

## **SECURITIES AND EXCHANGE COMMISSION**

(Release Nos. 33-7085; 34-34616; IC-20508; International Series Release No. 706)

File No. S7-23-94

Nationally Recognized Statistical Rating Organizations

**AGENCY:** Securities and Exchange Commission

**ACTION:** Concept Release

**SUMMARY:** The Securities and Exchange Commission ("Commission") solicits recommendations on the Commission's role in using the ratings of nationally recognized statistical rating organizations ("NRSROs"). Because of the expanded use of credit ratings in the Commission's rules, the Commission believes that it is appropriate to examine the process employed by the Commission to designate rating agencies as NRSROs and the nature of the Commission's oversight role with respect to NRSROs.

**DATES:** Comments should be received on or before [90 days after publication in the Federal Register].

**ADDRESSES:** Persons wishing to submit written comments should file three copies thereof with Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. All written comments should refer to File No. S7-23-94. All comments received will be available for public inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, N.W., Washington, D.C. 20549.

**FOR FURTHER INFORMATION CONTACT:** Michael A. Macchiaroli, 202/942-0132, Roger G. Coffin, 202/942-0136 or Elizabeth K. King, 202/942-0140.

**SUPPLEMENTARY INFORMATION:**

### **I. INTRODUCTION AND BACKGROUND**

In recent years, the credit ratings issued by agencies that are recognized as nationally recognized statistical rating agencies ("NRSROs") have attained an increased level of importance within the context of the Commission's rules and regulations. The Commission

looks to the credit ratings issued by NRSROs in a variety of contexts, and for different purposes, to distinguish among various grades of debt and other rated securities.

The increasing utilization of credit ratings as a component in Commission rules, in turn, has prompted a number of domestic and foreign rating agencies to seek NRSRO status. Currently, the Commission's rules do not define the term "NRSRO," nor is there a formal mechanism for monitoring the activities of agencies that have been recognized as NRSROs. Accordingly, the Commission believes that it is appropriate to issue a concept release soliciting comment on the appropriate role of ratings in the federal securities laws, and the need to establish formal procedures for designating and monitoring the activities of NRSROs.

#### A. The Development of the Term "NRSRO"

In 1975, the Commission adopted the uniform net capital Rule, Rule 15c3-1 under the Securities Exchange Act of 1934 ("Exchange Act"), which in part also incorporated the use of ratings issued by NRSROs in connection with certain provisions of the net capital rule.<sup>1</sup> Rule 15c3-1 requires broker-dealers, when computing net capital, to deduct from net worth certain percentages of the market value ("haircuts") of their proprietary securities positions. Haircuts serve as a safeguard against the risks associated with fluctuations in the price of each broker-dealer's proprietary securities. Broker-dealers' proprietary positions in commercial paper, nonconvertible debt securities and nonconvertible preferred stock are accorded preferential treatment under the net capital rule, in the form of reduced haircuts, if the instruments are rated investment grade by at least two NRSROs.<sup>2</sup> The Commission did

---

<sup>1</sup> 17 CFR 240.15c3-1. See Adoption of Amendments to Rule 15c3-1 and Adoption of Alternative Net Capital Requirement for Certain Brokers and Dealers, Exchange Act Release No. 11497 (June 26, 1975), 40 FR 29795 (July 16, 1975).

<sup>2</sup> See 17 CFR 15c3-1(c)(2)(vi)(E) (haircuts applicable to commercial paper that has been rated in one of the three highest categories by at least two NRSROs); 17 CFR 15c3-1(c)(2)(vi)(F) (haircuts applicable to nonconvertible debt securities that are rated in one of the four highest rating categories by at least two NRSROs); 17 CFR 15c3-1(c)(2)(vi)(H) (continued...)

not attempt to define the term in the context of the net capital rule and, in using the term subsequently in other regulatory contexts, the Commission generally has stated that the term should have the same meaning as it does for purposes of the net capital rule.<sup>3</sup>

**B. Expanded Use of the Term "NRSRO" and Utilization of the Ratings Assigned to Securities by NRSROs**

Over time, the NRSRO concept has been incorporated into other areas of the federal securities laws and Congress itself employed the term "NRSRO" in the definition of "mortgage related security." Pursuant to Section 3(a)(41) of the Exchange Act, which was added by the Secondary Mortgage Market Enhancement Act of 1984,<sup>4</sup> a mortgage related security must, among other things, be rated in one of the two highest rating categories by at least one NRSRO.<sup>5</sup> Although Congress did not define what it meant by an NRSRO, its reliance on the term used in Commission rules is significant because it reflects a congressional recognition that the "term has acquired currency as a term of art."<sup>6</sup>

---

<sup>2</sup>(...continued)

(haircuts applicable to cumulative, nonconvertible preferred stock rated in one of the four highest rating categories by at least two NRSROs).

<sup>3</sup> See, e.g., Rule 2a-7 under the Investment Company Act of 1940, 17 CFR 270.2a-7 (the term "NRSRO" is defined to mean any NRSRO "as that term is used in Rule 15c3-1. . . .").

<sup>4</sup> Pub. L. No. 98-440, § 101, 98 Stat. 1689, 1689 (1984). See 15 U.S.C. 78c(a)(41).

<sup>5</sup> In 1989, Congress added the term NRSRO to Section 1831e of the Federal Deposit Insurance Act, which prescribes the permissible activities of savings associations in defining the term "investment grade." 12 U.S.C. § 1831e(d)(4)(A). Under Section 1831e(d)(4)(A), any corporate debt security is not of "investment grade" unless the security is rated in one of the four highest categories by at least one NRSRO.

<sup>6</sup> H.R. Rep. No. 994, 98th Cong., 2d Sess. 46 (1984) (appending Statement of Charles C. Cox, Commissioner, Securities and Exchange Commission, to the Subcommittee on Telecommunications, Consumer Protection, and Finance of the House Committee on Energy and Commerce, March 14, 1984).

In addition, several regulations issued pursuant to the Securities Act of 1933 ("Securities Act"),<sup>7</sup> the Exchange Act,<sup>8</sup> and the Investment Company Act of 1940 ("Investment Company Act")<sup>9</sup> have incorporated the term "NRSRO" as it is used in the net capital rule. For example, the Commission employs NRSRO ratings as a basis for distinguishing between certain types of securities that may be issued using simplified registration procedures under the Securities Act.<sup>10</sup> NRSRO ratings also are employed in connection with investment restrictions applicable to money market funds. Rule 2a-7 under the Investment Company Act requires a money market fund to limit its investments to securities that are "Eligible Securities,"<sup>11</sup> which, among other things, are securities rated in one of the two highest rating categories for short-term debt by the requisite number of NRSROs.

Rule 3a-7 under the Investment Company Act, which exempts certain structured financing from registering under and complying with the Investment Company Act, also utilizes the ratings of NRSROs.<sup>12</sup> Under paragraph (2)(a) of Rule 3a-7, an issuer of fixed income securities that are rated in one of the four highest categories by at least one NRSRO

---

<sup>7</sup> See, e.g., Regulation S-K (17 CFR 229.10); Rule 436 (17 CFR 230.436); Form S-3 (17 CFR 239.13); Forms F-2 and F-3 (17 CFR 239.32, 239.33).

<sup>8</sup> See, e.g., Rule 10b-6 (17 CFR 240.10b-6). See also Form 17-H (17 CFR 249.328T).

<sup>9</sup> See, e.g., Rule 2a-7 (17 CFR 270.2a-7); Rule 10f-3 (17 CFR 270.10f-3); Rule 3a-7 (17 CFR 270.3a-7). Cf. Investment Company Act Release No. 19716, 58 FR 49425 (Sept. 23, 1993) (amending Rule 12d3-1 by, among other things, dropping the requirement that investment companies limit their purchases of debt securities issued by securities-related businesses to those that are investment grade).

<sup>10</sup> See Adoption of Integrated Disclosure System, Securities Act Release No. 6383 (Mar. 16, 1982). Adoption of Simplification of Registration Procedures for Primary Securities Offerings, Securities Act Release No. 6964 (Oct. 22, 1992).

<sup>11</sup> See 17 CFR 270.2a-7.

<sup>12</sup> Exclusion from the Definition of Investment Company for Structured Financing, Investment Company Act Release No. 19105 (November 19, 1992), 52 SEC Dkt. 4014.

is deemed not to be an investment company under the Investment Company Act. In adopting the rule, the Commission recognized that rating agencies had been "successful in analyzing the structural integrity of financing . . . [and] appear to have been a major factor in investor acceptance of structured financing."<sup>13</sup>

In proposing Rule 3a-7, the Commission requested specific comment on whether a rating requirement was necessary and, if not, on what alternative bases the Commission should exclude structured financing from the Investment Company Act. The Commission also requested comment on whether rating agencies should be subject to additional regulatory requirements. Those commentators who specifically addressed the issue registered strong support for use of NRSRO ratings in the structured financing context. The North American Securities Administrators Association, Inc. and the Investment Company Institute ("ICI") opposed reliance on NRSRO ratings in this context. Of the commentators addressing additional regulatory requirements for rating agencies generally, a large majority opposed Commission regulation of rating agencies, whereas several others argued that questions of regulatory oversight should be addressed separately from the merits of the proposed rule. The ICI was the only commentator supporting additional government oversight.

Finally, Rule 10b-6 under the Exchange Act, which prohibits persons participating in a distribution of securities from artificially conditioning the market for the securities in order to facilitate the distribution, employs an NRSRO concept as well. Generally, Rule 10b-6 exempts certain transactions in nonconvertible debt and nonconvertible preferred securities from its coverage if the securities, among other things, are rated investment grade by at least one NRSRO.<sup>14</sup>

---

<sup>13</sup> Id. at 4028.

<sup>14</sup> See 17 CFR 240.10b-6(a)(4)(xiii). In addition, the Board of Governors of the Federal Reserve System uses the term "NRSRO" in Regulation T. See 12 CFR Part 220.

The utilization of NRSRO ratings, therefore, is an important component of the Commission's regulatory program. Initially, the Commission solicits comment as to whether it should continue to employ in its rules the term "NRSRO" and the ratings assigned to various debt and other rated securities by NRSROs. The Commission also invites commentators to consider alternative means by which the Commission could distinguish among various grades of debt and other rated securities.

In addition, with the advent of limited scope ratings of the type applied, for example, to "cash flow securities,"<sup>15</sup> and with the proliferation of structured securities subject to substantial non-credit payment risks, it is appropriate to review the regulatory use of ratings and to specify, if necessary, what types of ratings fall within each of the regulatory provisions that refer to specific ratings. We also request comment regarding whether a limited scope rating by NRSROs should qualify for the exemption from liability under section 11 of the Securities Act.<sup>16</sup>

Rating agencies and other organizations have developed ratings of open-end and other types of investment companies. These ratings serve a number of purposes. Three rating agencies, Fitch Investors Service, Inc. ("Fitch"), Standard & Poor's Corporation ("Standard & Poor's"), and Moody's Investors Service, Inc. ("Moody's"), issue ratings that assess the safety of principal invested in a money market mutual fund. These rating agencies also have

---

<sup>15</sup> A cash flow security represents an interest in a pool of several classes of previously issued unrelated mortgage backed securities, which typically are highly sensitive to principal prepayment speed and have volatile yields. The Commission has been informed that certain NRSROs have developed rating techniques to measure the likelihood that holders of a particular class of securities will receive a specified dollar amount by the maturity date, without regard to whether such payment amount constitutes interest or principal repayment. Assessing the likelihood of receipt of this cash flow combines both a credit rating and non-credit payment evaluation of prepayments on the underlying pooled securities, and thus represents a significant departure from traditional credit rating techniques. The Commission is issuing a release that proposes amendments with respect to the use of securities ratings in disclosure documents. See Securities Act Release No. 33-7086 (Aug. 31, 1994).

<sup>16</sup> 15 U.S.C. § 77k. See also 17 CFR § 230.436(g).

begun to rate different characteristics of bond funds.<sup>17</sup> For example, Fitch, Standard & Poor's, and Moody's each issue bond fund ratings designed to identify the degree of credit risk in a bond fund's underlying investments. Fitch and Standard & Poor's also issue bond fund "stability" or "market risk" ratings that purport to quantify the potential volatility of the market value of bond fund shares, based on an analysis of interest rate risk, spread risk, currency risk, and the fund's use of derivatives.<sup>18</sup> Other organizations issue mutual fund risk ratings that are designed to quantify different types of investment risk. These ratings may provide investors with information that may be useful in assessing the risks of investing in a mutual fund; however, they also may create expectations of investment performance that may not be achieved, notwithstanding disclaimers that they are not projections of future results.

Comment is requested regarding whether the Commission should encourage or require these types of ratings to be disclosed in fund prospectuses, sales literature, and advertisements. Commenters are asked to address the type of disclosure that should accompany these types of ratings to assure that their significance and limitations are appreciated by investors, and any other appropriate conditions for their use in fund prospectuses and advertisements (such as conditions to assure that an issuer will only use a rating that is current and that changes in a fund rating are promptly disclosed to investors). Comment is requested as to whether these ratings may lead an investor to select a fund based solely on a fund's ratings rather than other information that bears on the appropriateness of the fund for the investor's investment objectives and goals. Finally, comment is requested on whether Rule 436(g) under the Securities Act should be amended

---

<sup>17</sup> The mutual fund ratings, generally, are accompanied by a suffix (e.g., an "m" to indicate a money market fund rating or an "f" to indicate a bond fund rating) to differentiate them from traditional bond and preferred stock ratings.

<sup>18</sup> See Bond Fund Rating Guidelines, Fitch Research, June 14, 1993; Bond Fund Risk Rating Criteria, Standard & Poor's Credit Week (Jan. 17, 1994).

so that a fund could include these types of ratings in its registration statements without having to provide a written consent conveying expert liability to the organization preparing the ratings.<sup>19</sup> Further questions regarding NRSROs are set forth below.

## II. DESIGNATING AND MONITORING NRSROs

### A. Designation of NRSROs

Six rating organizations currently are "designated" as NRSROs for purposes of the net capital rule:<sup>20</sup> (1) Standard & Poor's; (2) Moody's; (3) Fitch; (4) Duff & Phelps, Inc. ("Duff & Phelps");<sup>21</sup> (5) Thomson BankWatch, Inc. ("BankWatch");<sup>22</sup> and (6) IBCA Limited and its subsidiary, IBCA Inc. (collectively known as "IBCA").<sup>23</sup> Standard & Poor's,

---

<sup>19</sup> Mutual fund ratings relate to the fund's equity securities. Currently, because Rule 436(g) under the Securities Act does not cover equity securities, a fund would be required to file an NRSRO's consent if the rating assigned by the NRSRO to the fund's common stock is disclosed in the fund's prospectus. Because NRSROs, generally, will not provide the required consent, funds have been unable to use NRSRO ratings in their prospectuses. In 1986, the Commission proposed to extend Rule 436(g) to ratings of money market fund securities. See Investment Company Act Release No. 14984 (Mar. 14, 1986), 51 FR 9838 (Mar. 21, 1986). These proposed amendments were not adopted.

<sup>20</sup> McCarthy, Crisanti & Maffei, Inc. ("McCarthy"), a seventh rating agency designated as an NRSRO on September 13, 1983 by the Division of Market Regulation, has discontinued its ratings business. Duff & Phelps purchased the credit research and ratings business of McCarthy on February 7, 1991. See Letter from Michael A. Macchiaroli, Assistant Director, Division of Market Regulation, to Paul J. McCarthy, President of McCarthy (Sept. 13, 1983); Letter from J. Christopher Jackson, Vice President and Associate General Counsel, Van Kampen Merritt, to Michael A. Macchiaroli, Assistant Director, Division of Market Regulation (Mar. 13, 1991).

<sup>21</sup> See Letter from Nelson S. Kibler, Assistant Director, Division of Market Regulation, to John T. Anderson, Attorney, Lord, Bissell & Brook, on behalf of Duff & Phelps (Feb. 24, 1982).

<sup>22</sup> See Letter from Michael A. Macchiaroli, Assistant Director, Division of Market Regulation, to Gregory A. Root, President, BankWatch (Aug. 6, 1991). BankWatch is recognized as an NRSRO only for the purposes of rating debt issued by banks, bank holding companies, non-bank banks, thrifts, broker-dealers and broker-dealers' parent companies. *Id.*

<sup>23</sup> See Letter from Michael A. Macchiaroli, Assistant Director, Division of Market Regulation, to Mr. Robin Monro-Davies, President, IBCA Limited (Nov. 27, 1990); Letter  
(continued...)



Moody's and Fitch were the only rating agencies initially designated as NRSROs by the Division of Market Regulation ("Division"). The Division indirectly designated these three rating agencies as NRSROs by granting no-action relief to broker-dealers who sought assurances concerning their status as NRSROs for purposes of the net capital rule. Subsequently, based on requests directly from rating agencies, the Division provided no-action assurances to three additional rating agencies, Duff & Phelps, BankWatch and IBCA, that they would be considered NRSROs for purposes of the net capital rule.

In reaching a decision regarding whether to provide no-action assurances to rating agencies regarding NRSRO designation, the Division staff undertakes an informal examination of the agency's operations, its position in the marketplace, as well as considering other factors. If the Division staff determines that no-action assurances are appropriate, the staff prepares a letter stating that it will not recommend enforcement action to the Commission if the rating agency is considered to be an NRSRO for purposes of applying the relevant subdivisions of the net capital rule.

In determining whether a rating agency possesses the characteristics of an NRSRO, the staff considers a number of criteria. The Division believes that the single most important criterion is that the rating agency is in fact nationally recognized by the predominant users of ratings in the United States as an issuer of credible and reliable ratings. Consistent with this standard of national recognition is a minimum level of operational capability and reliability of ratings. Therefore, the staff also assesses, among other factors: (a) the agency's organizational structure; (b) the agency's financial resources (to determine, among other things, whether it is able to operate independently of economic

---

<sup>23</sup>(...continued)

from Michael A. Macchiaroli, Assistant Director, Division of Market Regulation, to David L. Lloyd, Jr., Attorney, Dewey, Ballantine, Bushby, Palmer & Wood, on behalf of IBCA (Oct. 11, 1990). At present, IBCA is designated as an NRSRO only for the purposes of rating debt issued by banks, bank holding companies, United Kingdom building societies, broker-dealers, broker-dealer parent companies and bank-supported debt. Id.

pressures); (c) the size and quality of the agency's staff (to determine if the entity is capable of thoroughly and competently evaluating an issuer's credit); (d) the agency's independence from the companies it rates and its reputation for integrity in the marketplace; (e) the agency's rating procedures (to determine whether it has systematic procedures designed to ensure credible and accurate ratings); and (f) the agency's establishment and compliance with internal procedures to prevent misuses of non-public information.<sup>24</sup>

In the letter providing no-action assurances to a rating agency, the Division advises the rating agency that the decision to confer NRSRO status has been based on representations made by or on behalf of the rating agency during the no-action process. The Division then directs the rating agency to bring to its attention any material change in the facts that served as the basis for granting the no-action letter. In this manner, the Division retains the ability to withdraw a no-action letter designating the particular rating agency as an NRSRO if the facts so warrant. Although it has the authority to revoke a no-action letter previously granted to a rating agency, the Commission would like to explore more effective vehicles for soliciting information from NRSROs. Material changes in an NRSRO's organizational structure or modifications of its rating practices, for example, could affect the NRSRO's standing in the credit market. Although the Commission notes that all of the existing rating agencies that have received no-action assurances are registered as investment advisers under the Investment Advisers Act of 1940, the Commission receives only limited, informational filings from NRSROs.

The Division staff currently is reviewing no-action requests from other rating agencies regarding NRSRO designation. Although no final determination has been made, the staff has not been able to provide no-action assurances to any of these agencies.

---

<sup>24</sup> See No-Action Letter from Nelson S. Kibler, Assistant Director, Division of Market Regulation to John T. Anderson, Esq., Lord, Bissell & Brook (Mar. 24, 1982).

Nonetheless, the staff intends to continue to evaluate these agencies pending the comment period for this release.

**B. Questions for Comment**

1. Comment is invited on whether the Commission should continue to employ an NRSRO concept to distinguish various types of debt and other securities for purposes of its rules.

2. The Commission solicits comment on whether it should propose to adopt, in the net capital rule or another rule, a definition of the term "NRSRO," for purposes of all of its rules. Commentators are invited to provide suggestions as to how the term NRSRO could be defined and as to what, if any, objective criteria should be considered in determining whether a rating agency is an NRSRO for purposes of the Commission's rules.

3. The Commission requests comment as to whether the current no-action letter process with respect to NRSROs is satisfactory, or if not, whether the Commission should establish alternate procedures for designating NRSROs. Commentators are requested to address whether the current practice needs to be formalized, and if so, how this should be accomplished.

4. The Commission also solicits comment on the practice of NRSROs charging issuers for ratings and, more specifically, whether it is appropriate for an NRSRO to charge an issuer based on the size of the transactions being rated.

5. Comment regarding the use of limited scope ratings that may not denote an assessment solely of the credit risk of an instrument also is requested.

6. Comment is invited on whether the Commission should take further steps regarding NRSROs in order to increase its regulatory oversight role, including seeking additional legislative authority, if necessary. Commentators are requested to consider whether NRSROs should be required to register with the Commission, or whether other types of regulatory oversight are appropriate and necessary to satisfy the purposes of the federal securities laws.

By the Commission.

Jonathan G. Katz,  
Secretary

Dated: August 31, 1994