of the Exchange Act: credit ratings performance measurement statistics over short-term, mid-term, and long-term periods (as applicable) of the credit rating agency.[47] The instructions for the Exhibit provide that an applicant and NRSRO must include in the Exhibit definitions of the credit ratings (i.e., an explanation of each category and notch) and explanations of the performance measurement statistics, including the metrics used to derive the statistics.

Exhibit 2 elicits the information required by Section 15E(a)(1)(B)(ii) of the Exchange Act: information regarding the procedures and methodologies used by the credit rating agency to determine credit ratings.[48] The instructions for the Exhibit require a description of the procedures and methodologies (not the submission and disclosure of each actual procedure and methodology). The instructions further provide that the description must be sufficiently detailed to provide users of credit ratings with an understanding of the processes the applicant or NRSRO employs to determine credit ratings. The instructions also identify a number of areas that must be addressed in the description to the extent they are applicable.[49]

Exhibit 3 elicits the information required by Section 15E(a)(1)(B)(iii) of the Exchange Act: the policies or procedures adopted and implemented by the credit rating agency to prevent the misuse of material, nonpublic information in violation of Exchange Act provisions and rules.[50] The instructions for the Exhibit provide that the applicant or NRSRO is not required to submit in the Exhibit any specific information in the policies and procedures that is proprietary or would diminish the effectiveness of the policies and procedures if such information is disclosed.

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47 15 U.S.C. 78o-7(a)(1)(B)(i).

48 15 U.S.C. 78o-7(a)(1)(B)(ii).

49 Specifically, the instructions require an NRSRO to provide descriptions of the following areas (as applicable): policies for determining whether to initiate a credit rating; a description of the public and non-public sources of information used in determining credit ratings, including information and analysis provided by third-party vendors; the quantitative and qualitative models and metrics used to determine credit ratings; the methodologies by which credit ratings of other credit rating agencies are treated to determine credit ratings for securities or money market instruments issued by an asset pool or as part of any asset-backed or mortgaged-backed securities transaction; the procedures for interacting with the management of a rated obligor or issuer of rated securities or money market instruments; the structure and voting process of committees that review or approve credit ratings; procedures for informing rated obligors or issuers of rated securities or money market instruments about credit rating decisions and for appeals of final or pending credit rating decisions; procedures for monitoring, reviewing, and updating credit ratings; and procedures to withdraw, or suspend the maintenance of, a credit rating.

50 15 U.S.C. 78o-7(a)(1)(B)(iii).

Exhibit 4 elicits the information required by Section 15E(a)(1)(B)(iv) of the Exchange Act: information regarding the organizational structure of the credit rating agency.[51] The instructions for the Exhibit provide that the applicant or NRSRO must provide three different charts as applicable. The first required organizational chart is of the credit rating agency's ultimate and sub-holding companies, subsidiaries, and material affiliates, if applicable. The second organizational chart is of the credit rating agency's divisions, departments, and business units, if applicable. The third organizational chart is of the credit rating agency's management structure and senior management reporting lines and must include its designated compliance officer under Section 15E(j) of the Exchange Act.[52]

Exhibit 5 elicits the information required by Section 15E(a)(1)(B)(v) of the Exchange Act: whether the credit rating agency has a code of ethics in effect or an explanation of why the credit rating agency has not established a code of ethics.[53] The instructions for the Exhibit require the credit rating agency to attach a copy of any established code of ethics or an explanation of why it does not have a code of ethics.

Exhibit 6 elicits the information required by Section 15E(a)(1)(B)(vi) of the Exchange Act: information regarding any conflict of interest relating to the issuance of credit ratings by the applicant and NRSRO.[54] The instructions to the Exhibit require the credit rating agency to provide a list describing in general terms the types of conflicts of interest that arise from its business activities. The instructions list 10 different generic conflicts of interest that may apply to a credit rating agency based on its business model and activities.[55] These conflicts are included in the instructions as examples of

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[51] 15 U.S.C. 78o-7(a)(1)(B)(iv).

[52] 15 U.S.C. 78o-7(j).

[53] 15 U.S.C. 78o-7(a)(1)(B)(v).

[54] 15 U.S.C. 78o-7(a)(1)(B)(vi).

[55] The conflicts of interest identified in Exhibit 6 are:

- The Applicant/NRSRO is paid by issuers or underwriters to determine credit ratings with respect to securities or money market instruments they issue or underwrite.
- The Applicant/NRSRO is paid by obligors to determine credit ratings of the obligors.
- The Applicant/NRSRO is paid for services in addition to determining credit ratings by issuers, underwriters, or obligors that have paid the Applicant/NRSRO to determine a credit rating.
- The Applicant/NRSRO is paid by persons for subscriptions to receive or access the credit ratings of the Applicant/NRSRO and/or for other services offered by the Applicant/NRSRO where such persons may use the credit ratings of the Applicant/NRSRO to comply with, and obtain benefits or relief under, statutes and regulations using the term "nationally recognized statistical rating organization."
- The Applicant/NRSRO is paid by persons for subscriptions to receive or access the credit ratings of the Applicant/NRSRO and/or for other services offered by the Applicant/NRSRO where such persons also may own investments or have entered into transactions that could be favorably or adversely impacted by a credit rating issued by the Applicant/NRSRO.

conflicts.[56] The instructions further provide that the credit rating agency can use the descriptions provided in the instructions to identify an applicable conflict of interest and is not required to provide any further information. Thus, the credit rating agency can review each item on the list and determine whether it describes an applicable conflict. A credit rating agency can choose to provide its own description of the conflict or further explanation to one of the descriptions in the instructions.

Exhibit 7 requires the credit rating agency to furnish a copy of the written policies and procedures it establishes, maintains, and enforces to address and manage conflicts of interest pursuant to Section 15E(h) of the Exchange Act.[57] The instructions for the Exhibit provide that the credit rating agency is not required to submit in the Exhibit any specific information in the policies and procedures that is proprietary or would diminish the effectiveness of the policies and procedures if such information were disclosed.

Exhibit 8 requires the credit rating agency to furnish summary information about its credit analysts. Specifically, the Exhibit requires the following information:

- The total number of credit analysts.
- The total number of credit analyst supervisors.
- A general description of the minimum required qualifications of the credit analysts, including education level and work experience (if applicable, distinguish between junior, mid, and senior level credit analysts).
- A general description of the minimum required qualifications of the credit analyst supervisors, including education level and work experience.

- The Applicant/NRSRO allows persons within the Applicant/NRSRO to:
  - Directly own securities or money market instruments of, or have other direct ownership interests in, obligors or issuers subject to a credit rating determined by the Applicant/NRSRO.
  - Have business relationships that are more than arms length ordinary course business relationships with obligors or issuers subject to a credit rating determined by the Applicant/NRSRO.
- A person associated with the Applicant/NRSRO is a broker or dealer engaged in the business of underwriting securities or money market instruments (identify the person).
- The Applicant/NRSRO has any other material conflict of interest that arises from the issuances of credit ratings (briefly describe).

[56] As discussed below, these conflicts of interest also are identified in paragraph (b) of Rule 17g-5. 17 CFR 240.17g-5(b). Rule 17g-5 provides that these types of conflicts are prohibited unless the NRSRO discloses them in Form NRSRO and establishes procedures to manage them as required by 15 U.S.C. 78o-7(h).

[57] 15 U.S.C. 78o-7(h).

Exhibit 9 (the last of the Exhibits that must be publicly disclosed under Rule 17g-1(i)) requires an applicant and NRSRO to provide certain background information on the entity's designated compliance officer.

Exhibit 10 elicits the information required by Section 15E(a)(1)(B)(viii) of the Exchange Act: on a confidential basis, a list of the 20 largest issuers and subscribers that use the credit rating services provided by the credit rating agency by amount of net revenue received by the credit rating agency in the fiscal year immediately preceding the date of submission of the application.[58] The instructions for the Exhibit provide that the credit rating agency must disclose in the list large obligors (i.e., persons who are rated as an entity as opposed to having their securities rated) and underwriters if they are determined to have provided at least as much net revenue as the 20th largest issuer or subscriber. Consequently, a credit rating agency is required to identify the 20 largest issuers and subscribers as required by Section 15E(a)(1)(B)(viii) of the Exchange Act[59] and include in the list any obligor and underwriter that meets the above criteria. An NRSRO does not need to publicly disclose this information pursuant to Rule 17g-1(i).[60] Instead, Rule 17g-3 requires an NRSRO to include similar information in an annual report furnished to the Commission.[61]

Exhibit 11 requires the credit rating agency to furnish audited financial statements for the past three fiscal or calendar years immediately preceding the date of the application. To accommodate credit rating agencies that did obtain audits in the normal course prior to registration as NRSROs, the instructions for the Exhibit provide that the credit rating agency may furnish an audited financial statement for the fiscal year immediately preceding the date of the application and unaudited financial statements for the prior years. An NRSRO does not need to publicly disclose this information pursuant to Rule 17g-1(i). Instead, Rule 17g-3 requires an NRSRO to include audited financial statements in an annual report furnished to the Commission.[62]

Exhibit 12 requires the credit rating agency to provide information as to the amount of revenue generated from various credit rating services and a separate computation of total revenue from all other services. Specifically, the instructions for the Exhibit require the following information:

- Revenue from determining and maintaining credit ratings;
- Revenue from subscribers;

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58 15 U.S.C. 78o-7(a)(1)(B)(viii).

59 Id.

60 17 CFR 240.17g-1(i).

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

62 17 CFR 240.17g-3(a)(1).

- Revenue from granting licenses or rights to publish credit ratings; and

- Revenue from all other services and products offered by the credit rating agency (include descriptions of any major sources of revenue).

The instructions provide that this information be for the most recently completed fiscal or calendar year and is not required to be audited. An NRSRO does not need to publicly disclose this information pursuant to Rule 17g-1(i).[63] Instead, Rule 17g-3 requires an NRSRO to include similar information in an annual report furnished to the Commission.[64]

Exhibit 13 requires the credit rating agency to furnish the Commission with the amount of total aggregate annual compensation paid to its credit analysts and the median compensation. The instructions provide that the information must be for the most recently completed fiscal or calendar year and will not have to be audited. An NRSRO does not need to publicly disclose this information pursuant to Rule 17g-1(i).[65] Instead, Rule 17g-3 requires an NRSRO to provide similar information in an annual report furnished to the Commission.[66]

2. Rule 17g-2

Rule 17g-2 requires an NRSRO to make and retain certain records relating to its business and to retain certain other records made in the normal course of business operations.[67] The rule also prescribes the time periods and manner in which all these records must be retained.[68] Paragraph (a) of Rule 17g-2 requires an NRSRO to make and retain the following records:[69]

- Records of original entry into the accounting system of the NRSRO and records reflecting entries to and balances in all general ledger accounts of the NRSRO for each fiscal year;[70]

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63 17 CFR 240.17g-1(i).

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

65 17 CFR 240.17g-1(i).

66 See 17 CFR 240.17g-3(a)(4).

67 See 17 CFR 240.17g-2.

68 Id.

69 17 CFR 240.17g-2(a).

70 17 CFR 240.17g-2(a)(1).

- Records with respect to each current credit rating of the NRSRO indicating (as applicable): (1) the identity of any credit analyst(s) that participated in determining the credit rating; (2) the identity of the person(s) that approved the credit rating before it was issued; (3) whether the credit rating was solicited or unsolicited; (4) and the date the credit rating action was taken;[71]

- An account record for each person (for example, an obligor, issuer, underwriter, or other user) that has paid the NRSRO for the issuance or maintenance of a credit rating indicating: (1) the identity and address of the person; and (2) the credit rating(s) determined or maintained for the person;[72]

- An account record for each subscriber to the credit ratings and/or credit analysis reports of the NRSRO indicating the identity and address of the subscriber;[73]

- A record listing the general types of services and products offered by the NRSRO;[74]

- A record documenting the established procedures and methodologies used by the NRSRO to determine credit ratings;[75] and

- A record that lists each security and money market instrument and its corresponding credit rating issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction where the NRSRO, in determining the credit rating for the security or money market instrument, treats assets within such pool or as a part of such transaction that are not subject to a credit rating of the NRSRO by any or a combination of the following methods: (1) determining credit ratings for the unrated assets; (2) performing credit assessments or determining private credit ratings for the unrated assets; (3) determining credit ratings or private credit ratings, or performing credit assessments for the unrated assets by taking into consideration the internal credit analysis of another person; or (4) determining credit ratings or private credit ratings, or performing credit

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71 17 CFR 240.17g-2(a)(2).

72 17 CFR 240.17g-2(a)(3).

73 17 CFR 240.17g-2(a)(4).

74 17 CFR 240.17g-2(a)(5).

75 17 CFR 240.17g-2(a)(6).

assessments for the unrated assets by taking into consideration (but not necessarily adopting) the credit ratings of another NRSRO.[76]

Paragraph (b) of Rule 17g-2 identifies certain types of records that an NRSRO must retain if the NRSRO makes or receives the record.[77] These records are:

- Significant records (for example, bank statements, invoices, and trial balances) underlying the information included in the annual financial reports furnished by the NRSRO to the Commission pursuant to Rule 17g-3;[78]

- Internal records, including nonpublic information and work papers, used to form the basis of a credit rating issued by the NRSRO;[79]

- Credit analysis reports, credit assessment reports, and private credit rating reports of the NRSRO and internal records, including nonpublic information and work papers, used to form the basis for the opinions expressed in these reports;[80]

- Compliance reports and compliance exception reports;[81]

- Internal audit plans, internal audit reports, documents relating to internal audit follow-up measures, and all records identified by the internal auditors of the NRSRO as necessary to perform the audit of an activity that relates to its business as a credit rating agency;[82]

- Marketing materials of the NRSRO that are published or otherwise made available to persons that are not associated with the NRSRO;[83]

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76 17 CFR 240.17g-2(a)(7).

77 17 CFR 240.17g-2(b).

78 17 CFR 240.17g-2(b)(1). In the Adopting Release, the Commission stated that this would include: bank statements, bills payable and receivable, trial balances, and records relating to the determination of the largest customers. See Adopting Release, 72 FR at 33586.

79 17 CFR 240.17g-2(b)(2). In the Adopting Release, the Commission stated that this would include, for example: notes of conversations with the management of an issuer or obligor that was the subject of the credit rating and the inputs and raw results of a quantitative model used to determine the credit rating. See Adopting Release, 72 FR at 33586.

80 17 CFR 240.17g-2(b)(3).

81 17 CFR 240.17g-2(b)(4).

82 17 CFR 240.17g-2(b)(5).

83 17 CFR 240.17g-2(b)(6).

- External and internal communications, including electronic communications, received and sent by the NRSRO and its employees that relate to initiating, determining, maintaining, changing, or withdrawing a credit rating;[84]

- Internal documents that contain information, analysis, or statistics that were used to develop a procedure or methodology to treat the credit ratings of another NRSRO for the purpose of determining a credit rating for a security or money market instrument issued by an asset pool or part of any asset-backed or mortgage-backed securities transaction;[85]

- For each security or money market instrument identified in the record required to be made and retained under paragraph (a)(7) of Rule 17g-2, any document that contains a description of how assets within such pool or as a part of such transaction not rated by the NRSRO but rated by another NRSRO were treated for the purpose of determining the credit rating of the security or money market instrument;[86] and

- Form NRSROs (including Exhibits and accompanying information and documents) submitted to the Commission by the NRSRO.[87]

Paragraph (c) of Rule 17g-2 requires an NRSRO to retain the records identified in paragraphs (a) and (b) for three years after the date the record is made or received.[88] Paragraph (d) of Rule 17g-2 requires an NRSRO to maintain an original, or a true and complete copy of the original, of each record required to be retained pursuant to paragraphs (a) and (b) of Rule 17g-2 in a manner that, for the applicable retention period specified in paragraph (c) of Rule 17g-2, makes the original record or copy easily accessible to the principal office of the NRSRO and to any other office that conducted activities causing the record to be made or received.[89] Paragraph (f) of Rule 17g-2 requires an NRSRO to promptly furnish the Commission or its representatives with legible, complete, and current copies, and, if specifically requested English translations, of those records of the NRSRO required to be retained under Rule 17g-2, or any other records of the NRSRO subject to examination under Section 17(b) of the Exchange Act [90]

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84 17 CFR 240.17g-2(b)(7).

85 17 CFR 240.17g-2(b)(8).

86 17 CFR 240.17g-2(b)(9).

87 17 CFR 240.17g-2(b)(10).

88 17 CFR 240.17g-2(c).

89 17 CFR 240.17g-2(d).

90 See 15 U.S.C 78q(b).

that are requested by the Commission or its representatives.[91] The requirement for an English translation arises from the fact that foreign credit rating agencies can register as NRSROs.[92]

3. Rule 17g-3

Rule 17g-3 requires an NRSRO to furnish the Commission four, or in some cases five, financial reports annually.[93] The reports must be furnished not more than 90 days after the end of the NRSRO's fiscal year and the information in the reports must be as of the most recently ended fiscal year.[94] Certain of the information required to be included in the reports is identical or similar to the information that credit rating agency applicants seeking registration as NRSROs furnish in Exhibits 10 through 13 of Form NRSRO.[95] The financial reports required by Rule 17g-3 are:

- Audited financial statements of the NRSRO or audited consolidated financial statements of its parent if the NRSRO is a separately identifiable division or department of the parent;[96]

- If applicable, unaudited consolidated financial statements of the parent of the NRSRO that include the NRSRO;[97]

- An unaudited financial report providing information concerning the revenue of the NRSRO in each of the following categories (as applicable) for the fiscal year: (i) Revenue from determining and maintaining credit ratings; (ii) Revenue from subscribers; (iii) Revenue from granting licenses or rights to publish credit ratings; and (iv) Revenue from all other

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91 17 CFR 240.17g-2(f).

92 See Adopting Release, 72 FR at 33589-33590.

93 17 CFR 240.17g-3.

94 17 CFR 240.17g-3(a).

95 See Adopting Release, 72 FR at 33591-33593.

96 17 CFR 240.17g-3(a)(1). Rule 17g-3 provides that the audited financial statements must include a balance sheet, an income statement and statement of cash flows, and a statement of changes in ownership equity and be prepared in accordance with generally accepted accounting principles in the jurisdiction where the NRSRO or its parent is incorporated, organized, or has its principal office. In addition, the audited financial statements must be certified by an accountant who is qualified and independent in accordance with 17 CFR 240.210.2-01(a), (b), and (c)(1), (2), (3), (4), (5) and (8). Further, the accountant must give an opinion on the financial statements in accordance with 17 CFR 210.2-02(a), (b), (c) and (d). See 17 CFR 240.17g-3(a)(1)(i) – (iii).

97 17 CFR 240.17g-3(a)(2). This financial report must be furnished only if the audited financial statements provided pursuant to paragraph (a)(1) of Rule 17g-3 are consolidated financial statements of the parent of the NRSRO. See Note to paragraph (a)(2) in Rule 17g-3.

services and products (include descriptions of any major sources of revenue);[98]

- An unaudited financial report providing the total aggregate and median annual compensation of the credit analysts of the NRSRO for the fiscal year;[99] and

- An unaudited financial report listing the 20 largest issuers and subscribers that used credit rating services provided by the NRSRO by amount of net revenue attributable to the issuer or subscriber during the fiscal year.[100]

Paragraph (b) of Rule 17g-3 provides that the NRSRO must attach to each financial report a signed statement by a duly authorized person associated with the NRSRO that the person has responsibility for the report and, to the best knowledge of the person, the financial report fairly presents, in all material respects, the financial condition, results of operations, cash flows, revenues, and analyst compensation, as applicable, of the NRSRO for the period presented.[101]

4. Rule 17g-4

As noted above, Section 15E(g)(1) of the Exchange Act[102] requires an NRSRO to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the misuse of material, nonpublic information in violation of the Exchange Act.[103] Rule 17g-4 requires an NRSRO to establish procedures to address three areas where material, nonpublic information could be inappropriately disclosed or used.[104] Specifically, it requires that the written policies and procedures an NRSRO establishes, maintains, and enforces pursuant to section 15E(g)(1) of the Exchange Act must include policies and procedures reasonably designed to prevent:

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98 17 CFR 240.17g-3(a)(3).

99 17 CFR 240.17g-3(a)(4).

100 17 CFR 240.17g-3(a)(5). Rule 17g-3 further provides that the NRSRO include on the list any obligor or underwriter that used the credit rating services provided by the NRSRO if the net revenue attributable to the obligor or underwriter during the fiscal year equaled or exceeded the net revenue attributable to the 20th largest issuer or subscriber. Additionally, the NRSRO must include the net revenue amount for each person on the list. Id.

101 17 CFR 240.17g-3(b).

102 15 U.S.C. 78o-7(g)(1).

103 15 U.S.C. 78a et seq.

104 17 CFR 240.17g-4.

- The inappropriate dissemination within and outside the NRSRO of material nonpublic information obtained in connection with the performance of credit rating services;[105]

- A person within the NRSRO from purchasing, selling, or otherwise benefiting from any transaction in securities or money market instruments when the person is aware of material nonpublic information obtained in connection with the performance of credit rating services that affects the securities or money market instruments;[106] and

- The inappropriate dissemination within and outside the NRSRO of a pending credit rating action before issuing the credit rating on the Internet or through another readily accessible means.[107]

Paragraph (b) of Rule 17g-4, defines the term "person within" an NRSRO to mean, for the purposes of the Rule, the NRSRO, its credit rating affiliates identified on Form NRSRO, and any partner, officer, director, branch manager, and employee of the NRSRO or its credit rating affiliates (or any person occupying a similar status or performing similar functions).[108]

5. Rule 17g-5

Section 15E(h)(1) of the Exchange Act requires an NRSRO to establish, maintain, and enforce policies and procedures reasonably designed, taking into consideration the nature of its business, to address and manage conflicts of interest.[109] Section 15E(h)(2) of the Exchange Act requires the Commission to adopt rules to prohibit or require the management and disclosure of conflicts of interest relating to the issuance of credit ratings.[110] The statute also identifies certain types of conflicts relating to the issuance of

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105 17 CFR 240.17g-4(a)(1). The Commission stated in the Adopting Release that some credit rating agencies, as part of their analysis, contact senior management of the obligors and issuers subject to their credit ratings. In the course of these contacts, an issuer or obligor may provide the credit rating agency with nonpublic information including contemplated business transactions or estimated financial projections. See Adopting Release, 72 FR at 33593.

106 17 CFR 240.17g-4(a)(2).

107 17 CFR 240.17g-4(a)(3). The Commission stated in the Adopting Release that this provision recognizes that a credit rating action of an NRSRO may be material, nonpublic information. Consequently, an NRSRO must have policies designed to ensure that its pending credit rating actions are not selectively disclosed before the credit rating is issued on the Internet or through another readily accessible means. See Adopting Release, 72 FR at 33594-33595.

108 17 CFR 240.17g-4(b).

109 15 U.S.C. 78o-7(h)(1).

110 15 U.S.C. 78o-7(h)(2).

credit ratings that the Commission may include in its rules.[111] Furthermore, it contains a catchall provision for any other potential conflict of interest that the Commission deems is necessary or appropriate in the public interest or for the protection of investors to include in its rules.[112] The Commission implemented these statutory provisions through the adoption of Rule 17g-5, which prohibits the conflicts identified in the statute and certain additional conflicts either outright or if the NRSRO has not disclosed them and established policies and procedures to manage them.[113]

Paragraph (a) of Rule 17g-5[114] prohibits a person within an NRSRO from having a conflict of interest relating to the issuance of a credit rating that is identified in paragraph (b) of the rule unless the NRSRO has disclosed the type of conflict of interest in compliance with Rule 17g-1 (i.e., in Exhibit 6 to Form NRSRO) and has implemented policies and procedures to address and manage the type of conflict of interest in accordance with Section 15E(h)(1) of the Exchange Act.[115] The following conflicts are identified in paragraph (b) of Rule 17g-5 and, therefore, subject to the provisions of paragraph (a):

- Being paid by issuers or underwriters to determine credit ratings with respect to securities or money market instruments they issue or underwrite;[116]

- Being paid by obligors to determine credit ratings with respect to the obligors;[117]

- Being paid for services in addition to determining credit ratings by issuers, underwriters, or obligors that have paid the NRSRO to determine a credit rating;[118]

- Being paid by persons for subscriptions to receive or access the credit ratings of the NRSRO and/or for other services offered by the NRSRO where such persons may use the credit ratings of the NRSRO to comply

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111 See 15 U.S.C. 78o-7(h)(2)(A) – (D).

112 See 15 U.S.C. 78o-7(h)(2)(E).

113 See 17 CFR 240.17g-5.

114 17 CFR 240.17g-5(a).

115 15 U.S.C. 78o-7(h)(1).

116 17 CFR 240.17g-5(b)(1).

117 17 CFR 240.17g-5(b)(2).

118 17 CFR 240.17g-5(b)(3).

with, and obtain benefits or relief under, statutes and regulations using the term "NRSRO;"[119]

- Being paid by persons for subscriptions to receive or access the credit ratings of the NRSRO and/or for other services offered by the NRSRO where such persons also may own investments or have entered into transactions that could be favorably or adversely impacted by a credit rating issued by the NRSRO;[120]

- Allowing persons within the NRSRO to directly own securities or money market instruments of, or having other direct ownership interests in, issuers or obligors subject to a credit rating determined by the NRSRO;[121]

- Allowing persons within the NRSRO to have a business relationship that is more than an arms length ordinary course of business relationship with issuers or obligors subject to a credit rating determined by the NRSRO;[122]

- Having a person associated with the NRSRO that is a broker or dealer engaged in the business of underwriting securities or money market instruments;[123] and

- Any other type of conflict of interest relating to the issuance of credit ratings by the NRSRO that is material to the NRSRO and that is identified by the NRSRO in Exhibit 6 to Form NRSRO in accordance with section 15E(a)(1)(B)(vi) of the Act (15 U.S.C. 78o-7(a)(1)(B)(vi)) and Rule 17g-1.[124]

Paragraph (c) of Rule 17g-5 specifically prohibits outright four types of conflicts of interest.[125] Consequently, an NRSRO would violate the rule regardless of whether it had disclosed them and established procedures reasonably designed to address them. The four prohibited conflicts are:

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119 17 CFR 240.17g-5(b)(4).

120 17 CFR 240.17g-5(b)(5).

121 17 CFR 240.17g-5(b)(6).

122 17 CFR 240.17g-5(b)(7).

123 17 CFR 240.17g-5(b)(8).

124 17 CFR 240.17g-5(b)(9).

125 17 CFR 240.17g-5(c)(1) – (4).

- The NRSRO issues or maintains a credit rating solicited by a person that, in the most recently ended fiscal year, provided the NRSRO with net revenue (as reported under Rule 17g-3) equaling or exceeding 10% of the total net revenue of the NRSRO for the fiscal year;[126]

- The NRSRO issues or maintains a credit rating with respect to a person (excluding a sovereign nation or an agency of a sovereign nation) where the NRSRO, a credit analyst that participated in determining the credit rating, or a person responsible for approving the credit rating, directly owns securities of, or has any other direct ownership interest in, the person that is subject to the credit rating;[127]

- The NRSRO issues or maintains a credit rating with respect to a person associated with the NRSRO;[128] or

- The NRSRO issues or maintains a credit rating where a credit analyst who participated in determining the credit rating, or a person responsible for approving the credit rating, is an officer or director of the person that is subject to the credit rating.[129]

6. Rule 17g-6

Section 15E(i)(1) of the Exchange Act[130] provides that the Commission shall adopt rules prohibiting any act or practice by an NRSRO that the Commission determines is unfair, abusive, or coercive, including certain acts and practices set forth in paragraphs

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126 17 CFR 240.17g-5(c)(1). In the Adopting Release, the Commission responded to comments from smaller credit rating agencies that this prohibition could impact them, particularly with respect to ratings business they get from large sponsors of structured finance products, by stating that it would monitor whether this prohibition interferes with how NRSROs as a matter of course deal with structured finance product sponsors. See Adopting Release, 72 FR at 33598. The Commission stated that it would evaluate whether the rule should be modified to accommodate this business practice or whether an exemption would be appropriate. Id. Two of the NRSROs granted registration during the year were given one year exemptions from this prohibition. See Order Granting Temporary Exemption of LACE Financial Corp. from the Conflict of Interest Prohibition in Rule 17a-5(c)(1) of the Securities Exchange Act of 1934, Exchange Act Release No. 57301 (February 11, 2008) and Order Granting Temporary Exemption of Realpoint LLC from the Conflict of Interest Prohibition in Rule 17a-5(c)(1) of the Securities Exchange Act of 1934, Exchange Act Release No. 58001 (June 23, 2008).

127 17 CFR 240.17g-5(c)(2). In the Adopting Release, the Commission stated the prohibition applied to "direct" ownership of securities and, therefore, would not apply to indirect ownership interests, for example, through mutual funds or blind trusts. See Adopting Release, 72 FR at 33598.

128 17 CFR 240.17g-5(c)(3).

129 17 CFR 240.17g-5(c)(4).

130 15 U.S.C. 78o-7(i)(1).

(i)(1)(A)-(C) of Section 15E of the Exchange Act.[131] In explaining this statutory provision, the Senate Report stated that "the Commission, as a threshold consideration, must determine that the practices subject to prohibition under this section are unfair, coercive or abusive before adopting rules prohibiting such practices."[132] The Commission implemented this statutory authority by adopting Rule 17g-6,[133] which prohibits the following practices:

- Conditioning or threatening to condition the issuance of a credit rating on the purchase by an obligor or issuer, or an affiliate of the obligor or issuer, of any other services or products, including pre-credit rating assessment products, of the NRSRO or any person associated with the NRSRO;[134]

- Issuing, or offering or threatening to issue, a credit rating that is not determined in accordance with the NRSRO's established procedures and methodologies for determining credit ratings, based on whether the rated person, or an affiliate of the rated person, purchases or will purchase the credit rating or any other service or product of the NRSRO or any person associated with the NRSRO;[135]

- Modifying, or offering or threatening to modify, a credit rating in a manner that is contrary to the NRSRO's established procedures and methodologies for modifying credit ratings based on whether the rated person, or an affiliate of the rated person, purchases or will purchase the credit rating or any other service or product of the NRSRO or any person associated with the NRSRO;[136] and

- Issuing or threatening to issue a lower credit rating, lowering or threatening to lower an existing credit rating, refusing to issue a credit rating, or withdrawing or threatening to withdraw a credit rating, with respect to securities or money market instruments issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction, unless all or a portion of the assets within such pool or part of such

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131 15 U.S.C. 78o-7(i)(1)(A), (B) and (C).

132 Senate Report, p. 11.

133 See 17 CFR 240.17g-6.

134 17 CFR 240.17g-6(a)(1). This prohibition addresses the situation where an NRSRO conditions the issuance of a credit rating on the purchase of another service or product. See Adopting Release, 72 FR at 33600.

135 17 CFR 240.17g-6(a)(2). This prohibition addresses the situation where an NRSRO conditions the opinion reached in the credit rating on the purchase of the credit rating or another service or product. See Adopting Release, 72 FR at 33600.

136 17 CFR 240.17g-6(a)(3).

transaction also are rated by the NRSRO, where such practice is engaged in by the NRSRO for an anticompetitive purpose.[137]

III. COMMISSION'S PROPOSED AMENDMENTS AND RULE

On June 11, 2008, the Commission took two actions related to NRSROs by voting to propose amendments to certain of the NRSRO rules and to propose a new rule.[138] The comment period for the rules will end on July 25, 2008.

The proposals are designed to address concerns raised about the policies and procedures for, transparency of, and potential conflicts of interest relating to ratings of residential mortgage-backed securities backed by subprime mortgage loans and collateralized debt obligations linked to subprime loans. The proposals also are designed to achieve the goals of the Rating Agency Act; namely, greater accountability, transparency, and competition in the credit rating industry.[139] The following sections provide a description of the proposed amendments to the NRSRO rules and the proposed new NRSRO rule. The Commission notes, however, that these are proposals and that final rules will be issued only after full consideration of the comments received on the proposals. Final rules may differ from the proposals.

A. Proposed Amendments to Form NRSRO

1. Exhibit 1

The Commission proposed to amend the instructions for Exhibit 1 to Form NRSRO to enhance the comparability of the performance measurement statistics NRSROs are required to publicly disclose in the Form. Currently, the instructions require the disclosure of "performance measurement statistics of the credit ratings of the Applicant/NRSRO over short-term, mid-term, and long-term periods (as applicable) through the most recent calendar year-end."

The first proposed amendment to the Exhibit would require the disclosure of separate sets of default and transition statistics for each asset class of credit rating for which an NRSRO is registered and any other broad class of credit ratings issued by the NRSRO. This would result in the generation of performance statistics that are specific to each class of credit ratings for which the NRSRO is registered. This proposal is designed to make it easier for users of credit ratings to compare the accuracy of NRSRO credit ratings on a class-by-class basis.

The second proposed amendment would require that these class-by-class disclosures be broken out over 1, 3, and 10-year periods. Section 15E(a)(1)(B)(i) of the

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137 17 CFR 240.17g-6(a)(4).

138 See Proposing Release, 73 FR 36212.

139 See Senate Report, p. 1.

Exchange Act requires that the performance statistics be over short, mid, and long-term periods.[140] The proposed amendment would define those statutorily prescribed periods in specific years so that the performance statistics generated by the NRSROs cover comparable time periods.

The third proposed amendment would modify what ratings actions are required to be included in these performance measurement statistics by replacing the term "down-grade and default rates" with "ratings transition and default rates." The proposed switch to "ratings transition" rates from "downgrade" rates is designed to clarify that upgrades (as well as downgrades) should be included in the statistics. The fact that an NRSRO upgrades a substantial amount of credit ratings may be just as indicative of a flaw in the initial rating as a large number of downgrades. For example, an NRSRO could try to manipulate its performance statistics by issuing overly conservative ratings.

The final proposed amendment would specify that the default statistics required under the Exhibit must show defaults relative to the initial rating and incorporate defaults that occur after a credit rating is withdrawn. This amendment is designed to prevent an NRSRO from manipulating the performance statistics by not including defaults when generating statistics for a category of credit ratings (e.g., AA) because the defaults occur after the rating is downgraded to a lower category (e.g., CC) or withdrawn.

2. Exhibit 2

The Commission proposed to amend the instructions for Exhibit 2 to Form NRSRO to require enhanced disclosures about the procedures and methodologies an NRSRO uses to determine credit ratings. The Commission proposed to add three additional areas that an applicant and a registered NRSRO would be required to address in the descriptions of its procedures and methodologies in Exhibit 2. The inclusion of these areas would serve to better disclose the actions an applicant and NRSRO is, or is not taking, in determining credit ratings. The additional areas required to be addressed in the exhibit would be:

- Whether and, if so, how information about verification performed on assets underlying or referenced by a security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction is relied on in determining credit ratings;

- Whether and, if so, how assessments of the quality of originators of assets underlying or referenced by a security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction play a part in the determination of credit ratings; and

- How frequently credit ratings are reviewed, whether different models or criteria are used for ratings surveillance than for determining initial

[140] 15 U.S.C. 78o-7(a)(1)(B)(i).

ratings, whether changes made to models and criteria for determining initial ratings are applied retroactively to existing ratings, and whether changes made to models and criteria for performing ratings surveillance are incorporated into the models and criteria for determining initial ratings.

B. Proposed Amendments to Rule 17g-2

1. A Record of Rating Actions and the Requirement that they be made Publicly Available

The Commission proposed to amend Rule 17g-2 by adding a paragraph (8). This new paragraph would require an NRSRO to make and retain a record showing all rating actions (initial rating, upgrades, downgrades, and placements on watch for upgrade or downgrade) and the date of such actions identified by the name of the security or obligor and, if applicable, the CUSIP for the rated security or the Central Index Key (CIK) number for the rated obligor. Furthermore, the Commission is proposing to amend paragraph (d) of 17g-2 to require that this record be made publicly available on the NRSRO's corporate Internet Web site in an interactive data file that uses a machine-readable computer code that presents information in eXtensible Business Reporting Language in electronic format XBRL Interactive Data File. The purpose of this disclosure is to provide users of credit ratings, investors, and other market participants and observers the raw data with which to compare how the NRSROs initially rated an obligor or security and, subsequently, adjusted those ratings, including the timing of the adjustments.

The proposed amendment to Rule 17g-2(d) also would provide that the records be made publicly available no later than six months after the date of the rating action. The Commission stated in the Proposing Release that it anticipates that the record required under this amendment would need to be updated frequently as new credit ratings are issued and existing credit ratings are upgraded, downgraded, and put on ratings watch.[141] For purposes of the internal record, the NRSRO would need to keep the record current to reflect the complete ratings history of each extant credit rating. However, for purposes of the requirement to make the record publicly available, the NRSRO would be permitted to disclose the record on its Internet Web site six months after the record is updated to reflect a new ratings action. The proposed six-month time lag for publicly disclosing the updated record is designed to accommodate NRSROs that operate using the subscriber-pay model because they are paid for access to their current credit ratings. It also is designed to preserve the revenues that NRSROs operating using the issuer-pay model derive from selling download access to their current credit ratings.

2. A Record of Material Deviation from Model Output

The Commission proposed to amend paragraph (a)(2) of Rule 17g-2 to add an additional record that would be required to be made for each current credit rating;

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[141] Proposing Release, 73 FR at 36229.

namely, if a quantitative model is a substantial component in the process of determining the credit rating, a record of the rationale for any material difference between the credit rating implied by the model and the final credit rating issued. The requirement to make the record would be triggered in cases where a quantitative model is a substantial component of the credit ratings process for the type of obligor or security being rated and the output of the model would result in a materially different conclusion if the NRSRO relied on it without making an out-of-model adjustment. This proposal is designed to enhance the recordkeeping processes of the NRSROs so that Commission examiners (and any internal auditors of the NRSRO) could reconstruct the analytical process by which a credit rating was determined. This would facilitate their review of whether the NRSRO followed its disclosed and internally documented procedures for determining credit ratings.

3. Records Concerning Third-Party Analyst Complaints

The Commission proposed to amend Rule 17g-2 to add a requirement that an NRSRO retain records of any complaints regarding the performance of a credit analyst in determining credit ratings. Specifically, the proposed amendment would add a new paragraph (b)(8) to Rule 17g-2 to require an NRSRO to retain any communications that contain complaints about the performance of a credit analyst in initiating, determining, maintaining, monitoring, changing, or withdrawing a credit rating. The proposal is designed to assist the Commission in reviewing how NRSROs address conflicts interest that could impair the integrity of their credit rating processes. For example, an NRSRO might respond to complaints from issuers that an analyst is too conservative by removing the analyst from the responsibility of rating the securities of those issuers and assigning a new analyst that is more willing to determine credit ratings desired by the issuers.

The complaint file that would be established by this proposed amendment would allow Commission examiners to follow-up with the relevant persons within the NRSRO as to how a particular complaint was addressed. Furthermore, as the Commission noted in the Proposing Release, the potential for such a review by Commission examiners could reduce the willingness of an NRSRO to re-assign or terminate a credit analyst for inappropriate business considerations.[142]

C. Proposed Amendments to Rule 17g-3

The Commission proposed to amend Rule 17g-3 to require an NRSRO to furnish the Commission with an additional annual report indicating the number of credit rating actions during the fiscal year in each class of security for which the NRSRO is registered. Specifically, the amendment would add a new paragraph (a)(6) to Rule 17g-3, which would require an NRSRO to provide the Commission with a report of the number of credit rating actions (upgrades, downgrades, and placements on watch for an upgrade or downgrade) during the fiscal year in each class of credit ratings for which the NRSRO is registered with the Commission.

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[142] Proposing Release, 73 FR at 36231.

The proposal is designed to assist the Commission in its examination function with respect to NRSROs. As the Commission noted in the Proposing Release, large spikes in ratings actions within a class of credit ratings could indicate the processes for determining the ratings may be compromised by inappropriate factors.[143] For example, a substantial increase in the number of downgrades in a particular class of credit ratings may be indicative of the fact that the initial ratings were higher than the NRSRO's procedures and methodologies would have implied because the NRSRO sought to gain favor with issuers and underwriters by issuing higher ratings. A substantial increase in upgrades also could be the result of the NRSRO attempting to gain favor with issuers and underwriters.

D. Proposed Amendments to Rule 17g-5

1. Requirements Designed to Address the Particular Conflict Arising from Rating Structured Finance Products by Enhancing the Disclosure of Information Used in the Rating Process

The Commission proposed to amend Rule 17g-5 to add to the list of conflicts that must be disclosed and managed the additional conflict of repeatedly being paid by certain entities to rate structured finance products. This conflict is a subset of the broader conflict already identified in paragraph (b)(1) of Rule 17g-5; namely, "being paid by issuers and underwriters to determine credit ratings with respect to securities or money market instruments they issue or underwrite."[144] The Commission stated in the Proposing Release that, in the case of structured finance products, it preliminarily believes this "issuer/underwriter-pay" conflict is particularly acute because certain arrangers of structured finance products repeatedly bring ratings business to the NRSROs.[145] As sources of constant deal-based revenue, some arrangers have the potential to exert greater undue influence on an NRSRO than, for example, a corporate issuer that may bring far less ratings business to the NRSRO.

The amendments proposed by the Commission would re-designate paragraph (b)(9) of Rule 17g-5 as paragraph (b)(10) and in new paragraph (b)(9) identify the following conflict: issuing or maintaining a credit rating for a security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction that was paid for by the issuer, sponsor, or underwriter of the security or money market instrument. To address this conflict, proposed new paragraph (a)(3) would require that as a condition to the NRSRO rating a structured finance product

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143 Proposing Release, 73 FR at 36235.

144 17 CFR 240.17g-5(b)(1). As the Commission noted when adopting Rule 17g-5, the concern with the conflict identified in paragraph (b)(1) "is that an NRSRO may be influenced to issue a more favorable credit rating than warranted in order to obtain or retain the business of the issuer or underwriter." Adopting Release, 72 FR at 33595.

145 Proposing Release, 73 FR at 36219.

the information provided to the NRSRO and used by the NRSRO in determining the credit rating would need to be disclosed through a means designed to provide reasonably broad dissemination of the information.[146] Specifically, the amendments would require the disclosure of the following information:

- All information provided to the NRSRO by the issuer, underwriter, sponsor, depositor, or trustee that is used by the NRSRO in determining the initial credit rating for the security or money market instrument, including information about the characteristics of the assets underlying or referenced by the security or money market instrument, and the legal structure of the security or money market instrument; and

- All information provided to the NRSRO by the issuer, underwriter, sponsor, depositor, or trustee that is used by the NRSRO in undertaking credit rating surveillance on the security or money market instrument, including information about the characteristics and performance of the assets underlying or referenced by the security or money market instrument.

The Commission stated in the Proposing Release that it anticipates that the information that would need to be disclosed prior to the issuance of a credit rating (i.e., the information used by the hired NRSRO to determine the initial rating) generally would include the characteristics of the assets in the pool underlying the structured finance product and the legal documentation setting forth the capital structure of the trust, payment priorities with respect to the tranche securities issued by the trust (the waterfall), and all applicable covenants regarding the activities of the trust.[147] For example, for an initial rating for an RMBS, this information generally would include the "loan tape" (frequently a spreadsheet) that identifies each loan in the pool and its characteristics such as type of loan, principal amount, loan-to-value ratio, borrower's FICO score, and geographic location of the property. In addition, the information also would include a description of the structure of the trust, the credit enhancement levels for the tranche securities to be issued by the trust, and the waterfall cash flow priorities. After the disclosure of the information used by the NRSRO to perform the initial rating, the proposed amendment would require the disclosure of information about the underlying assets that is provided to, and used by, the NRSRO to perform any ratings surveillance. The Commission anticipates that generally this information would consist of reports from the trustee describing how the assets in the pool underlying the structured finance product are performing.[148]

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[146] This proposed requirement would be in addition to the current requirements of paragraph (a) that an NRSRO disclose the type of conflict of interest in Exhibit 6 to Form NRSRO; and establish, maintain, and enforce written policies and procedures to address and manage the conflict of interest. 17 CFR 240 17g-5(a)(1) and (2).

[147] Proposing Release, 73 FR at 36220.

[148] Proposing Release, 73 FR at 36220.

The intent behind the disclosures required under the proposed amendment is to create the opportunity for other credit rating agencies to use the information to rate the instrument as well. Any resulting "unsolicited ratings" could be used by market participants to evaluate the ratings issued by the NRSRO hired to rate the product and, in turn, potentially expose an NRSRO that was allowing business considerations to impact its judgment. The Commission anticipates that this would enhance the integrity of the ratings process by making it easier for users of credit ratings to compare NRSROs and evaluate whether an NRSRO's objectivity had been compromised by the undue influence of an arranger. It also could make it easier for the NRSROs hired to determine credit ratings for structured finance products to resist pressure from arrangers insomuch as the parties would be aware that the potential for exposing a compromised NRSRO had been increased through the proposed amendment's disclosure requirements.

2. Prohibition on Conflict of Interest Related to Rating an Obligor or Debt Security where the Obligor or Issuer Received Ratings Recommendations from the NRSRO or a Person Associated with the NRSRO

The Commission proposed to amend Rule 17g-5(c) to add a new paragraph (5) that would prohibit an NRSRO from issuing a credit rating with respect to an obligor or security where the NRSRO or a person associated with the NRSRO made recommendations to the obligor or the issuer, underwriter, or sponsor of the security (that is, the parties responsible for structuring the security) about the corporate or legal structure, assets, liabilities, or activities of the obligor or issuer of the security. This proposal would prohibit the NRSRO and, in particular, its credit analysts from making recommendations to obligors, issuers, underwriters, and sponsors such as arrangers of structured finance products about how to obtain a desired credit rating during the rating process. It also would prohibit an NRSRO from issuing a credit rating where a person associated with the NRSRO, such as an affiliate, made such recommendations.

3. Prohibition on Conflict of Interest Related to the Participation of Certain Personnel in Fee Discussions

The Commission proposed to amend Rule 17g-5 by adding a new paragraph (c)(6) of Rule 17g-5 to prohibit the conflict of interest that arises when a fee paid for a rating is discussed or arranged by a person within the NRSRO who has responsibility for participating in determining credit ratings (including analysts and rating committee members) or for developing or approving procedures or methodologies used for determining credit ratings, including qualitative and quantitative models.

As the Commission stated in the Proposing Release, the amendment is designed to effectuate the separation within the NRSRO of persons involved in fee discussions from persons involved in the credit rating analytical process.[149] While the incentives of the persons discussing fees could be based primarily on generating revenues for the

[149] Proposing Release, 73 FR at 36227.

NRSRO; the incentives of the persons involved in the analytical process should be based on determining accurate credit ratings. There is a significant potential for these distinct incentive structures to conflict with one another where persons within the NRSRO are engaged in both activities. The potential consequences are that a credit analyst or person responsible for approving credit ratings or credit rating methodologies could, in the context of negotiating fees, let business considerations undermine the objectivity of the rating process. For example, an individual involved in a fee negotiation with an issuer might not be impartial when it comes to rating the issuer's securities. In addition, persons involved in approving the methodologies and processes used to determine credit ratings could be reluctant to adjust a model to make it more conservative if doing so would make it more difficult to negotiate fees with issuers.

4. Prohibition of Conflict of Interest Related to Receipt of Gifts

The Commission proposed to amend Rule 17g-5 by adding a new paragraph (c)(7) that would prohibit an NRSRO from having a conflict of interest relating to the issuance or maintenance of a credit rating where a credit analyst who participated in determining or monitoring the credit rating, or a person responsible for approving the credit rating, received gifts, including entertainment, from the obligor being rated, or from the issuer, underwriter, or sponsor of the securities being rated, other than items provided in the context of normal business activities such as meetings that have an aggregate value of no more than $25. Thus, this proposed prohibition would prohibit any gifts to credit analysts and persons on credit rating committees from the obligors, issuers, underwriters, or sponsors with respect to whom they had determined, monitored or approved credit ratings. It also would create an exception for items provided during normal business activities such as meetings to the extent they do not, in the aggregate, exceed $25 per meeting. For example, the provision of pens, notepads, or minor refreshments, such as soft drinks or coffee, generally are incidental to meetings and other normal course business interactions and not treated as gifts per se. The proposed $25 exception is designed to be high enough to permit these types of exchanges without implicating the prohibition.

The Commission stated in the Proposing Release that persons seeking credit ratings for an obligor or debt security could use gifts to gain favor with the analyst responsible for determining the credit ratings and cause the analyst to be less objective during the rating process.[150] In the case of a substantial gift, the potential to impact the analyst's objectivity could be immediate. With smaller gifts, the danger is that over time the cumulative effect of repeated gifts can impact the analyst's objectivity. Therefore, the proposal would establish an absolute prohibition on gifts with the exception of minor incidentals provided in business meetings.

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[150] Proposing Release, 73 FR at 36228.

E. Proposed New Rule 17g-7 (Special Reporting or Use of Symbols to Differentiate Credit Ratings for Structured Finance Products)

The Commission proposed the establishment of a new rule, Rule 17g-7, to address concerns that certain investors assumed the risk characteristics for structured finance products, particularly highly rated instruments, were the same as for other types of similarly rated debt instruments.[151] The proposal also is designed to address concerns that some investors may not have performed internal risk analysis on structured finance products before purchasing them.

Specifically, under proposed Rule 17g-7, each time an NRSRO publishes a credit rating for a structured finance product it also would be required to publish a report describing how the credit ratings procedures and methodologies and credit risk characteristics for structured finance products differ from those of other types of rated instruments such as corporate and municipal debt securities. The objective of this proposal is to alert investors that there are different rating methodologies and risk characteristics associated with structured finance products. As an alternative to publishing the report, an NRSRO would be allowed to use ratings symbols for structured finance products that differentiated them from the credit ratings for other types of debt securities.

More specifically, paragraph (a) of proposed Rule 17g-7 would require an NRSRO to publish a report accompanying every credit rating it publishes for a security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction that describes the rating methodology used to determine the credit rating and how it differs from a rating for any other type of obligor or debt security and how the risks associated with a security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction are different from other types of rated obligors and debt securities. The Commission noted in the Proposing Release that a possible risk associated with this approach is that investors would come to view such reports as "boilerplate" and, therefore, would not review them.[152]

However, the Commission also stated in the Proposing Release that it preliminarily believes that requiring an NRSRO to publish such a report along with each publication of a credit rating for a structured finance product likely would provide certain investors with useful information about structured finance products.[153] The goal of the proposal is to spur investors to perform more rigorous internal risk analysis on structure finance products so that they do not overly rely on NRSRO credit ratings in making

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151 Commissioner Paul S. Atkins, Commission, voted against this proposal. See "Speech by SEC Commissioner: Statement at Open Meeting to Consider Proposed Rules under the Rating Agency Act," Commissioner Paul S. Atkins (July 11, 2008).

152 Proposing Release, 73 FR at 36235.

153 Proposing Release, 73 FR at 36325.

investment decisions. A possible ancillary benefit of such reports is that they could cause certain investors to seek to better understand risks that are not necessarily addressed in credit ratings of structured products, such as market and liquidity risk.

The Commission stated in the Proposing Release that the goal of the rule is to foster greater independent analysis by investors and, consequently, the Commission preliminarily believes that permitting an NRSRO to comply with the rule by differentiating its structured finance product rating symbols would be an equally effective alternative. The differentiated symbol would alert investors that a structured finance product was being rated and, therefore, raise the question of how it differs from other types of debt instruments.

The Commission did not propose that specific rating symbols be used to distinguish credit ratings for structured finance products. Under the proposal, an NRSRO would be permitted to choose the appropriate symbol. The Commission stated in the Proposing Release that it preliminarily believes that methods for identifying credit ratings for structured finance products could include using a different rating symbol altogether, such as a numerical symbol, or appending identifying characters to existing ratings scales, e.g., "AAA.sf" or "AAA_{SF}."[154]

IV. SCOPE OF THE ONGOING NRSRO EXAM

Commission staff members from the Office of Compliance Inspections and Examinations, the Division of Trading and Markets, and the Office of Economic Analysis (collectively "the staff") are conducting examinations of the three NRSROs most active in rating structured finance products. These examinations are primarily focused on the NRSROs' activities in rating subprime residential mortgage-backed securities and related collateralized debt obligations.[155] More specifically, issues under review include:

- the NRSROs' ratings policies, procedures and practices, including reviews of ratings models, assumptions, criteria and protocols;

- the adequacy of the disclosure of the ratings process and methodologies used by the NRSROs;

- whether the NRSROs complied with their ratings policies and procedures for initial ratings and ongoing surveillance;

- the efficacy of the NRSROs' conflict of interest procedures; and

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[154] Proposing Release, 73 FR at 36235.

[155] During these examinations, the staff is mindful that Section 15E(c)(2) of the Exchange Act expressly states that the Commission may not regulate the "the substance of the credit ratings or the procedures and methodologies" by which any NRSRO determines credit ratings.

- whether ratings were unduly influenced by conflicts of interest related to the NRSROs' role in bringing issues to market and the compensation they receive from issuers and underwriters.

The examination review period is from January 2004 through the present. The staff has conducted extensive on-site interviews with relevant NRSRO staff and reviewed a large volume of documents, including hundreds of deal files for residential mortgage backed security and collateralized debt obligation ratings, emails of certain relevant analysts and other personnel, public disclosures by the NRSROs, and policies and procedures and other internal records of the NRSROs.

As the examinations are ongoing, the staff has not finalized its examination findings. The staff plans to provide a final report to the Commission this summer.[156]

V. STATUS OF REGISTRANTS AND APPLICANTS

During the year, the Commission received applications from ten credit rating agencies to be registered as NRSROs. The Commission has granted each applicant registration within the timeframes mandated by the Rating Agency Act. The registered credit rating agencies and the dates of their registration are:

A.M. Best Company, Inc. ("A.M. Best)	(September 24, 2007)
DBRS Ltd. ("DBRS")	(September 24, 2007)
Fitch, Inc. ("Fitch")	(September 24, 2007)
Japan Credit Rating Agency, Ltd. ("JCR")	(September 24, 2007)
Moody's Investor Services, Inc. ("Moody's")	(September 24, 2007)
Rating and Investment Information, Inc. ("R&I")	(September 24, 2007)
Standard & Poor's Rating Services ("S&P")	(September 24, 2007)
Egan-Jones Rating Company ("EJR")	(December 21, 2007)
LACE Financial Corp. ("LACE")	(February 11, 2008)
Realpoint LLC ("Realpoint")	(June 23, 2008)

There are no applications for registration currently pending before the Commission. In addition, the Commission did not institute any proceedings during the year to determine whether the application of a credit rating agency for registration should be denied.

VI. COMMISSION'S VIEW ON COMPETITION

A. Ratings Outstanding by NRSRO

As discussed above, the Commission has granted NRSRO registration to 10 credit rating agencies. Seven of these credit rating agencies (A.M. Best, DBRS, Fitch, JCR, Moody's, R&I, and S&P) had previously received staff no-action letters recognizing

[156] In addition, the staff has recently initiated a review of the NRSROs' processes for rating Constant Proportion Debt Obligations.

them as NRSROs. These seven firms applied for registration as NRSROs in June of 2007 under the new registration rules adopted by the Commission that month. Subsequently, the Commission granted three additional credit rating agencies NRSRO registration (EJR, LACE, and Realpoint).

The table below reports the number of outstanding ratings reported by each NRSRO in their Form NRSROs. For each NRSRO, the table sets forth the number of outstanding ratings for the five classes of ratings identified in Section 3(a)(62) of the Exchange Act: (1) financial institutions, brokers, or dealers; (2) insurance companies; (3) corporate issuers; (4) issuers of asset-backed securities; and (5) issuers of government securities, municipal securities, or securities issued by a foreign government ("sovereign securities").

Outstanding Credit Ratings Reported by NRSROs on Form NRSRO by Ratings Class

NRSRO	Financial Institutions	Insurance Companies	Corporate Issuers	Asset-Backed Securities	Government, Municipal & Sovereign Securities	Total Ratings
A.M. Best	3	6,129	2,696	54		8,882
DBRS	855	35	590	840	45	2,365
EJR	62	46	803			911
Fitch	79,125	4,871	15,865	72,278	787,781	962,920
JCR	155	32	559	68	85	899
LACE	18,000	100	10	246	58	18,414
Moody's	70,000	6,500	25,000	110,000	175,000	386,500
R&I	100	36	629	214	89	1,068
Realpoint				10,235		10,235
S&P	44,800	6,900	28,900	197,700	967,600	1,245,900
Total Ratings	213,000	24,649	75,052	394,635	1,930,658	2,638,094
HHI	3,031	2,488	3,055	3,657	4,259	3,778

Three NRSROs (Fitch, Moody's, and S&P) issued almost 99% of all outstanding ratings across all categories reported. 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 ratings for asset backed securities and government securities, but less than 75% of all ratings for insurance companies.

Market concentration is generally measured by economists using the Herfindahl-Hirschmann Index (HHI), which is a measure of the size of firms in relationship to the industry and an indicator of the amount of competition among them. It is defined as the sum of the firm market shares squared, i.e., the average market share, weighted by market share. The HHI is measured on a scale of 0 to 10,000 and approaches zero when a market consists of a large number of firms of relatively equal size. The HHI increases both as the number of firms in the market decreases and as the disparity in size between those firms increases. According to the U.S. Department of Justice, markets in which the

HHI is between 1000 and 1800 points are considered to be moderately concentrated, and those in which the HHI is in excess of 1800 points are considered to be concentrated.[157] The HHI for all NRSRO ratings outstanding is 3,778, which is the equivalent of (10,000/3,778) 2.65 equally sized firms.

Among these three large NRSROs, concentration is not consistent across rating classes. For credit ratings related to financial institutions, Fitch and Moody's each had almost twice as many outstanding ratings as did S&P. Moody's and S&P were the two dominant issuers of credit ratings for corporate issuers. And Fitch and S&P had between 4.5 and 5.5 times more government securities ratings outstanding than did Moody's.

Among the other NRSROs, LACE Financial reports having the largest number of outstanding credit ratings for financial institutions (18,000 or approximately 8% of all ratings in the category) while A.M. Best reports the largest number of outstanding ratings for the insurance company and corporate issuer categories (6,129 for 25% and 2,696 for 3.6% of all ratings within category, respectively).

The Commission notes that, after credit ratings for government, municipal and sovereign securities, the next highest level of concentration is in the provision of credit ratings for asset-backed securities.[158] Specifically, of the over 394,635 outstanding ratings in this credit rating class, all but 11,657 are issued by the Fitch, Moody's, and S&P.[159] The products themselves are highly complex and require specific and technical knowledge of financial engineering and valuation of the underlying assets.[160] 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 one party to the transaction (the issuer) has more or better information about the transaction than the other party (the investor).[161] This informational imbalance, combined with very high concentration in NRSRO credit raters, increases the potential for conflicts of interest to impair market integrity.

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157 http://www.usdoj.gov/atr/public/testimony/hhi.htm.

158 Fitch, Moody's, and S&P issued 1,930,381 of the total 1,930,658 credit ratings for government, municipal and sovereign securities and issuers.

159 Of the ratings in this category issued by NRSROs other than Fitch, Moody's and S&P, the vast majority (10,235) were issued by Realpoint, the most recent registrant.

160 There is strong economic theory to suggest that high concentration in ratings of these products (i.e., very few ratings providers) may be expected. See, e.g, Shapiro, Carl. (1983). "Premiums for High Quality Products as Returns to Reputations." Quarterly Journal of Economics **98**(4): 659-79.

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

B. NRSRO Products and Other Credit Analytic Products

Ratings produced by credit rating agencies, including NRSROs, are generally letter-based symbols intended to reflect assessments of credit risk for various entities issuing debt obligations in public markets. These credit assessments are designed to measure and predict the probability of default, or loss given default, for an individual debt obligation or an obligor. These assessments reflect the scoring of quantitative computer models and, in most cases, qualitative analyst review. These ratings are described by the credit rating agencies as intended to reflect only credit risk, not other valuation factors such as liquidity or currency risk. Thus, while bond yields are strongly correlated with credit ratings, ratings are not the sole determinant of prices.

Demand for credit ratings exists from investors, both individual and institutional, who value an independent assessment of the relative or absolute credit risk of a particular debt obligation or obligor. As such, credit ratings serve a certification function in the marketplace, providing issuers with higher ratings and less costly access to debt markets.[162] In many cases, investment managers and banks are required by regulations, including Commission rules, to use ratings to establish investment risk standards for their portfolio holdings.[163] Parties can write contracts that create obligations based on a change in ratings – the use of so-called "ratings triggers."

Ratings, like most economic goods, cannot be evaluated immediately upon purchase. Credit defaults remain fairly rare and are highly sensitive to macroeconomic forces, which may be particularly difficult to forecast. Because it is difficult to evaluate a particular credit rating easily, establishing and maintaining a reputation for ratings quality is very important to any credit rating agency.[164] Obtaining such a reputation is difficult, which might partly explain the historically small number of firms in this industry. Regulatory barriers to entry served as a considerable obstacle as well. These barriers were reduced substantially by the Rating Agency Act.

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[162] See, e.g., Partnoy (1999), or Boot, et al. (2006). Kerwer (2002) and Sinclair (2000) argue that credit ratings agencies create value through standardizing the credit assessment process. Frank Partnoy, 1999, "The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Ratings Agencies," Washington University Law Quarterly, 77 (3), 619-714. Arnoud W.A. Boot, Todd T. Milbourn and Anjolein Schmeits, 2006, "Credit Ratings as Coordination Mechanisms," Review of Financal Studies, 19 (1), 81-118. Deiter Kerwer, 2002, "Ratings Agencies Setting a Standard for Global Financial Markets," Economic Sociology European Electronic Newsletter, 3 (3), 40-46. Timothy J. Sinclair, "Reinventing Authority: Embedded Knowledge Networks and the New Global Finance," Environment and Planning C: Government and Policy, 18 (4), 487-502.

[163] European Central Bank, 2004, "Market Dynamics Associated with Credit Ratings: A Literature Review," Occasional Paper Series No. 16.

[164] Indeed, one problem with entering the CRA market is the need to create a reputation. A firm may have to give away its product for years before establishing a reputation with which it can gain revenues.

In addition to NRSROs and credit rating agencies, the staff is aware of other relevant providers of credit research and analysis.[165] 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.

Economists point to several factors that have increased the demand for credit ratings in recent years.[166] Structural changes in financial markets have increased the number of participants, increased their anonymity, and increased the complexity of their investment strategies. At the same time, financial disintermediation shifted credit from banks to capital markets, leading to the creation of increasingly complex financial instruments through securitization. The increasing complexity likely created additional reliance by investors on NRSRO ratings as they provided a single summary measure of the credit risks of difficult to evaluate financial instruments. At the same time, banking and finance regulators around the world increased their reliance on NRSRO ratings.

The increased reliance by regulators on recognized credit ratings may pose unique risks in terms of competition for providers of credit assessments, more broadly. As noted above, credit ratings agencies, including NRSROs, are only one type of firm providing third-party credit assessments to the market. When users of credit assessments for non-regulatory purposes also need NRSRO ratings for regulatory purposes, they may choose to purchase only NRSRO ratings so as to avoid purchasing both. The economic case for purchasing a non-NRSRO credit assessment may be even more difficult if the provider is a newer entrant, without the same established level of reputation even when that assessment is valuable to the investor. As the reliance on ratings for regulatory purposes expanded both in the U.S and abroad, it implicitly increased barriers to entry for those credit assessment providers who were not certified for regulatory purposes.[167]

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165 These include, for example, CreditSights, RapidRatings and RiskMetrics, the last of which acquired the Center for Financial Research and Analysis (CFRA) in 2007. In addition, many sophisticated market participants, like broker/dealers and investment advisers, create internal models to measure credit risk of potential investments (The Bond Market Association (2006)). These internal models appear to exist for all categories of ratings.

166 See e.g., Fabian Dittrich, 2007, "The Credit Rating Industry: Competition and Regulation," Doctoral Dissertation, Universitat zu Koln, Koln, Germany and Isabelle Gras, 2003, "The Power to Rate," REGEM Analysis No. 6.

167 See e.g., "Speech by SEC Commissioner: Remarks to the Institute of International Bankers," Commissioner Paul S. Atkins, Commission, March 3, 2008; "Speech by SEC Commissioner: Remarks before the Conference on SEC Regulation Outside the United States," Commissioner Kathleen L. Casey, Commission (March 6, 2008).

C. The Status of Competition among NRSROs

The Findings section of the Rating Agency Act noted that "the 2 largest credit rating agencies serve the vast majority of the market."[168] Further, the Senate Report accompanying the Rating Agency Act described the largest two NRSROs (Moody's and S&P) as a "duopoly" or "partner-monopoly."[169] Information about the number of ratings outstanding obtained from NRSROs, and presented above, suggests that in combination with Fitch, these two entities still are dominant market players.

As a consequence of the Rating Agency Act and the Commission's rules, three credit rating agencies have registered as NRSROs in addition to the seven credit rating agencies that were identified as NRSROs by the staff prior to the June 2007 implementation of the Rating Agency Act. The registration of these three "new" NRSROs has increased the available outstanding credit ratings that can be relied upon for regulatory purposes by approximately 29,560. In addition, the three new NRSROs operate primarily under the subscriber-pay compensation scheme, providing users of ratings an alternative to the issuer-pay compensation scheme employed by each of the seven credit rating agencies that had been identified as NRSROs prior to the implementation of the Rating Agency Act.

Although the credit ratings of Moody's and S&P now represent a 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 the Commission under the Rating Agency Act that requires disclosure of information about outstanding ratings for NRSROs is less than one year old. Consequently, there is insufficient history to determine the impact that being registered as an NRSRO has had on obtaining additional business.

Second, it is inappropriate to simply compare the number of outstanding ratings of the incumbent and newly registered NRSROs. The large, incumbent NRSROs have a significantly longer history of issuing ratings and their reported outstanding ratings include ratings for debt obligations (and obligors) that may have been rated long before the establishment of the newer entrants. Only with the passing of time, as older debt obligations reach maturity, might it be possible to infer whether today's entrants are providing significant competition to the currently market-dominant NRSROs.

Third, as noted above, all seven of the credit rating agencies previously identified as NRSROs by the staff rely on an issuer-pay compensation model, whereas the three new NRSROs primarily rely on a subscriber-pay compensation model. For the incumbent NRSROs, each outstanding rating was provided based on the demand by a paying client (the issuer) for that individual rating. Increases and decreases in total

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[168] See Section 2 of the Rating Agency Act (Pub. L. No. 109-291 (2006)).

[169] Senate Report, p.1.

number of outstanding ratings reflect trends in securities issuances and the demand for the specific rating by identifiable clients from that NRSRO.

The subscriber-pay compensation model is a different economic model. Subscriber-pay NRSROs attract customers who want access to at least some of their credit ratings. Investors and other market participants purchase the right to access the pool of credit ratings issued by these NRSROs and are not necessarily users of all credit ratings provided. Thus, a client of a subscriber-pay NRSRO may request a rating on an individual security or those securities of a specific issuer, but 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 were specifically demanded by investors or that they are being relied upon by market participants widely.

D. Assessing the Impact of Additional Competition

As noted above, 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."[170] The Senate Report also noted that competition would "provide investors with more choices, higher quality ratings, and lower costs."[171] Competition increases the quality of ratings where the introduction of new NRSROs leads to credit ratings that are of higher quality to investors on some dimension (e.g., more accurate, more timely) or ratings of equivalent quality and reputation at a lower price.

Merely increasing the number of entities providing credit ratings for regulatory purposes may not have a significant effect on competition. The new NRSROs, by showing themselves (or causing the incumbents) to provide ratings that are superior in either quality or price, could create additional competition. Because of the importance of reputation, and the difficulty in obtaining reputation quickly, it may take some time before the impact of increased competition can be observed. 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 just two or three of the currently market-dominant NRSROs. Altering such policies and procedures would require affirmative actions on the part of investors.

As described above, the provisions of Section 15E(h) of the Exchange Act and Rule 17g-5 require NRSROs to establish procedures to manage conflicts of interest, to disclose applicable conflicts of interest, and prohibit them from having certain conflicts of interest.[172] In the credit rating industry, conflicts of interest may arise from a number of activities, including the manner of compensation, the provision of consulting or advisory services, and business relationships and affiliations. Reducing the barriers to

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170 Senate Report, p. 1.

171 Senate Report, p. 7.

172 See, respectively, 15 U.S.C 78o-7(h) and 17 CFR 240.17g-5.

entry in the market for providing NRSRO ratings and, hence increasing competition, may, in fact, reduce conflicts of interest in substantive ways. For instance, NRSROs may distinguish themselves from their competitors by the manner of their compensation. NRSROs that are compensated by subscribers appear less likely to be susceptible to "ratings shopping" or reducing quality for initial ratings to induce revenues because subscribers will not continue to pay NRSROs that can be shown to be worse with respect to their assessment of credit quality. Of course, this market disciplining mechanism will be less effective the more difficult it is for investors to determine the true credit quality of the rated debt security or obligor.

E. The Potential Impact on Competition of Newly Proposed NRSRO Amendments and Rule

Based on the discussion above, it is possible to identify ways in which Commission activity can increase competition among NRSROs to the benefit of the public interest: First, the Commission could reduce barriers to entry for new NRSROs so that they might provide alternate sources of credit ratings for regulatory purposes. Second, the Commission could reduce artificial barriers to information access that might prevent new entrants from assessing credit quality with the same precision as do incumbents. Third, the Commission could reduce artificial barriers to information access that impede investors from assessing easily and in a timely way the relative quality of credit ratings provided by any NRSRO. Finally, the Commission could reduce the artificial barriers to competition and ratings quality by removing from its rules references to NRSRO ratings, which effectively grant a regulatory "seal of approval" to NRSROs.

The Rating Agency Act and the registration and oversight program for NRSROs implemented by the Commission in June 2007 under the Act are designed, among other things, to promote competition. For example, the registration process prescribed by the Rating Agency Act and Rule 17g-1 make it easier for credit rating agencies to become NRSROs and, thereby, to compete with incumbent NRSROs. In addition, the disclosure requirements of Form NRSRO 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 make it easier for users to assess 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.

The new rules proposed by the Commission in June 2008 are designed, among other things, to promote competition. For example, proposed amendments to Rule 17g-5 would require that, as a condition to the NRSRO rating a structured finance product, the information provided to the NRSRO and used by the NRSRO in determining the credit rating would need to be disclosed through a means designed to provide reasonably broad dissemination of the information. This broad disclosure about underlying assets would

create an opportunity for other NRSROs to rate the product, and these "unsolicited ratings" could be used by market participants to evaluate the ratings issued by the NRSRO that was hired to rate the product. In addition, the Commission believes that this proposal would foster competition by making it easier for NRSROs that are not contracted by an arranger to rate structured finance products and establish a track record for rating such products.

In addition, the Commission proposed amendments that would enhance the performance statistics disclosed by NRSROs. The first proposal would require an NRSRO to disclose for each current credit rating all previous rating actions. This would provide users of credit ratings with the history of each credit rating (initial rating, upgrades, downgrades, and placement on watch for upgrades and downgrades) maintained by each NRSRO. The purpose of this disclosure is to provide users of credit ratings, investors, and other market participants and observers the raw data with which to compare how the NRSROs initially rated an obligor or security and, subsequently, adjusted those ratings, including the timing of the adjustments. Further, the disclosure of this information on the history of each credit rating would create the opportunity for the marketplace to use the information to develop performance measurement statistics to evaluate the accuracy of the various NRSROs' ratings.

The second proposal would prescribe greater specificity with respect to the default and ratings transition statistics the NRSROs disclose in Form NRSRO. For example, under the proposal, they would be required to calculate these statistics over specific time periods – 1, 3, and 10 years and across the different classes of credit ratings for which they are registered – as applicable: (1) financial institutions, brokers, or dealers; (2) insurance companies; (3) corporate issuers; (4) issuers of asset-backed securities; and (5) issuers of government securities, municipal securities, or sovereign securities.

These enhanced disclosures with respect to the performance of the NRSROs' credit ratings are designed to foster greater accountability of the NRSROs with respect to their credit ratings as well as competition among the NRSROs by making it easier for persons to analyze the actual performance of the credit ratings the NRSROs issue in terms of accuracy in assessing creditworthiness. Ultimately, this could make it easier for a smaller, newer NRSRO to demonstrate that it has a superior credit rating methodology and, thereby, increase its reputation.

VII. COMMISSION'S VIEW ON TRANSPARENCY

One of the goals of the Rating Agency Act is to increase transparency in the credit rating industry. As discussed above, the provisions of Section 15E of the Exchange Act and Rule 17g-1 require NRSROs to publicly disclose their Form NRSROs and Exhibits 1 through 9, which contain information about their performance statistics; procedures and methodologies for determining credit ratings; procedures to prevent the misuse of material, non-public information; their organizational structure; their code of ethics (or explanation of why they do not have a code of ethics); their conflicts of interest; their

procedures to manage conflicts of interest; information about their credit analysts; and information about their designated compliance officers. 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. The NRSRO oversight program has increased the amount of information disclosed and concentrated the disclosure in a single location: Form NRSRO. The following is a list of the Internet Web site links where the Form NRSRO for each credit rating agency registered as an NRSRO currently can be obtained:[173]

A.M. Best Company, Inc.
http://www.ambest.com/nrsro/formnrsro.pdf

DBRS Ltd.
http://www.dbrs.com/intnlweb/jsp/search/listResults.faces

Egan-Jones Rating Company
http://www.egan-jones.com/publicdocs/Form%20NRSRO%20Nov%202007.doc

Fitch, Inc.
http://www.fitchratings.com/jsp/corporate/PolicyRegulation.faces?context=3&detail=4

Japan Credit Rating Agency, Ltd.
http://www.jcr.co.jp/english/nrsro/index.html

LACE Financial Corp.
http://www.lacefinancial.com/Out/documents/Disclosure.pdf

Moody's Investor Services, Inc.
http://www.moodys.com/cust/content/loadcontent.aspx?source=staticcontent/Free%20Pages/Regulatory%20Affairs/NRSRO.htm

Rating and Investment Information, Inc.
http://www.r-i.co.jp/eng/rating/nrsro/nrsro.html

Realpoint LLC
http://www.realpoint/ComplianceDocuments/NRSRO.pdf.

Standard & Poor's Rating Services
http://www2.standardandpoors.com/portal/site/sp/en/us/page.topic/ratings_nrsro/2,1,1,6,0,0,0,0,0,0,0,0,0,0,0.html

[173] These are the Internet Web site addresses as of June 2008. The addresses may change over time.

The Commission believes that the requirement to make these disclosures has enhanced the transparency of the credit rating industry but that such transparency could still be enhanced further. Consequently, the Commission's June 11, 2008 proposals for amendments to the NRSRO rules contain a number of new requirements designed to further increase the transparency of the credit rating processes of the NRSROs. First, the proposed amendments to Rule 17g-5 that would require the disclosure of the information used by an NRSRO to initially rate and monitor the rating of a structured finance product is designed to increase the marketplace's ability to scrutinize these ratings. As noted above, the goal is to provide a mechanism for credit rating agencies that are not hired to rate the product to determine their own unsolicited ratings. This could increase the amount of information available to investors about the credit risk associated with these products.

Second, the amendments to Exhibit 2 to Form NRSRO proposed by the Commission are designed to enhance the quality of the disclosures NRSROs make about their procedures and methodologies for determining credit ratings. The first proposed amendment would require an NRSRO to disclose whether it considers in its rating process for structured finance products steps taken to verify information about the assets in the pool backing the structured finance products. Underwriters and sponsors of structured finance products frequently take some steps to verify information provided by borrowers in loan documentation. Generally, they have been reluctant to provide the results of this verification to NRSROs for proprietary reasons. The proposed amendment would not require that the NRSROs incorporate verification (or the lack of verification) into their ratings processes. Rather, it would require an NRSRO to disclose whether and, if so, how information about verification performed on the assets is relied on in determining credit ratings for structured finance products. For example, an NRSRO would need to disclose, as applicable: if it does not consider steps taken to verify the information; if it requires some minimum level of verification to be performed before it will determine a credit rating for a structured finance product; and how it incorporates the level of verification performed into its procedures and methodologies for determining credit ratings (e.g., if it compensates for the lack of verification by requiring greater levels of credit enhancement for the tranche securities).

This disclosure would benefit users of credit ratings by providing information about the potential accuracy of an NRSRO's credit ratings. The NRSROs determine credit ratings for structured finance products based on assumptions in their models as to how the assets underlying the instruments will perform under varying levels of stress. These assumptions are based on the characteristics of the assets (e.g., value of the property, income of the borrower) as reported by the arranger of the structured finance product. If this information is inaccurate, the capacity of the model to predict the potential future performance of the assets may be significantly impaired. Consequently, information about whether an NRSRO requires that some level of verification be performed or takes other steps to account for the lack of verification or a low level of verification would be useful to users of credit ratings in assessing the potential for an NRSRO's credit ratings to be adversely impacted by bad information about the assets underlying a rated structured finance product.

The second proposed amendment would require an NRSRO to disclose whether it considers qualitative assessments of the originator of assets underlying a structured finance product in the rating process for such products. Certain qualities of an asset originator, such as its experience and underwriting standards, may impact the quality of the loans it originates and the accuracy of the associated loan documentation. This, in turn, could influence how the assets ultimately perform and the ability of the NRSRO's models to predict their performance. Consequently, the failure to perform any assessment of the loan originators could increase the risk that an NRSRO's credit ratings may not be accurate. Therefore, disclosures as to whether the NRSRO performs any qualitative assessments of the originators would be useful in comparing the efficacy of the NRSRO's procedures and methodologies.

The third proposed amendment would require an NRSRO to disclose the frequency of its surveillance efforts and how changes to its quantitative and qualitative ratings models are incorporated into the surveillance process. The goal is to provide to users of credit ratings information that would be useful in comparing the ratings methodologies of different NRSROs. For example, how often and with what models an NRSRO monitors its credit ratings would be relevant to assessing the accuracy of the ratings insomuch as ratings based on stale information and outdated models may not be as accurate as ratings of like products determined using newer data and models. Moreover, with respect to new types of rated obligors and debt securities, the NRSROs refine their models as more information about the performance of these obligors and debt securities is observed and incorporated into their assumptions. Consequently, as the models evolve based on more robust performance data, credit ratings of obligors or debt securities determined using older models may be at greater risk for being inaccurate than the newer ratings. Therefore, whether the NRSRO verifies the older ratings using the newer methodologies would be useful to users of credit ratings in assessing the accuracy of the credit ratings.

VIII. COMMISSION'S VIEW ON CONFLICTS OF INTEREST

There are two business models in the credit rating industry and each has potential inherent conflicts of interest. As discussed above, the business model of the largest NRSROs is to receive compensation from obligors for rating the obligor or securities issued by the obligor (the "issuer-pay model"). This issuer-pay model creates a potential conflict in that an NRSRO, in order to gain favor with the issuer and retain its business, may determine a credit rating that is higher than the NRSRO's objective analysis would imply. This conflict potentially could be broader than a single issuer to the extent that an NRSRO determines higher credit ratings for a class of issuers in order to retain or attract business across all issuers in that class. As discussed below, the Commission, in proposing its new set of rules for NRSROs, believes this broader potential conflict may be particularly acute in the structured finance product area where issuers are separate legal entities created and operated by a relatively concentrated group of sponsors, underwriters, and managers (collectively "arrangers").

The other business model is the subscriber-pay model, which also is subject to potential conflicts of interest. For example, a subscriber may hold a securities position (long or short) that potentially could be advantaged by an NRSRO upgrading or downgrading the position to the extent such rating action caused the market value for the security to increase or decrease. Furthermore, a subscriber may want to hold a particular security in an investment portfolio but may be constrained from doing so because its credit rating is lower than its internal investment guidelines, an applicable contract, or an applicable regulation permit. An upgrade of the credit rating of the security by the NRSRO could remove this impediment to investing in the security.

The Commission recognized the potential conflicts in both business models when it adopted the rules implementing the registration and oversight program for NRSROs. As discussed above, the approach taken in the rules is to require the disclosure in Form NRSRO of the general types of conflicts that arise from the NRSRO's business activities. Additionally, the Commission adopted Rule 17g-5, which prohibits an NRSRO from having certain conflicts of interest unless it discloses them and has procedures for managing them, and prohibits outright an NRSRO from having certain other conflicts of interest.

Since the rules became effective in June 2007, the Commission has preliminarily determined that the issuer-pay conflict is particularly acute in the structured finance area. This is because certain arrangers of structured finance products repeatedly bring ratings business to the NRSROs. As sources of constant deal-based revenue, some arrangers have the potential to exert greater influence on an NRSRO than, for example, a corporate issuer. Consequently, the Commission has proposed amendments to Rule 17g-5 that would require additional measures to address this particular type of issuer-pay conflict.

Specifically, the amendments would require that, as a condition to the NRSRO rating a structured finance product, the information provided to the NRSRO and used by the NRSRO in determining the credit rating would need to be disclosed through a means designed to provide reasonably broad dissemination of the information. The intent behind this disclosure is to create the opportunity for other NRSROs to use the information to rate the instrument as well. Any resulting "unsolicited ratings" could be used by market participants to evaluate the ratings issued by the NRSRO hired to rate the product and, in turn, potentially expose an NRSRO whose ratings were influenced by the desire to gain favor with the arranger in order to obtain more business. The proposal also is designed to make it more difficult for arrangers to exert undue influence on the NRSROs that they hire to determine ratings for structured finance products. In particular, by opening up the rating process to greater scrutiny, the proposal is designed to make it easier for the hired NRSRO to resist pressure from the arranger by increasing the likelihood that any compromise of the NRSRO's objectivity could be exposed to the market.

The Commission also proposed to prohibit three additional conflicts outright. First, the Commission proposed to prohibit an NRSRO from issuing a credit rating with respect to an obligor or security where the NRSRO, or a person associated with the

NRSRO, made recommendations to the obligor or the issuer, underwriter, or sponsor of the security (that is, the parties responsible for structuring the security) about the corporate or legal structure, assets, liabilities, or activities of the obligor or issuer of the security. This proposal would prohibit the NRSRO and, in particular, its credit analysts from making recommendations to obligors, issuers, underwriters, and sponsors such as arrangers of structured finance products about how to obtain a desired credit rating during the rating process. It also would prohibit an NRSRO from issuing a credit rating where a person associated with the NRSRO, such as an affiliate, made such recommendations.

It has been suggested that during the process of rating structured finance products the NRSROs have recommended to arrangers how to structure a trust or complete an asset pool to receive a desired credit rating and then rated the securities issued by the trust – in effect, rating their own work. This proposal would prohibit this conduct based on the Commission's preliminary belief that it creates a conflict that cannot be effectively managed insomuch as it would be very difficult for an NRSRO to remain objective when assessing the creditworthiness of an obligor or debt security where the NRSRO or person associated with the NRSRO made recommendations about steps the obligor or issuer of the security could take to obtain a desired credit rating.

The second proposal would prohibit the conflict of interest that arises when a fee paid for a rating is discussed or arranged by a person within the NRSRO who has responsibility for participating in determining credit ratings (including analysts and rating committee members) or for developing or approving procedures or methodologies used for determining credit ratings, including qualitative and quantitative models. This proposal is designed to effectuate the separation within the NRSRO of persons involved in fee discussions from persons involved in the credit rating analytical process. The incentives of the persons discussing fees could be based primarily on generating revenues for the NRSRO; whereas the incentives of the persons involved in the analytical process should be based on determining accurate credit ratings. There is a significant potential for these distinct incentive structures to conflict with one another where persons within the NRSRO are engaged in both activities.

The potential consequences are that a credit analyst or person responsible for approving credit ratings or credit rating methodologies could, in the context of negotiating fees, let business considerations undermine the objectivity of the credit rating process. For example, an individual involved in a fee negotiation with an issuer might not be impartial when it comes to rating the issuer's securities. In addition, persons involved in approving the methodologies and processes used to determine credit ratings could be reluctant to adjust a model to make it more conservative if doing so would make it more difficult to negotiate fees with issuers. For these reasons, the Commission preliminarily believes that this conflict should be prohibited.

The third proposal would prohibit the conflict of interest relating to the issuance or maintenance of a credit rating where a credit analyst who participated in determining or monitoring the credit rating, or a person responsible for approving the credit rating, received gifts, including entertainment, from the obligor being rated, or from the issuer,

underwriter, or sponsor of the securities being rated, other than items provided in the context of normal business activities that have an aggregate value of no more than $25. Persons seeking credit ratings for an obligor or debt security could use gifts to gain favor with the analyst responsible for determining the credit ratings and cause the analyst to be less objective during the credit rating process. In the case of a substantial gift, the potential to impact the analyst's objectivity could be immediate. With smaller gifts, the danger is that over time the cumulative effect of repeated gifts can impact the analyst's objectivity. Therefore, the proposal would establish an absolute prohibition on gifts with the exception of minor incidentals provided in business meetings.

IX. CONCLUSION

As described above, the Commission took a number of actions during the year with respect to NRSROs. In the coming year, the Commission will complete its examination of the NRSROs' role in rating residential mortgage backed securities and collateralized debt obligations linked to subprime mortgage loans. The Commission also will adopt final rules after a full consideration of the comments received on the proposals outlined above.