Moody's Investors Service

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Hon. Steven M.H. Wallman
U.S. Securities and Exchange Commission
450 5th Street, N.W.
Washington, D.C. 20549

Re: Use of Private Sector Ratings in Regulation
File Nos. S7-23-94 and S7-24-94

Dear Commissioner Wallman:

Pursuant to the request contained in your letter, dated 18 May 1995, Moody's is pleased to offer certain suggestions with respect to how certain regulations administered by the SEC might be revised to eliminate the reliance therein on debt ratings. In offering the following suggestions, we assume the reader's familiarity with Moody's letters, dated 5 December 1994, bearing the above-captioned file numbers.

I. Ratings Used in Lieu of Disclosure: 1933 Act and 1934 Act Forms

Certain forms promulgated under the Securities Act use ratings essentially as a substitute for disclosure. Satisfaction of a condition that a rating be assigned to an issue of securities may be a criterion for use of a streamlined form for registration of such securities or may enable a registrant to reduce the amount of information that it would otherwise be required to disclose. In proposing the use of ratings as a transactional eligibility criterion, the SEC stated:

> Under the second Transaction Requirement any registrant which meets the Registrant Requirements, even one which does not meet the float criteria, would be able to register certain high grade non-convertible debt securities, defined as "investment grade debt securities," on Form S-3. ***This proposal reflects the views of a number of commentators on the ABC Release and the Commission's position that with respect to offerings of high quality debt issues a detailed prospectus is unnecessary since such securities are generally purchased on the basis of interest rates and security ratings.***[46] Formerly, the Commission provided a short registration statement, [F]orm S-9, which permitted the registration of certain high quality debt securities.[47] The criteria for use of former Form S-9 related primarily to the quality of the issuer. They included net income during each of the registrant's last five fiscal years, no defaults in the payment of principal, interest or sinking funds on debt or of rental payments for leases, and various fixed charge coverages (at least three for utilities and six for other industries). While these eligibility criteria delineated the type of

> issuer of high quality debt for which Form S-9 was intended, certain of its requirements may have overly restricted the availability of the form. ***Rather than base the availability of Form S-3 on specified quality of the issuer criteria, the Commission believes that security ratings are a more appropriate standard. In addition to considering indicia of the quality of the registrant, security ratings are also based on marketplace information[48] about the registrant which is analogous to the efficient market for widely followed equity securities***. Moreover, security ratings issued by nationally recognized statistical rating organizations are widely used and relied upon by the marketplace. Thus, security ratings appear to provide a recognized criterion for the use of proposed Form S-3.
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> [46] These commentators indicated their belief that persons who invest in debt securities generally require less disclosure than equity investors and usually are primarily interested in the bond or credit rating and information on general credit market conditions.
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> [47] Form S-9 was rescinded on December 20, 1976, because it was being used by only a very small number of registrants. The Commission believed the lack of usage was due in part to interest rate increases which made it difficult for many registrants to meet the minimum fixed charge coverage standards required by the Form. Securities Act Release No. 5791 (December 20, 1976).
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> [48] *See* H. Sherwood, HOW CORPORATE AND MUNICIPAL DEBT IS RATED, John Wiley & Sons, New York, at 22 (1976).

See, Release No. 33-6331, *Reproposal of Comprehensive Revision to System for Registration of Securities Offerings* (6 Aug. 1981) (emphasis added).

Although Moody's believes that the integrated disclosure system has served the market reasonably well since its adoption, we take issue with the use of ratings therein. The use of ratings in the integrated disclosure system was premised on the notion that if a security has an "investment grade" rating there must already be adequate information about the security available in the public domain and such information is fully reflected in the security's price. This is not factually correct. Experience since 1981 has clearly demonstrated that for many types of debt securities, investors must consider important factors beyond merely interest rates and credit ratings. In addition, to the extent that certain ratings may be based on non-public information,[1] reliance on ratings as a transactional eligibility criterion serves only to undermine the core premise of the integrated disclosure system.

Ratings presuppose adequate information in the public domain, and the use of ratings as a basis for altering or reducing a registrant's disclosure obligations will therefore ultimately undermine both the basis of the ratings business and the SEC's disclosure regime.

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[1] As discussed in Moody's letters, dated 5 December 1994, the information contained in a registration statement *should* always be sufficient for rating a security. However, Moody's generally receives both public and non-public information in connection with rating SEC-registered securities. In addition, ratings of privately placed securities are typically based on non-public information and ratings of certain securities of non-U.S. issuers may be based on information that is not generally available to the public.

Form S-3 is available for registration of certain offers and sales of non-convertible "investment grade securities" (General Instruction I.B.2.) and "investment grade" asset-backed securities (General Instruction I.B.5.). The instructions to the Form should be revised to eliminate the "investment grade" criterion. Form S-3 should be made available to all asset-backed securities regardless of credit quality. In addition, with respect to other non-convertible debt and preferred securities, a float test similar to the one used in General Instruction I.B.1. should be substituted for the rating criterion in Instruction I.B.2. A suitable float test for instruction I.B.2. would require that the aggregate market value of all publicly traded securities of the registrant held by non-affiliates of the registrant be $350 million or more.

Part of Form S-4 refers to the "investment grade" standard of Form S-3. If Form S-3 is changed as proposed above, Form S-4 will obviously need to be conformed.

Likewise, Schedule 14A under the Exchange Act refers to the "investment grade" standard of Form S-3. If Form S-3 is revised as proposed, corresponding revisions to Schedule 14A will be in order.

Forms F-1, F-2, F-3, F-4, and 20-F all apply to the registration of offers and sales of securities by certain foreign private issuers. Each form permits certain reductions in required disclosure if the registrant is issuing non-convertible, "investment grade" debt. The preferential treatment for "investment grade" debt should be eliminated by requiring all registrants to use Item 18 of Form 20-F and by eliminating the special treatment of "investment grade" securities in paragraph (b)(2)(i) of Form F-2.[2] The fact that a foreign registrant's securities have been assigned a rating at or above a particular level should not in and of itself be used as justification for depriving potential investors in such securities of the benefits of full disclosure with respect thereto.

Form F-9 applies to the registration of "investment grade" debt or "investment grade" preferred securities of certain Canadian issuers. For purposes of Form F-9, the term "investment grade" encompasses ratings issued by Canadian rating agencies as well as by agencies designated by the SEC as "nationally recognized statistical rating organizations" (NRSROs). In general, the Form permits a registrant to use standards of disclosure embodied in Canadian securities regulation. For the same reasons stated above, the rating criterion should be eliminated from Form F-9 and should be replaced by the same float test proposed above for Form S-3.

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[2] Forms F-1, F-2, F-3, and F-4 permit a registrant to utilize Item 17 instead of Item 18 of Form 20-F when issuing non-convertible, "investment-grade" debt securities under certain circumstances. The two major differences between Item 17 and Item 18 of Form 20-F are: (i) Item 18 requires disclosure of all information required by GAAP and Regulation S-X while Item 17 requires only a subset of such information, and (ii) the financial statements presented by an issuer that can use Item 17 do not have to comply with SFAS 14. Paragraph (b)(2)(i) of Form F-2 permits a waiver of the requirement that a registrant be subject to Section 12 or 15(d) of the Exchange Act for at least three years, if the securities being registered are "investment grade".

II. Ratings Used in Lieu of Merit Regulation

Rule 3a-7 under the Investment Company Act (the "ICA") establishes a safe harbor for issuers of "investment grade" asset-backed securities. Availability of the safe harbor should not depend on the rating assigned to any issue of asset-backed securities. As we have noted in previous letters to the SEC, ratings address only the credit dimension of risk and generally do not specifically address the abusive practices that the ICA was designed to prevent. In its report, *Protecting Investors: A Half Century of Investment Company Regulation*, the SEC acknowledged that "the Act . . . is not intended to protect investors from credit risk," but rather is more concerned about "abusive practices such as self-dealing and overreaching by insiders, misvaluation of assets, and inadequate asset coverage." Although Moody's shares the SEC's concerns and takes such considerations into account in its rating process, there is no guarantee that Moody's or any other NRSRO will share the same concerns or maintain the same analytical standards in the future. Accordingly, ratings issued by private sector entities may not provide the measure of overall safety that is implied by their use in Rule 3a-7. The rating requirement should be eliminated from the Rule, and the SEC should amend Rule 3a-7 to capture more appropriately the SEC's concerns regarding such abusive practices or, alternatively, the scope of the Rule should be expanded to include all asset-backed securities that would otherwise qualify under the Rule.

III. Ratings Used to Permit Otherwise Impermissible Conduct by Dealers and Investment Companies

Paragraph (a)(4)(xiii) of Rule 10b-6 under the Exchange Act exempts "investment grade" debt securities from the general prohibition against trading by persons interested in a distribution. The exemption was adopted in 1983 (Release No. 34-19565) based upon the belief that "the fungibility of certain investment grade debt securities makes manipulation of their price very difficult" because "investment grade debt and preferred securities are traded on the basis of their yields and financial ratings and therefore are largely fungible." Since 1983, however, it has become clear that the assumption of fungibility is flawed, especially with respect to securities that embody significant non-credit risks. Accordingly, the exemption contained in paragraph (a)(4)(xiii) should be based on a float test (as the SEC considered prior to adopting the exemption) or should be eliminated entirely.

Rule 10f-3 under the ICA exempts certain purchases of securities from the general prohibition of Section 10(f). Subsection (c) of Rule 10f-3 extends the exemption to certain municipal securities that are rated "investment grade" or that, if the issuer has not been in continuous existence for at least three years, are rated in one of the three highest rating categories. The proposing release (Release No. IC-10592 (13 Feb. 1979)) for amendments to the Rule states that:

> As a condition to purchasing municipal securities during the underwriting period, the Commission in its orders under section 10(f) has required that, on the date of purchase, the issue have an investment grade rating from Standard & Poor's Corporation or Moody's Investors Service, Inc.; provided, however, that if the issuer of the securities, or the entity supplying the revenues from which the issue is to be paid, was in continuous operation for less than three years,

> including the operation of any predecessor, the issue would be required to have received a rating of "A" or better from such rating services.

The clear implication of the Release is that the rating standard used in Rule 10f-3(c) was intended to serve as a measure of overall investment quality. As discussed above, ratings do not provide such a measure. Accordingly, the rating standard should be removed from subsection (c) of Rule 10f-3 and the exemption for securities rated at certain levels should be eliminated.

Rules 138 and 139 under the Securities Act extend favorable treatment to broker-dealers that publish information on certain "investment grade" securities issued by private, non-reporting, foreign companies. This favorable treatment is otherwise available only to securities of reporting companies or to companies that have a minimum float. Such favorable treatment should be restricted to only those securities that fully meet the appropriate registrant and transaction requirements of Form F-3, by eliminating the references to “investment grade securities provisions” in paragraph (c)(3) of Rule 138 and paragraphs (a)(1) and (a)(2) of Rule 139.

IV. Ratings Used to Permit Relaxed Disclosure Procedures

Rule 434 under the Securities Act specifies liberalized procedures for delivery of prospectuses in certain offerings of “investment grade” securities. Instead of having to prepare a traditional unified prospectus, the relevant offerings can be made through a prospectus delivered in pieces. The Rule does not reduce the substance or the amount of disclosure required. Although Rule 434 does not use ratings as a direct substitute for disclosure, such substitution is the practical effect of the Rule in some cases. In practice, the Rule results in a lower level of investor understanding in the case of certain securities — especially complex instruments such as asset-backed securities. Rule 434 should be rescinded. Alternatively, should the SEC decide that the cost of rescinding Rule 434 would outweigh the benefits, the scope of the rule should be expanded to cover all firm commitment underwritten offerings of securities for cash without regard to the rating of the securities.

V. Ratings Used As an Indication of Credit Quality

Rule 2a-7 under the ICA is arguably the only SEC rule that uses ratings in a manner consistent with their design. The rule uses ratings in a merit regulation context to limit investment by money-market funds in commercial paper issued by all but the most creditworthy issuers. The rule is intended to alleviate concerns arising from the perceived use by investors of money-market funds as a substitute for FDIC-insured bank accounts. The rating requirements of the rule were motivated, in part, by the highly publicized defaults of certain commercial paper issuers, *e.g.*, Integrated Resources, and a desire to prevent money market fund shares from "breaking the buck".

Although the rating requirements of Rule 2a-7 may contribute to limiting investment by money-market funds in risky investments, the rating requirements should be deleted from the rule. Instead, the board of directors of each fund should be responsible for determining that the investments made by that fund present minimal credit risks.[3] A fund's board of directors should have the freedom, in selecting investments for the fund, to disagree with the opinions of rating agencies, but the board should be required conspicuously to disclose the fund's policies toward credit risk. Following a revision of Rule 2a-7 to eliminate the rating requirement, the boards of many money-market funds might reasonably adopt investment policies that employ ratings as a benchmark. However, the funds should not be *required* to incorporate ratings into their investment policies and, more significantly, should not be required, as Rule 2a-7 now encourages them to do, to substitute a fundamentally arbitrary rating standard for the independent exercise of discretion by boards and their delegates.

VI. Ratings Used As Measures of Price Volatility

Rule 15c3-1 under the Exchange Act uses ratings in connection with the determination of haircuts applied to securities in the calculation of a broker-dealer's required net capital. Securities that have received an investment grade rating receive a more favorable (*i.e.*, smaller) haircut. Although the use of ratings in this context is apparently based to some degree on credit risk concerns, the primary focus of the haircut system seems intended to address price volatility and liquidity concerns. Indeed, the haircut system is predicated on the notion that securities held by a broker-dealer can be rapidly liquidated to raise cash.

The traditional credit ratings published by NRSROs do not address price volatility and liquidity. This is true for all types of bonds but is most readily apparent in the case of structured notes and mortgage-backed securities.

The investment grade rating standard of Rule 15c3-1 should be deleted and replaced with a standard based on price volatility. Although a shift to a volatility-based haircut system would somewhat increase the administrative burden of calculating securities haircuts, the increased burden would not be unreasonable. In fact, such an approach is used by the bank regulatory agencies in connection with the determination of whether a given mortgage-backed security constitutes a "high risk mortgage security". The Federal Financial Institutions Examination Council (FFIEC) has promulgated a three-part test that all regulated financial institutions must periodically perform on all mortgage derivative products in their portfolios.[4] The test classifies a mortgage-backed security as a "high-risk mortgage security", if the security passes any one or more of three subtests:

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[3] In proposing Rule 2a-7, the SEC chose to employ a "high quality" rating standard in addition to a requirement that a fund's board of directors determine that investments present only minimal credit risk. *See* Release No. IC-12206 (1 Feb. 1982) (text accompanying n.25). However, in the adopting release for the Rule, the SEC noted that "[s]ome commentators believed that the rule should rely totally upon fund management to judge the quality of instruments and recommended deleting the requirement that the instruments, if rated by a third party, receive a high quality rating." *See* Release No. IC-13380 (11 July 1983) (text accompanying n.31).

[4] Federal Financial Institutions Examination Council, Supervisory Policy Statement on Securities Activities, 57 Fed. Reg. 4028 (3 Feb. 1992).

- the security has an expected weighted average life greater than 10.0 years;
- the expected weighted average life of the security would either (i) increase by more than 4.0 years or (ii) decrease by more than 6.0 years, as a result of an assumed immediate and sustained parallel shift in the yield curve of plus or minus 300 basis points; or
- the estimated change in the price of the security resulting from an assumed immediate and sustained parallel shift in the yield curve of plus or minus 300 basis points would exceed 17 percent.

All financial institutions, from the largest to the smallest, are required to apply the test. Many apply the test by using a standardized calculation model available through the Bloomberg® system. Administration of the test is generally routine and mechanical. Examiners have discretion, however, to challenge any unreasonable assumptions used in performing the test's calculations. A similar (perhaps even identical) approach could and should be used for distinguishing among securities for differing haircut treatment under the uniform net capital rule.

VII. Ratings Referred To, But Not Substantively Used, in Regulations

In addition to the forms and rules discussed above, several rules refer to, but do not in fact make use of, ratings. For example, Rule 134 under the Securities Act permits the disclosure in tombstone advertisements of ratings assigned by NRSROs. Rule 134 should be revised to permit the disclosure of all ratings without regard to the status of the rater as an NRSRO.

Rule 436 under the Securities Act exempts ratings assigned by NRSROs from the regular consent requirement applicable to reports and opinions of experts. The scope of Rule 436 should be extended to all ratings without regard to the status of the rater as an NRSRO.

Rule 10b-10 under the Exchange Act requires broker-dealers to disclose specified information in writing to customers at or before completion of a transaction, including, for certain securities, the absence of a rating assigned by an NRSRO to the subject security. This provision should be dropped from the Rule.

Form 17-H under the Exchange Act requires a listing of the securities holdings, borrowings, and extensions of credit of "material associated persons" of regulated brokers and dealers. The ratings assigned by NRSROs to commercial paper used as a source of funding are required to be listed. The requirement that ratings be listed should be eliminated.

Guide 6 of Form N-2 under the ICA mandates certain disclosure about ratings that may be assigned by NRSROs to a registrant's senior securities. Although this reference to NRSRO ratings is seemingly benign, it should be removed from the Guide, and the need to disclose ratings and their effects on the registrant's securities should instead be governed by traditional principles of materiality.

Item 10 of Regulation S-K and of Regulation S-B describes the SEC's policy on disclosure of ratings. The relevant provision of Regulation S-K is paragraph (c) of Item 10. In Release No.

33-7086 (31 Aug. 1994), it is proposed that paragraph (c) be deleted and there be substituted therefor a new paragraph (g) to Item 202 providing for certain mandatory disclosures about solicited securities ratings assigned by NRSROs. For the reasons cited in our comment letter, dated 5 December 1994 (File No. S7-24-94), responding to that Release, we favor the deletion of paragraph (c) of Item 10, but strongly urge that proposed paragraph (g) to Item 202 not be adopted to replace it.

Paragraph (e) of Item 10 of Regulation S-B corresponds to Item 10 (c) of Regulation S-K. Paragraph (e) should be deleted from Item 10 of Regulation S-B to conform it to the recommended change in Regulation S-K. For the same reasons cited in the last sentence of the preceding paragraph hereof, we similarly strongly urge that proposed paragraph (d) to Item 202 of Regulation S-B not be adopted to replace Item 10 (e) thereof.

Conclusion

The foregoing suggestions are necessarily somewhat general at this stage. We have not attempted to draft revised language for each affected rule. We are, however, confident that if the Commission in fact desires to eliminate the use of ratings in its regulations, the task of crafting appropriate language will not be a major obstacle.

In the event that you would like to discuss any of these suggestions, please contact either Matthew Molé at (212) 553-7958 or me at (212) 553-0420. We appreciate having had the opportunity to work with the Commission and the Staff on this issue and to articulate our views as to the appropriate resolution thereof.

Very truly yours,

Thomas J. McGuire
Executive Vice President

cc: Matthew C. Molé