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BY ELECTRONIC MAIL

Mr. Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
Washington, D.C. 20549-0609
Re: File No. S7-12-03, Concept Release: Rating Agencies and the Use of Credit Ratings under the Federal Securities Laws

Dear Mr. Katz:

On June 4, 2003, the Securities and Exchange Commission ("the Commission," or "the SEC") issued its Concept Release[1] ("the Release") regarding the credit ratings industry, wherein it posed and requested public comment on a series of relevant questions. In our response, Moody's Investors Service ("Moody's") will address these questions by categorizing them into the three broad areas identified by the Commission: 1) should credit ratings continue to be used for regulatory purposes under the federal securities laws; 2) if so, what should be the process for determining whose credit ratings to use; and, 3) if credit ratings continue to be used in federal securities law, what is the appropriate level of oversight for the agencies whose ratings are used?

[1] SEC Concept Release, Rating Agencies and the Use of Credit Ratings under the Federal Securities Laws [Release Nos. 33-8236; 34-47972; IC-26066; File No. S7-12-03] (June 4, 2003).

Summary

Ratings help level the information playing field between borrowers and lenders by providing a readily understood language for credit risk. Some of the most important attributes of credit ratings as currently made available by the major rating agencies include their independence, predictive content, broad coverage, and free dissemination to the general public. These attributes are the result of decades of evolution in line with market-based needs. But they have also caused ratings to be a "public good," which in turn has led to their adoption by various authorities for certain public policy objectives.

There is an impression among market commentators that the SEC's existing Nationally Recognized Statistical Ratings Organization ("NRSRO") designation process has caused the development and success of the rating agency industry. That impression misconstrues the history of the use of credit ratings in federal securities laws, which use was appropriated because rating agencies *already* provided a valuable public good. It is also important to note that there has been very significant expansion of the U.S. capital market and development of new types of securities[2] *after* the Commission commenced using the designation. Further, the widespread use of ratings in the global markets, many of which do not require ratings or have a governmental designation process similar to that of the United States, demonstrates that ratings are used because they are valued by market participants, not because they are required by governmental action. Therefore:

- Moody's would support elimination of the use of credit ratings in federal securities laws. If ratings cease to be used for regulatory purposes, we believe that credit rating agencies can continue to serve their primary objectives in support of market efficiency and investor protection.
    - As an incidental consequence, the elimination of regulatory use would directly address the concerns of some commentators that the high barriers to entry and nature of competition in the credit ratings industry are a byproduct of government action.
- If authorities determine to continue to use ratings in federal securities laws, that determination should not be the justification for intrusive regulation – including efforts to control rating agencies' independent opinion content or to effect a change in the rating agencies' exposure to civil litigation. As ratings are not intentionally produced by rating agencies for use in federal securities law, Moody's would oppose a designation process if it were to lead to intrusive oversight measures, which would potentially alter the core attributes of ratings or the current business model.
- Should the Commission choose to maintain the use of ratings in federal securities laws, it should adopt an approach that promotes greater disclosure and openness in the designation process while preserving the existing core attributes of rating opinions. This would enhance confidence in the system. To achieve these objectives, Moody's would recommend the following:

[2] New types of securities have been especially prevalent in the use of structured financings.

1) Number of rating agencies recognized for regulatory purposes

Moody's recommends that the Commission consider designating more rather than fewer entities. This could increase the number of valuable opinions available to the financial markets, and would address criticisms that current rating agency performance is degraded by an environment of limited competition. However, any such expansion will need to be balanced against the potential risk of inflated opinions and higher ratings through rating shopping, which may undercut the objectives that regulation in a given area seeks to achieve.

2) Appropriate recognition criteria

Arguably, one of the highest perceived barriers to designation of new entrants as NRSROs under the current regime is the requirement that applicants be "nationally recognized" prior to receiving an NRSRO designation. It is possible to craft regulation and criteria that avoids the *"N"*ationally *"R"*ecognized chicken-or-egg quandary. Moody's would support abandoning the usage of this subjective test[3] and would instead recommend that the Commission look to the following criteria in any recognition process:

- wide, public dissemination of the actual ratings contemporaneous with their determination;
- process and performance disclosure;
- appropriate management of conflicts of interest; and
- appropriate controls of dissemination of non-public information.

Only through wide, public dissemination of the actual ratings on public debt securities contemporaneous with their determination can ratings continue to serve their existing "public good" function. Disclosure of the rating processes and performance is the most direct mechanism to allow the market to assess which credit opinion provider to use for what purpose. Appropriate management of potential conflicts of interest in the ratings business model is necessary to maintain rating agency independence and freedom from corruption. Protection against selective disclosure of non-public information is an important principle for fair security markets and investor protection.

3) Recognition or oversight regulation should not control independent credit opinion content

The Commission should refrain from employing measures, either in its recognition or potential oversight functions, that would require or promote harmonization in process, methodology, or rating opinions among those entities designated as NRSROs. Credit ratings are predictive opinion forecasts about an uncertain future, not statements of fact. Harmonization would, in effect, force

[3] If the Commission decides to de-emphasize the "*NR*" criterion for rating agencies recognized for regulatory purposes, Moody's suggests a change in the manner to which such agencies are made reference. "Recognized Rating Agency" or "RRA" might be a more appropriate designation. For the purposes of our comment, however, we will continue to use the acronym "NRSRO."

artificial "agreements" among agencies about the future, stifling diversity of opinion and the motivation to compete on the basis of improving credit analysis. Competition is not achieved if the number of credit rating providers increases while the diversity in rating opinions declines. One opinion from multiple sources would in fact eliminate quality-based competition and substitute in its place less investor protection-oriented alternatives. In order to support an information-efficient capital market, rating agencies should compete vigorously on the basis of the reliability and usefulness of differing and independently formed opinions.

4) **Oversight should not increase rating agencies' exposure to civil litigation**

Finally, Moody's strongly opposes any supervision processes that would impair existing Constitutional, federal or state law protections designed to mitigate our exposure to third- party subpoenas and civil litigation. Such exposure for opinion providers is not only contrary to the protections provided by the First Amendment of the U.S. Constitution, but it would also have the ultimate chilling effect on our ability to publish independent and potentially controversial opinions. Arguably, the outcome would be similar to that of harmonization measures. Greater exposure to potential civil litigation would implicitly influence all NRSROs toward a similar view, even if that view would not be the opinion of each agency absent such exposure.

I. Should Ratings Continue to be Used in Securities Law?

- Eliminating the use of credit ratings in federal securities laws would address criticisms that the character of the industry is a byproduct of government action.
- Eliminating national recognition (the NRSRO designation) would be the most direct response to criticisms that performance is degraded by an "artificially" low number of competitors.
- Moody's would advocate that the use of ratings in federal securities laws be eliminated if regulatory recognition and oversight measures materially reduced the motivation or ability of those designated to produce independent rating opinions or otherwise impeded the development of rating analysis.

A. Eliminate NRSRO Designation

Recent criticisms of rating agencies have included the perceived inadequacy of their performance. Some critics have asserted that national recognition is the cause of an "artificially" low number of competitors, which has reduced the incentives for accuracy. Thus, the argument continues, enlarging the pool of recognized rating agencies will create

competitive pressures which will improve performance. Others argue that expanding national recognition will not improve the performance of rating agencies, but that enhancing governmental oversight or increasing their contingent liability will. Finally, it has been asserted that increased oversight will do little to improve the quality of the rating,[4] and that perhaps ratings and rating agencies have outlived their utility and should be replaced by other, purportedly more advanced technologies.[5]

If the Commission wishes to discontinue the designation of rating agencies and the use of ratings in federal securities laws in an attempt to address any or all of these assertions, Moody's would support such discontinuance. Discontinuance of "national recognition" would also eliminate risks associated with recognizing potentially less qualified rating agencies, "rating shopping" by issuers for the highest rating for regulatory qualification purposes, and other forms of standards-lowering competition.[6] Moreover, if "national recognition" results in regulation that impairs the constructive role of ratings in the capital markets, or which substantially increases regulatory or private litigation costs, then Moody's would oppose the continued use of ratings in federal securities laws or the recognition of rating agencies by the Commission.

B. Alternative Approaches

As an alternative to "national recognition," the Commission could rely directly on the regulated entities to make complete and full public disclosure with respect to the methodologies they have employed to distinguish higher from lower risk securities, and periodically approve or allow the market to determine the acceptability of such methods.

Specifically, and as indicated in the Concept Release, the Commission can rely upon broker-dealers' internal rating systems, in the case of Rule 15c3-1, and upon subjective evaluations for Rule 2a-7 purposes. A securities firm can be required to publicly disclose the framework that underlies its internal ratings system. If an institution relies on agency ratings within its internal system, it should disclose which agencies it uses, when it substitutes one rating agency for another and how it resolves split ratings. Provision of internal ratings to the SEC, for comparison with public and other private ratings, would minimize the need for direct SEC supervision and extensive firewalls. For current use of ratings in determining Form S-3 financial eligibility requirements, the SEC could substitute alternative criteria, such as issue size, number of investors, or market listing.

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[4] Steven Schwarcz, *Private Ordering of Public Markets: The Rating Agency Paradox*, 2002 U. ILL. L. REV. 1 [hereafter, Schwarcz, *The Rating Agency Paradox*].

[5] See, *e.g.*, Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 Wash. U. L. Q. 619; Lawrence J. White, *The Credit Rating Industry: An Industrial Organization Analysis*, *in* RATINGS, RATING AGENCIES AND THE GLOBAL FINANCIAL SYSTEM (R.M. Levich et al. eds., 2002).

[6] We have discussed with the SEC and market participants on previous occasions that it is conceivable that increased competition among NRSRO entities will be on the basis of offering the highest rating, rather than the highest quality rating.

II.SEC Recognition of Rating Agencies

- If the SEC continues to use ratings in federal securities laws, Moody's would advocate a transparent recognition process that supports industry independence and credibility, and does not cause the core attributes of ratings as a public good to be altered.
- Moody's would urge the Commission to base any recognition criteria on the delivery of the desired public good, requiring:
    i. public, free dissemination of ratings contemporaneous with their determination;
    ii. rating process and performance disclosure;
    iii. appropriate management of conflicts of interest; and
    iv. appropriate protection of non-public information.
- Moody's would oppose measures that would compel harmonization of rating opinions among the designated entities, because such measures contradict the fundamental concept that competition to provide the *best* credit opinion promotes more efficient markets and investor protection.
- Moody's would oppose recognition criteria that would result in significant incremental costs or increased exposure to civil litigation for the designated entities.

Moody's appreciates that the adoption of credit ratings for use under the federal securities laws was in response to the perceived utility of ratings in furtherance of certain public policy objectives,[7] including:

(i) to help manage principal/agent risks in asset management, and

(ii) to help specify required capital to cover risks in certain regulated institutions.

We also understand that use of ratings in federal securities laws is currently viewed by many to contribute to market efficiency and investor protection. If, therefore, the Commission chooses to maintain the NRSRO system, we believe that additional regulatory measures are not inappropriate *so long as* they neither cause those attributes of ratings valued by market participants for credit-sensitive securities to be altered, nor materially alter rating agencies' ability to produce and maintain ratings in the manner which have resulted in their adoption for public policy purposes in the first place.

[7] For a discussion of the use of ratings, and the perceived benefits thereof please see **Annex 1**.

A. Transparency in the SEC's Recognition Process

- We would advocate transparency in the Commission's disclosure of its approval process in order to help enhance market awareness of NRSRO qualifications and to satisfy the market that industry status is not the result of an "inherently unfair" system.

Moody's has always been, and will continue to be, a proponent of transparency in the capital market. To that end, we would favor the SEC's adoption of a set of standards for recognition of NRSROs, if these criteria do not cause alteration of the core attributes of our product, are equally applicable to all designated entities, and are well understood by the market.

B. Recognition Criteria

In determining recognition criteria, the SEC must weigh: (i) the benefits of having more recognized NRSROs, with the potential for greater diversity of opinion made freely available to market participants; against (ii) the potential detriment that greater diversity of opinion could result in opinion being used in regulation which does not satisfy the objectives the regulation seeks to achieve.

We recommend that any criterion used by the Commission to designate rating agencies should be adequately broad to permit open competition, thus allowing numerous entities the ability to distinguish themselves, one from the other, based on the quality of their individually held views. At the same time the Commission may wish to balance the benefits from an increase in the number of opinions against possible lowering of the substantive standards intended by the regulation in which NRSRO ratings are used. [8]

How well a rating agency performs over time is important and should ultimately be assessed by the market's acceptance and usage of its ratings. On the other hand, because there is not, nor should there be, one "sanctioned" model for rating agencies, we would suggest that precise requirements are not directly pertinent to the overall reliability of a rating agency and thus unduly raise the barrier to entry with little perceived advantage. Further, if the Commission were to adopt the following criteria as the designation requirements for recognized rating agencies, we are not convinced that the "national recognition" test would provide any added benefit.

1. Ratings must be made *widely* and *publicly* available

For ratings on public debt securities to be appropriately used in securities laws, they must be made widely available to the general public. A rating should not be construed as "publicly disseminated" if access to it is limited to subscribers, or made otherwise cumbersome or untimely. Such broad availability avoids selective disclosure of potentially

[8] Please see **Annex 1**.

material information and allows for ratings comparability. The "public-ness" of ratings helps level the information playing field among investors.[9]

Further, as investor protection is the ultimate aim of rules and regulations, we would suggest that the incidental benefit of public-ness of ratings is that it allows the market to test the reliability of the rating system over time.

2. Rating process and performance disclosure

Transparency in rating agencies' methodologies is important to the market's understanding of the ratings of a rating agency. Such methodologies may cover, for example, approach to broad industry divisions (such as industrial corporations, sovereigns, and financial institutions), to industry sectors within such divisions (for example within the industry sector we have published methodologies in relation to utilities), to regional sub-sectors, and where appropriate, to types of securities.[10] We believe such disclosure is helpful, and provides the users of ratings with the appropriate tools to judge the reliability of the rating process. Further, all market players should be given equal opportunity to understand the procedural approach employed by an agency to arrive at its opinion. It is Moody's practice to make publicly available all rating practices, rating methodologies, and performance metrics against our stated objectives for Moody's ratings.

3. Management of the potential conflicts of interest

As we have indicated in our previous communications with Commission staff and with market participants, ratings have the same problem as all other public goods: the free-rider problem.[11] Consumers of bond ratings have little incentive to pay for an opinion they can easily obtain at no cost. Thus, the rating agency model which has developed is an "issuer fee-based" model. This model has two intrinsic conflicts of interest which must be effectively managed:[12] a) issuers pay rating agencies for their credit opinions; and, b) issuers are one

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9 For the reason ratings are used in securities law, please see **Annex 1**.

10 In addition to our ratings, Moody's publishes:

Rating action announcements [the press releases]: announcements of all rating activity (upgrades, downgrades, Watchlist actions, changes in credit outlook, and new rating assignments), including an explanation of the rationale for the action.

Issuer- and transaction-specific analyses: descriptive reports on rated issuers and securities transactions; designed to provide readers with basic background on an issuer's business (or securities transaction), financial status and/or credit quality. These are typically published annually.

Special Comments: analyses of the credit implications of topical events, trends and market developments.

Default Studies: annual studies describing the correlation between bonds rated in a particular category and credit defaults. On a retrospective basis, these default studies demonstrate in aggregate the reliability of our ratings.

Credit Policy research: general research that makes clear Moody's view with respect to particular market or credit trends that cut across industries and regions, such as: liquidity analysis, hybrid analysis, or impact of securitization. Moody's has also published research that explains the rating committee process and what each rating symbol means, all of which are made available on our web-site.

11 Please see **Annex 1**.

12 Please see **Annex 2** for the measures Moody's has put in place to manage the potential conflict of interest.

source of input in a rating agency's formation of its opinion. Importantly, however, the issuer fee model also effectively avoids the necessity of selective disclosure of ratings, which would occur under alternative models such as the subscription service or "private sale" process models.

Issuer fees are supported by fundamental market mechanics and are critical to the public good nature of ratings – i.e., ratings offered to the public without charge. After all, investors do not need to pay - and thus will not pay - for ratings that are publicly disseminated rather than selectively disclosed. If ratings are to be made public and freely available to all interested parties, then rating agencies must generate fees by some other means. These means could include: i) fees from other services, which raise concerns about the independence of ratings that are subsidized by such services; ii) fees from sales of research, a business model that proved insufficient as early as the 1970's in funding the necessary professional staff to provide comprehensive coverage in rapidly expanding and increasingly complex financial markets; or iii) the issuer-fee model, which avoids having ratings subsidized by other activities, yet generates sufficient fees to support large professional staffs.

While it is important that rating agencies independently form their opinions, we believe that issuers can be a useful source of information in the rating process. In so far as the issuer can provide the rating agency with its perspective of its enterprise, such an exchange is both beneficial and helpful to the ultimate end user, the investor. If these discussions did not occur, it would likely lead to the dissemination of either less timely or less considered rating opinions, which would likely lead to a greater volatility and frequency of rating changes, including rating reversals.[13] Rating actions can and often do have an impact on the price of debt instruments or the cost of funding for an issuer. Unnecessary volatility in ratings would therefore increase the volatility of credit spreads and increase transaction costs for both issuers and investors, without providing a corresponding benefit.

We suggest that, to protect against the inherent conflict of interest, the following criteria be satisfied:

- **Rating agency business model.** To guard against potential conflicts of interest, rating agencies should make clear to the market whether their business model normally involves payments by issuers for ratings.[14]
- **Rating agency analysts' compensation.** To guard against potential conflicts of interest, rating agencies' criteria for measuring analyst performance and compensation should be clearly understood by the market.

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[13] Rating reversals are defined by Moody's as any rating change that is followed by a rating change in the opposite direction within a year. This occurs very infrequently at present. This is partly a result of the ability of rating agencies to be informed of strategic decisions under consideration by an issuer (e.g., remedial actions being planned to offset the negative credit impact of a debt funded acquisition). Issuers are highly motivated to avoid downgrades in the first place and therefore consider a reversal an indication that they have been subjected to an unnecessarily negative rating action. Investors are similarly intolerant of unnecessary rating reversals because of portfolio composition and performance measures that may result in the liquidation of an issuers' debt securities in the event of a downgrade. Investors wish to avoid liquidating holdings at a loss when the credit rating change proves temporary (e.g., forced sale at a loss when a bond is downgraded from investment grade to speculative grade – or Baa3 to Ba1 – only to have that bond shortly returned to investment grade status).

[14] For example, in the case of Moody's, the market is aware that we operate through an issuer-pays model.

- **Rating analysts' investments in rated entities**. Rating analysts should disclose ownership interests in any entity in which they participate in the rating process.[15]

4. Protection of non-public information

- Rating agencies should have appropriate measures to protect against selective disclosure, or inadvertent dissemination, of non-public information in their possession.
- We would recommend that the Commission allow investors to have the ability to contact rating agency analysts so long as the NRSROs have implemented appropriate guidelines to protect against selective dissemination of non-public information.
- If the Commission were to decide that investors should not have access to analysts, we would support such a requirement so long as it was made applicable to all other rating agencies -- including non-NRSROs -- that have access to confidential information.[16]

Moody's analysts can be contacted by issuers, investors, investment banks, the media, subscribers to our research service, and, in fact, the general public. Nonetheless, we have two types of primary relationships: the issuing entity, about whose debt securities we publish ratings; and the investor, for whose benefit we provide our opinions on the issuers' debt securities. As we have discussed above, we have interactions with issuers throughout the rating process. Our interaction with the investor community occurs in a number of ways. First, investors may access our ratings and press releases freely through our web-site and through media sources; second, they may subscribe to our research service; third, our rating teams hold periodic teleconferences; fourth, investors participate in investor conferences, where our analysts present their views on particular industries or sectors; and, finally, our rating analysts have individual meetings and telephone conversations with investors.

We have provided in **Annex 3**, some of the internal procedures we have adopted to protect confidential information in our possession. Moody's policy prohibits the disclosure of non-public information for two primary reasons:

i) our on-going relationship with the issuer is premised on the concept that the non-public information provided to us will remain out of the public domain until the issuer makes that information public; and

ii) we are fully aware that should we disseminate material, non-public information on a selective basis, we could be in violation of securities laws. While Moody's is very mindful of the necessity to safeguard confidential information, we

[15] Moody's prohibits our analysts from investing in entities for which they have rating responsibility or for which they participate in the rating committee process, except through diversified mutual funds.

[16] Other rating agencies may have access to non-public issuer information either under Regulation Fair Disclosure, 17 C.F.R. §§ 243.100 – 243.103 (2003), or through private confidentiality agreements with issuers.

nevertheless believe that investors gain insights from the discussions with our analysts as they are better able, for example, to understand the analytical reasoning behind a public rating.

We recommend that as part of any NRSRO designation regime, rating agencies should protect against improper communications through internal guidelines that specifically prohibit analysts from discussing non-public information concerning an issuer with anyone other than the issuer or its designated agents. We believe that such internal measures are the most effective means for safeguarding non-public information. However, should the Commission decide that more stringent rules in this area are necessary for the industry, we would support their imposition if they were applicable with equal force to all rating agencies with similar access to confidential information, including non-NRSROs.

C. Alleged Anti-Competitive, Abusive and Unfair Practices

Moody's appreciates the concern for an appropriate level of competition within the industry. We believe that vigorous competition in the rating agency industry has advantages and disadvantages in promoting primary regulatory objectives, and importantly depends on the bases upon which rating agencies are motivated to compete.

1. Harmonization

- It is Moody's position that should the Commission put in place criteria that demand or encourage harmonization in approach, methodology or ultimately the rating opinion, it would create an environment wherein there is a *de facto "*agreement" among the designated agencies to hold the same "opinion," thereby leading to *reduced competition* among agencies on quality of opinion, regardless of how many agencies have been designated as NRSROs. This result would be contrary to the desirable objective of increasing the number of credit opinions in the market and enabling the market to choose among such opinions.

Ratings opinions reflect opinion forecasts of the future. Two rating agencies looking at the same set of facts may legitimately reach different conclusions, based on their individual points of view or understanding of market behavior. The application of the methodology will be crucial in the formulation of the rating opinion. Moreover, diversity of opinion from credit ratings indicates that these rating agencies *are* independent of each other.

We believe that any attempt to harmonize rating opinions and meanings would reduce the amount of information available to the market. For example, Moody's ratings are a measure of expected loss. That is to say, they forecast the likelihood of default on a bond and the severity of loss in the event of that bond's default. Not all other rating agencies intend to convey the same information with their ratings systems.[17] If all opinion providers were

[17] Some turn on qualitative inputs, including the individual experience of the relevant rating committee members. *See also* Vladislav Peretyatkin and William Perraudin, *Expected Loss and Default Probability Approaches to Rating Collateralized Debt Obligations and the Scope for "Ratings Shopping," in* CREDIT RATINGS: METHODOLOGIES, RATIONALE AND DEFAULT RISK (Michael Ong ed., 2002).

compelled to assign the same rating symbol or adopt wholesale the same ratings as other agencies, the amount of information available to the market would be lessened, contrary to a primary objective of providing diverse opinions to promote efficient markets.

Finally, any regulation that requires the application of a prescribed methodology or approach will leave rating agencies less able to react to dynamic capital markets or future credit events. For example, the issues that have led to recent market failures – accounting fraud, ratings triggers, and corporate governance issues – have been identified, and Moody's has incorporated enhancements to our analytic processes, methodologies, and human capital to better address these issues. It is likely that the future will see different issues influencing creditworthiness, and it is imperative that credit rating agencies retain the operating flexibility necessary to meet these future demands.

In order for any opinion-based industry to produce the greatest public good, the individual opinion providers should operate independently of one-another, utilizing their own approaches and methodologies in crafting their opinions. If the SEC considers maintaining or augmenting the NRSRO system, we would ask that it provide a regime where all rating agency players are encouraged to compete vigorously on that basis. Otherwise, they would have less motivation to improve their performance as they would be discouraged from differentiating their product from other providers in the industry. If rules or regulation alter such a framework, it may change the rating product in such a way that its use will no longer be advantageous to either the market or the regulatory regime.

2. Unsolicited ratings

- We would recommend that NRSROs designate those ratings for which the issuer did not participate in the rating process, such that, the investor, the issuer and the regulator will have adequate information to judge whether to use the rating in question.

As a practical matter, Moody's has almost completely curtailed the assignment of unsolicited ratings in recent years. This is primarily due to hostile reactions to such ratings from many quarters, including from issuers, intermediaries, lawmakers and some investors. Beginning in January 2000, Moody's announced that we would identify in initial rating assignments those unsolicited ratings for which the issuer did not request a rating and declined Moody's invitation to participate in the rating assignment process. In order to be so designated, a rating must satisfy each of the following requirements:

- First-time rating;
- Unsolicited by the issuer, and
- The issuer declined Moody's invitation to participate in the rating process.

In such cases, the following statement will appear in the rating assignment press release:

> *"This rating was initiated by Moody's. The issuer did not participate in the assignment process."*

III. Examination and Oversight of NRSROs

- Moody's does not object to continued use of ratings in federal securities laws if:
  - i) oversight measures are limited and focused on the original[18] recognition criteria;
  - ii) regulators do not pursue inappropriate controls of ratings, which make them less valuable for primary market users; and
  - iii) such oversight does not substantially increase the costs of providing credit rating opinions.

Moody's will not object to continuing oversight of the designated rating agencies so long as the oversight measures are limited and focused on designation criteria similar to those recommended in this response. We believe it to be rational for the Commission to wish to reassess periodically the compatibility of a recognized rating agency with such designation criteria.

We would further suggest that the regulatory oversight and examination regime should be commensurate with that which has been evidenced as necessary by the industry practice. To that end, should the Commission decide to pursue a designation system, we urge that the continuing oversight procedures be proportionately tailored for the rating agency industry. For instance, rating agency regulation should not be modeled after the auditing, investment banking, investment advisory or brokerage industries.

Any regulatory regime that may have the ramification of inhibiting rating agencies from issuing independent rating opinions does not serve the best interests of the market. To that end, Moody's would recommend that the Commission carefully balance the public interest in oversight with the public interest in fearless and robust information gathering, analysis, and dissemination by the agencies.

[18] Please see section II. B. in this response, wherein we discuss our views on appropriate recognition criteria.

A. Increased Exposure to Litigation Will Have a Chilling Effect

- Ratings are forward-looking, probabilistic opinions, and should not be exposed to liability standards that treat them as either statements of fact or investment recommendations. Moody's would oppose oversight that would:
  - i) materially increase civil litigation for producing ratings or research, or
  - ii) control the bases on which we reach our rating opinions or the ratings themselves.
- As such, Moody's strongly urges the Commission to refrain from imposing oversight measures which would increase rating agencies' exposure to litigation, including any suggestion that individual rating opinions should be subjected to an inappropriate, 20:20 hindsight "rightness" or "wrongness" test.

1. Appropriate liability standard for opinions

A credit rating is an opinion about the future,[19] not a statement of fact, about the ability of a company to meet its debt obligations in a timely manner. It is based on information the agency has gathered and analyzed. It is forward-looking and predictive, resting on the agency's assessment of the information it has gathered, and in light of the agency's experience in rating other companies. Credit ratings provide only one element in support of the investment decision-making process. They are not, nor should they be treated as, recommendations, guarantees or statements of historical fact. Therefore, ratings should not be exposed to a liability standard that treats them as something they are not and have never purported to be.

A well-reasoned opinion may nevertheless be disagreed with by others, or may not in the end "come true." By way of example, no one can predict the future and similar to an insurance company which is uncertain as to exactly which holder will in fact draw on its policy, a rating agency is uncertain about exactly which issuer will default. However, insurance companies over time have learned to correlate certain factors with longevity and to assign greater or lesser weight to each factor. Thus, they know that over the next five years more 80 year-old smokers will die than 20 year-old non-smokers; and they know that over the same time period some 80 year-olds will live and some 20 year-olds

[19] Admittedly, simply characterizing one's statement as an opinion is not sufficient. That is why a real estate attorney's title opinion and an auditor's opinion regarding financial statements are not entitled to protection as "opinions" *per se* as they concern historical events and they are factual; i.e., who the prior owners of a parcel of real estate were is a fact, not an opinion, as is a statement about a company's revenue last quarter.

will not. However, they simply cannot name names. Rating opinions are analogous to actuarial opinions in this regard.[20]

Further, because ratings are at their core opinions, and speech on matters of public concern, they fall squarely under the protection of the First Amendment of the U.S. Constitution. It is the fundamental premise of that Amendment that "the marketplace of ideas"[21] thrives only when opinion providers have the "breathing space"[22] to express their thoughts without fear of retribution. An opinion (unlike a statement of fact) cannot be "true" or "false."[23] As such, the First Amendment has over time been interpreted to provide ratings with substantial protection from liability. The rating agency is entitled to decide what information to take into account, what weight to place on it, and what conclusions to draw from it.

Finally, it is the rating agency's task to make unbiased and sometimes unpopular observations regarding powerful and prestigious issuers. It is in the nature of the business that our opinions are at times neither welcomed nor applauded – not by the issuers, underwriters, governments, or current holders of the issuer's securities. We are not aware of a single instance where an issuer publicly stated that the rating of its company was too high or that a downgrade was needed. The unpopularity of some of our opinions is understandable. If, for example, an issuer's obligations are downgraded it may impact the issuer's borrowing costs, or an investment manager's ability to hold the security of that issuer. The issuer or investor may, therefore, be frustrated with our rating opinion and may contest the "rightness" of our rating.

2. Document retention and production

While Moody's does not object to the retention of documents, we would oppose measures that required NRSROs to *routinely* produce documents to the Commission as part of the oversight mechanism. We believe that it is part of the rating business to retain certain documents of which we, as opinion providers, repeatedly make use. Yet, the production of such documents to the Commission either in its capacity as the regulatory authority with oversight powers, or in its investigatory role, will *de facto* increase our exposure to civil litigation. Even assuming that a rating agency did not object to producing documents to the SEC, plaintiffs' attorneys would be certain to cite the agency's production to the SEC

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[20] But if a Aaa company defaults within a one year time-period, the rating agency which assigned that rating did not get it "wrong," similar to an insurance company that did not get it "wrong" if a 20 year-old non-smoker dies within a year of writing a policy.

[21] *Red Lion Broadcasting Co*. v. *FCC*, 395 U.S. 367, 390 (1969) ("It is the purpose of the First Amendment to preserve an uninhibited marketplace of ideas in which truth will ultimately prevail . . . .") (citing *Abrams* v. *United States*, 250 U.S. 616, 630 (1919) (Holmes, J., dissenting) ("the ultimate good desired is better reached by free trade in ideas . . . the best test of truth is the power of the thought to get itself accepted in the competition of the market").

[22] As stated in *New York Times* v. *Sullivan*: "That erroneous statement is inevitable in free debate, and that it must be protected if the freedoms of expression [] are to have the 'breathing space' that they 'need . . . to survive,'" 376 U.S. 254, 271-72 (1964) (citation omitted), has been at the core of the First Amendment's protection of the freedom of expression and the freedom of opinion.

[23] *Gertz* v. *Robert Welch, Inc*., 418 U.S. 323, 339-40 (1974) ("Under the First Amendment there is no such thing as a false idea. However pernicious an opinion may seem, we depend for its correction not on the conscience of judges and juries but on the competition of other ideas.").

as a waiver of the agency's journalists' privilege. Producing documents to the SEC could thus become tantamount to making the documents public, or at least public for purposes of the plaintiffs' bar.

Such documents may include not only our work product, but also any material we may have gathered from the issuer. There are two potential unintended but quite negative outcomes:

i) Erosion of the protections for privileged and confidential information, and increased availability of rating agencies' internal documents, will likely lead to an increase in frivolous litigation over the "correctness" of our individual rating opinions. As we noted above, this increase in litigation will discourage analysts from releasing non-conforming rating opinions. It is our position that measures that limit the ability of market participants to speak freely and interact openly are detrimental to overall market transparency and ultimately to the fundamental goals of securities law.

ii) It is likely that issuers will refrain from having discussions with us about their business. Such an outcome will reduce the sources of information upon which our rating opinions are based, and may in the long run damage the quality of our ratings. In the near term, however, it may potentially increase the volatility of our ratings as we will no longer be privy to the issuer's perspective of its business. Rating agencies may, thus, be left to take action on market rumors. We would suggest that such an outcome would undermine the purpose of using ratings in the securities law framework.

3. Unintended consequence - chilling effect

It is both conceivable and likely that if regulation exposes rating agencies to increased litigation and litigation costs, rating analysts would be urged to limit dissemination of objective, insightful and at times controversial opinions. The potential of a challenge on the ***"rightness"*** of the opinion each time one is published would eventually, almost certainly, discourage rating agencies from forthright opinions. Rating agencies would moderate their commentary, and potentially distort rating results to minimize administrative sanctions and/or civil actions.

Moreover, regulation that includes routine document production or efforts to control the bases on which we reach our rating opinions might cause rating agencies to decline to provide opinions about companies in more volatile industries, and companies with less clear or potentially misleading disclosure practices. Such an outcome would reduce comprehensive coverage, thus reducing the public good attribute of ratings which offers investors a tool for broad comparability of credit quality. It would also remove opinions from the market concerning exactly the companies about which investors would most benefit.

Conclusion

Moody's acknowledges that use of ratings in federal securities laws is perceived by many to support existing public policy objectives. Yet ratings and rating agencies primarily seek to meet the demands of participants in the market for credit-sensitive securities. Thus, the ongoing evolution of ratings should not necessarily be expected to maximize their value for regulatory use. In order to retain their primary value to market participants, credit ratings must continue to develop and keep pace with the evolution of the capital markets more broadly, not become static objects in regulation.

We thank the Commission for this opportunity to share our thoughts and opinions on any potential regulatory initiative upon which it may choose to embark. We look forward to further discussions in the near future.



Raymond W. McDaniel

Annex 1

The Use of Ratings in Securities Law

Market Efficiency[24]

Informational asymmetry is an enduring characteristic of markets. Sellers generally have more information about the good or service than buyers. In the context of the fixed income market, an issuer of a bond will, as a matter of course, have far more information about itself than is available to a potential investor. Such information can be important to enable the investor to assess the likelihood of that issuer's ability and willingness to pay. However, in the absence of some compelling force, most investors will remain ignorant of at least some important information.

This lack of transparency could lead to an environment wherein fewer transactions would be completed, and more of those transactions which are completed would likely be incorrectly priced. In the interest of market efficiency, the securities laws have sought to make transparency compulsory through a combination of information disclosure requirements and use of securities ratings and other publicly available information in regulations.[25]

1. Regulatory Use of Ratings – Ratings as Public Goods[26]

"Public goods" are a well-known economic concept. What has not been widely recognized, however, is the degree to which securities information from non-issuer sources constitutes a public good. The key characteristic of a public good is the non-excludability of users who have not paid for the good. People benefit regardless of whether they contribute to the costs of producing the good or not.

A rating is a symbol that encapsulates and conveys the agency's opinion about the likelihood of timely debt repayment. Once a rating has been publicly disseminated, one investor's use of the rating does not prevent another investor from using the same rating in exactly the same way, at exactly the same time. Therefore, publicly disseminated ratings are non-excludable.

The principal attributes of the ratings process and rating opinions as demanded by market users are:

(i) independence, including effective management of potential conflicts of interest;

(ii) predictive content;

(iii) relative stability;

(iv) comprehensive coverage to allow for comparison in the investment decision process; and

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[24] For the analysis in this section, *see generally* Joel Seligman, THE TRANSFORMATION OF WALL STREET 70 (1995); Marc I. Steinberg, UNDERSTANDING SECURITIES LAW 1 (2d ed. 1996); United States Securities and Exchange Commission, *The Investor's Advocate: How the SEC Protects Investors and Maintains Market Integrity*, *available at* http://www.sec.gov/about/whatwedo.shtml.

[25] *See generally* Frank H. Easterbrook and Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669 (1984); *see also* John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717,723 (1984); Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. Chi. L. Rev. 1047.

[26] For a discussion of information as a public good, *see generally* Coffee, *Market Failure*, *supra* note 27, at 722 ; John C. Coffee, Jr., *Beyond the Shut-Eyed Sentry: Toward a Theoretical View of Corporate Misconduct and an Effective Legal Response*, 63 VA. L. REV. 1099 (1976).

(v) broad, public and free dissemination.

Thus, from a public policy standpoint it is understandable why the private rating agency system has provided a helpful tool in support of regulatory objectives. Ratings condense a great deal of research into easy-to-use symbols that are relatively stable and accessible to all. In effect, they can be likened to other tools used by securities laws to promote transparency and stability in the capital market.[27]

As a result, regulatory authorities have increasingly utilized ratings as mechanisms to address dual policy goals of promoting transparency and limiting unnecessary volatility in the financial market. Over time, the regulatory use of ratings has proliferated. Securities regulators, banking regulators, insurance regulators, and legislators who oversee the activities of regulated entities use ratings. These forms of use have been similarly replicated in the private sector through adoption of ratings as proxy tools for portfolio composition and governance guidelines.

2. Market Use of Ratings

Moody's ratings provide predictive opinions on one characteristic of a corporate entity's financial enterprise – its likelihood to repay debt in a timely manner. In Moody's view, the main and proper role of credit ratings is to enhance transparency and efficiency in debt capital markets by reducing the information asymmetry between borrowers and lenders. We believe this function to be beneficial for the market as it enhances investor confidence and allows borrowers to have broader access to funds.

Yet, as discussed above, our ratings have a number of specific characteristics that have incrementally and over time encouraged their adoption across a wide range of functions. They are employed by issuers, intermediaries, counterparties to financial and commercial contracts, and large institutional investors, among others. Each group has different intended objectives in using ratings.

It is the role of ratings and the job of rating agencies to strike the appropriate balance and meet the demands of participants in the markets for credit-sensitive securities. Consequently, the attributes of the ratings process and ratings have evolved to serve the needs of these market participants. Moreover, the ongoing evolution of ratings should not necessarily be expected to maximize value for use in securities laws.

3. Competitive Landscape

As explained previously, Moody's and the other credit rating agencies operate within a framework wherein our ratings are used by numerous entities with sometimes opposing objectives and requirements. Investors associate "quality" with the most reliable ratings, while issuers associate "quality" with the highest possible plausible rating.[28] Many issuers and investment bankers would welcome a greater ability to select among ratings providers for purposes of having greater control over the rating outcome, which they perceive will positively influence the marketability of their debt.

New market entrants and marginal participants historically have sought to make their products more attractive to issuers by offering more "flattering" ratings than do more established market participants.[29] New entrants will understandably be inclined to compete in this manner because of the ease with which such a strategy could be implemented and the short-term benefits that might accrue to the entrant as a result.

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[27] One class of proxy tools for transparency is securities law. *See generally* Schwarcz, *The Rating Agency Paradox*, *supra* note 4.

[28] It is possible that a higher rating will provide lower cost funding options for the issuer. It is also possible that a low rating will potentially increase the cost of funding for the issuer, or in certain cases will impede the issuer's access to certain markets.

[29] *See* Richard Cantor & Frank Packer, *The Credit Rating Industry,* FED. RES. BANK OF NEW YORK Q. REV., Summer/Fall 1994. We note that Richard Cantor is presently an employee of Moody's.

Annex 2

Managing the Potential Conflict-of-Interest Created by the Issuer-Pays Structure

a. Among the elements of Moody's rating system management that demonstrate objectivity and mitigate latent conflicts are:

i. **Fundamental rating policies**. Moody's has adopted certain fundamental rating policies:

- The level of ratings are not affected by a commercial relationship with an issuer;
- Moody's will not forebear or refrain from taking a rating action based on the potential effect of the action on an issuer; and
- Rating actions will reflect judicious consideration of all circumstances influencing an issuer's creditworthiness

ii. **Little customer concentration.** No issuer represents more than one and one-half percent of Moody's annual revenue, and the vast majority represents less than one quarter of one percent each.

iii. **Annual "report card".** The predictive content and performance history of Moody's ratings is measurable, measured, and published each year—both in the form of Moody's Default Studies, and through third-party academic analysis and commentary.

iv. **Rating changes.** Despite the issuer-fee based business-model, actual global performance over the last 18 years shows that, on average, 15% of issuers experienced downgrades annually versus only 9% of issuers that experienced upgrades.

v. **Market discipline.** The market reviews the work of rating agencies on a daily basis.

vi. **Fixed fee schedules.** In general, Moody's charges fees according to written schedules; fees are disclosed in writing as part of the rating application.

vii. **Separation of the analyst from the business relationship.** The analyst is not a party to discussions regarding payment or prices. A separate, non-analytical group within Moody's handles such matters. That group involves the Team Managing Directors ("TMDs") as necessary.

viii. **No relationship between analyst compensation and revenues from rated issuers.** Analysts are not evaluated on or compensated for the revenues associated with the companies they rate.

ix. **No analyst-specific conflicts of interest.** As a matter of policy, rating analysts are not permitted to hold or trade in the securities of issuers they analyze, apart from holdings in diversified mutual funds.

x. **Protection of the credit process regardless of issuer payment status.** Unpaid published ratings are subject to the same standard of analysis and rating committee process as paid ratings.

b. **Advisory Services:** We would recommend that if NRSROs engage in ancillary business activities, they disclose operating guidelines that protect the integrity of their public ratings

Should a rating agency decide to provide ancillary services, the guidelines and procedures for such services should be disclosed to the market.

Moody's provides a Rating Assessment Service (RAS), which we offer as part of our rating services. RAS is a formalization of an activity that has been inherent in the rating process since the first issuer asked John Moody "what would happen to our rating if we did X?" Moody's engages in this form of dialogue with issuers regularly and without separate compensation. The formal RAS service is an accommodation to issuers who are

considering a complex or significant transaction in a limited time frame and want us to devote more significant resources to the assignment than would normally occur. Moody's charges a separate fee for that service. The RAS service is not now, nor is it expected to become, a consequential contributor to our revenue.[30]

In recognition that certain types of situations may present an inappropriate level of conflict for Moody's, we do not offer RAS to issuers if, for example:

i. the issuer is not prepared to deliver a fully developed hypothetical scenario.

ii. the scenario involves a merger or acquisition of a rated entity that could be legitimately construed by the acquirer, the target, or the market as "hostile."

iii. the issuer is under review or on Moody's Watchlist for possible near-term rating action.

Our terms for offering RAS make clear to issuers that RAS determinations may not be the same as the final public rating outcome. Final ratings are always based on the actual facts and circumstances at the time of the rating.

Finally, the parent company of Moody's Investors Service, Moody's Corporation, owns another subsidiary, Moody's KMV (MKMV). MKMV provides credit processing software, credit training, and credit risk assessment models to clients such as banks and asset managers. There is a strict firewall policy between MKMV and Moody's Investors Service.

[30] Presently, it accounts for approximately 1% of overall revenue.

Annex 3

Internal Procedural Safeguards

Protection of Confidential Information

- *Structural policies and procedures*

i. **Prospective Rating Change** - Analysts are prohibited from selectively discussing any future rating actions with any third party, including subscribers, investors, or the media.

ii. **Issuer specific confidential information** - Analysts are prohibited from publishing or in any way discussing non-public information received from issuers with third-parties.

iii. **Disclosure prohibition.** Analysts are required to not disclose any confidential information to any third party and to sign a confidentiality agreement, ensuring that they are aware of this requirement.

iv. **Data protection and integrity** - Moody's has recently introduced, on a system-wide basis, a means of automatically "locking" all employees' computer screens (thus preventing unauthorized access) after 30 minutes of inactivity. Logging onto the internet is monitored on a daily basis. Remote access to Moody's server is highly restricted through the use of password protection and a "virtual private network" software system.

Measures relating to Moody's physical premises

i. **Access to the building** - Only Moody's employees, with a valid identification card, have access to the Moody's offices in an unfettered way.

ii. **Outside visitors -** Upon arriving at Moody's reception area, all visitors to Moody's are directed to Moody's "public meeting" rooms, where analysts meet them.

iii. **Physical security measures** - Documents are stored, in the first instance, in the analysts' offices and on their computers. Analysts' computers, particularly laptops, are to be locked and secured.

- *Securities trading policy*

i. ***No conflicts with respect to the trading or ownership of securities.*** *As a matter of policy, apart from holdings in diversified mutual funds, Moody's analysts are not permitted to:*

- buy or sell a security if the analyst is aware of non-public and material information relating to the security or the issuer of the security;
- buy or sell any security of an entity within the analyst's assigned area of primary analytic responsibility. An employee has primary analytic responsibility for any entity rated by the employee's industry team; or
- own any security that could be affected by a rating action in which the employee directly or indirectly participates.

ii. **Trading restrictions.** Analysts are required to refrain from trading securities based on non-public information and to submit securities' trading compliance forms on a quarterly basis. The completion and content of such forms is monitored internally.

iii. **Quarterly Compliance Certificate:** Moody's employees are required to submit a signed "Quarterly Compliance Certificate" no later than 10 days after the end of the quarter. This constitutes an acknowledgement by the employee that they have read, are aware of and agree to comply with Moody's policies regarding securities trading.

- *Employee training and awareness*

As part of Moody's credit training program, which was instituted in the past several months, the importance of maintaining the confidentiality of non-public information will be further reinforced and analysts will be reminded of the appropriate handling of such information.