



**Dominion**

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June 10, 2005

**Electronic Submission**

Jonathan G. Katz, Secretary  
Securities and Exchange Commission  
450 Fifth Street, N.W.  
Washington, D.C. 20549

Re: *Definition of Nationally Recognized Statistical  
Rating Organization; Commission File No. S7-04-05*

Dear Mr. Katz:

Dominion Bond Rating Service ("DBRS") appreciates this opportunity to comment on the above-referenced proposal to define the term Nationally Recognized Statistical Rating Organization ("NRSRO").<sup>1</sup>

Based in Toronto and with offices in New York and Chicago, DBRS was founded in 1976 by Walter Schroeder, who remains the Company's President. DBRS is employee-owned, is not affiliated with any other organization, and limits its business to providing credit ratings and related research. DBRS is a "generalist" rating agency, in that we analyze and rate a wide variety of institutions and corporate structures, including government bodies, and various structured transactions. At this time, DBRS rates the securities of more than 1000 issuers.

DBRS is widely recognized as a provider of timely, in-depth and impartial credit analysis. Our ratings opinions are conveyed to the marketplace using a familiar, easy-to-use letter grade scale. These ratings, along with comprehensive rationales to support every rating opinion and action, are publicly available on our website, as well as through the Bloomberg network. Moreover, DBRS sponsors seminars and conference calls to promote ratings transparency and to answer questions from market participants. In addition to the publicly released ratings information, DBRS also makes full rating reports, industry studies, commentaries and securitization servicer reports available to paying subscribers. More than 4,500 institutional investors, financial institutions and governmental bodies currently subscribe to DBRS' services.

DBRS was designated as an NRSRO in 2003.<sup>2</sup> Since that time, DBRS has worked with regulatory bodies and industry groups to develop uniform standards to ensure that rating agencies

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<sup>1</sup> Rel. No. 34-51572 (April 19, 2005) 70 Fed. Reg. 21306 (Apr. 25, 2005) ("Proposing Release").

<sup>2</sup> Letter from Annette L. Nazareth, Director, Division of Market Regulation to Mari-Anne Pisarri, Pickard and Djinis LLP (February 24, 2003). DBRS has also been recognized by the National Association of Insurance Commissioners ("NAIC").

such as NRSROs disseminate credit ratings that are independent, objective and credible. For example, DBRS provided input to the International Organization of Securities Commissions ("IOSCO") in the development of the Code of Conduct Fundamentals for Credit Rating Agencies ("IOSCO Code"), and has agreed to abide by that Code.<sup>3</sup> More recently, we have engaged in discussions with SEC staff in an effort to create a framework that will allow the Commission to oversee NRSROs' continued compliance with applicable designation criteria. While this oversight framework is being designed to promote the independence, objectivity and credibility of credit ratings, it is not intended to be used as a way to evaluate the quality of an NRSRO's ratings opinions or to second-guess particular credit ratings decisions. Like the IOSCO Code which will be incorporated into it, the proposed oversight framework will operate on the premise that so long as a rating agency's activities are sufficiently transparent, the marketplace is the best judge of the quality of that agency's ratings opinions.

DBRS applauds the Commission's efforts to bring transparency to the NRSRO designation process by defining the term Nationally Recognized Statistical Rating Organization in proposed new Exchange Act Rule 3b-10. As explained in more detail below, DBRS generally endorses the three components of the proposed definition, although we believe that NRSROs should be required to make more information about their ratings and systematic procedures publicly available than the proposal would require, in order to bring the designation criteria more in line with industry best practices as reflected in the IOSCO Code. Moreover, as one of the most recent NRSRO designees, DBRS believes that a formal application process for designating NRSROs would be preferable to the existing no-action letter process. We further believe that regardless of which methodology is used, an NRSRO designation should remain effective unless and until it is withdrawn by the Commission for cause.

#### **The Nature of Credit Ratings**

The first component of proposed Rule 3b-10 concerns three aspects of the nature of the credit ratings issued by a rating entity. Under the proposed rule, an NRSRO's ratings must be publicly available, must be current assessments of creditworthiness and must relate to specific securities or money market instruments. We address each of these factors in turn.

DBRS agrees that users of credit ratings should not have to pay for access to ratings they employ for regulatory purposes. We also agree that broad dissemination of ratings is essential to the marketplace's ability to assess the quality of an entity's credit ratings. For these reasons, DBRS endorses the Commission's proposal that in order to meet the definition of NRSRO, an

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<sup>3</sup> Code of Conduct Fundamentals for Credit Rating Agencies, The Technical Committee of IOSCO (December 2004).

agency must (except in the case of "private ratings")<sup>4</sup> disseminate its ratings opinions on a widespread basis at no cost. While we do not believe Rule 3b-10 should specify the manner or method that must be used to distribute ratings, we encourage the Commission to confirm that publishing ratings in a readily accessible manner on a company's website will suffice.

We further suggest that the Commission rethink its position that the public availability requirement in Rule 3b-10(a) be limited to just the credit rating symbol and not apply to the agency's rating rationale as well.<sup>5</sup> A rating symbol, without more, is of limited probative value to the marketplace. In arriving at a rating decision, agencies may use a number of different methodologies, make different assumptions and give weight to different factors. While this diversity of approach enhances the safety and soundness of the capital markets, it also places a premium on transparency; in order to judge whether a particular agency's credit opinions have value, one needs to understand how those opinions were formed.

The IOSCO Code recognizes this fact when it states: "When issuing or revising a rating, the [credit rating agency ("CRA")] should explain in its press releases and reports the key elements underlying the rating opinion."<sup>6</sup> We urge the Commission to clarify that in order to qualify as an NRSRO, a rating agency must make not only its ratings, but also its ratings rationales available to the public at no cost. This is not to say that NRSROs may not offer more in-depth credit analyses, reports and consultations to subscribers for a fee. Indeed, such ancillary services are important resources for investors such as mutual fund companies.<sup>7</sup> But sufficient information about credit ratings should be publicly available to allow those ratings to be understood and assessed.

In addition to requiring the public availability of ratings used for regulatory purposes, Rule 3b-10 would also require that such ratings be current assessments of creditworthiness; that is, that they reflect the NRSRO's opinion as to creditworthiness from the time a rating is issued until the time it is changed or withdrawn. The Proposing Release instructs that an agency could meet this requirement by implementing policies and procedures designed to ensure that ratings are monitored on a continuous basis and updated, if necessary, upon the occurrence of material

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<sup>4</sup> "Private ratings" are provided to issuers with the understanding that they will not be publicly distributed. An issuer may request such a rating, for example, in connection with the sale of a debt instrument to a small number of institutional investors or in order to provide a service within a securitization. Because private ratings are not used for regulatory purposes, they would not be subject to the proposed requirement of public dissemination.

<sup>5</sup> See *Proposing Release* at 24, 70 Fed. Reg. at 21311.

<sup>6</sup> IOSCO Code, § 3.6.

<sup>7</sup> *Proposing Release*, note 64.

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events.<sup>8</sup> The Commission does not propose to specify a time within which ratings would need to be updated, instead giving NRSROs the flexibility to respond to material events affecting ratings on a case-by-case basis.

DBRS supports adding a currentness requirement to the NRSRO definition and agrees that outdated assessments could interfere with the intended regulatory uses of credit ratings. We further endorse the Commission's flexible approach to the timing of ratings updates. In both of these areas, proposed Rule 3b-10 is consistent with industry best practices as reflected in the IOSCO Code.<sup>9</sup> However, the Code adds a transparency element that is lacking in the proposed rule. In this regard, Section 1.10 of the IOSCO Code provides:

Where a CRA makes its ratings available to the public, the CRA should publicly announce if it discontinues rating an issuer or obligation. . . . [C]ontinuing publications by the CRA of the discontinued rating should indicate the date the rating was last updated and the fact that the rating is no longer being updated.

DBRS respectfully suggests that a similar concept should apply to Rule 3b-10. Adopting a currentness requirement without a corresponding transparency requirement could mislead the users of credit ratings into thinking that all published ratings reflect the NRSRO's up-to-date opinions on creditworthiness.

The third aspect of credit ratings that the proposed rule addresses concerns specificity. Here, Rule 3b-10 would require that an NRSRO's ratings relate to specific securities or money market instruments, rather than to the general creditworthiness of issuers. DBRS agrees that because the risk of default on different debt instruments of the same issuer can vary considerably, applying a single rating to all such instruments could have adverse regulatory consequences. Thus, DBRS also agrees that in order to qualify as an NRSRO, a rating agency should rate specific securities or obligations and not just issuers. Of course, NRSROs should also be allowed to use issuer ratings to clarify their views or to satisfy investor demand.

### Market Acceptance

Proposed Rule 3b-10's second component provides that in order to be considered an NRSRO, a rating agency must be generally accepted in the financial markets by the predominant users of securities ratings as an issuer of credible and reliable credit ratings. Because DBRS believes that the marketplace is the best judge of what constitutes a reliable credit rating, we also believe that market acceptance is a critically important test for determining whether a rating agency should be designated as an NRSRO. This acceptance can be demonstrated in a number

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<sup>8</sup> *Id.* at 26-27, 70 Fed. Reg. at 21312.

<sup>9</sup> IOSCO Code, § 1.9.

of ways, including proof of substantial use of an agency's ratings by mutual funds, pension plans, broker-dealers and insurance companies; proof that the agency has been retained to rate securities issued by a broad group of well-capitalized firms; or even proof that an agency's ratings are widely cited in the financial and mainstream press.

We also endorse the Commission's proposal to continue its practice of designating limited-coverage NRSROs. Experience has shown that such NRSROs can provide a full and accurate assessment of credit risks in their selected sectors of the debt market and that a limited designation does not inhibit an agency's ability to expand its business into other sectors over time.<sup>10</sup> We believe that designations limited by geographic area may also be appropriate, so long as the agencies seeking such designations can establish that they are recognized by the financial marketplace for issuing credible and reliable ratings within those areas.<sup>11</sup>

One way a rating agency can foster market acceptance (either on a broad or limited scale) is by publishing historical performance studies and data related to its credit ratings. Recognizing that this type of information promotes transparency and enables the market to best judge the performance of credit ratings, the IOSCO Code calls for rating agencies to publish historical default rates of their rating categories unless such information is unavailable or is likely to mislead the users of the ratings.<sup>12</sup> The Commission may wish to include a discussion of this topic in connection with Rule 3b-10 as well.

#### **Use of Systematic Procedures**

The third component of the proposed rule provides that in order to qualify as an NRSRO, a rating agency must use systematic procedures designed to ensure the issuance of credible and reliable ratings, manage potential conflicts of interest and prevent the misuse of nonpublic information. This component also addresses an NRSRO's need to have sufficient resources to comply with the procedures it has adopted.

The Proposing Release identifies a range of factors that the Commission believes should be examined in order to assess a rating agency's compliance with the third component of Rule 3b-10. These include the qualifications of a firm's analysts and the average number of issues

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<sup>10</sup> For example, after receiving a limited-purpose designation in 1991, Thomson BankWatch Inc. successfully expanded its business and received a full NRSRO designation in 1999. See *Proposing Release*, note 22.

<sup>11</sup> Although DBRS supports the granting of limited-scope designations, we do not support the granting of provisional designations. It is not clear what the utility of a provisional rating would be, and maintaining two classes of NRSROs in a given situation would likely cause confusion in the marketplace.

<sup>12</sup> IOSCO Code, § 3.8.

covered by each analyst; the sources of information used in arriving at a ratings opinion, including whether the agency has meaningful access to issuers' management; the rating agency's organizational structure and how that relates to the firm's independence from the companies it rates; how the agency identifies, and manages or eliminates conflicts of interest; the effectiveness of the firm's policies and procedures designed to prohibit the misuse of material, nonpublic information; and the sufficiency of the agency's financial resources to enable it to meet the definitional requirements of an NRSRO and to ensure the integrity of its credit ratings.<sup>13</sup>

DBRS heartily endorses requiring NRSROs to employ systematic procedures to ensure the quality and integrity of their credit ratings, minimize conflicts and prevent the misuse of inside information. We also agree that NRSROs should have sufficient financial resources to be able to comply with these procedures. The implementation and enforcement of such procedures are industry best practices and are the linchpins of the IOSCO Code. We further believe that the Commission has successfully identified the types of factors that are relevant to an assessment of a rating agency's compliance with the NRSRO definition. However, in considering these factors, DBRS respectfully suggests that two overarching principles be observed.

The first is that while it is appropriate for the Commission to evaluate those aspects of a rating agency's operations that relate to the objectivity, credibility and independence of the agency's credit ratings, the Commission should not interpose itself in the process by which a credit analysis is performed or a rating is issued. Because credit ratings are forward-looking opinions, there is no one "right" way to perform a credit analysis or determine a credit rating.<sup>14</sup> The best judge of the content or quality of a credit rating is the marketplace.

The second principle is that rating agencies come in many shapes and sizes and may follow different paths to reach the same end. Therefore, while all rating agencies should adopt and enforce written procedures that address (a) the key processes by which they conduct rating analyses; (b) how they identify, and eliminate or manage potential conflicts of interest that could affect their ratings business; and (c) how they protect, communicate and use material, non-public information, not all policies and procedures across the industry will look the same.

Following these principles leads DBRS to support the Commission's decision not to propose (i) minimum experience and training requirements for credit analysts, (ii) limits on the

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<sup>13</sup> *Proposing Release* at 32-33, 70 Fed. Reg. at 21313.

<sup>14</sup> Given the nature of a credit rating and the distinction between a credit rating and an auditor's report, DBRS commends the Commission for recognizing that a rating agency is not responsible for auditing an issuer's financial condition. *Id.*, note 80. DBRS believes, however, that it would be difficult to impose a broad requirement that NRSROs "test the integrity" of information they receive from issuers and third parties without straying too close to the line between auditors and rating agencies.

average number of securities rated per analyst, (iii) requiring systematic contact between NRSROs and issuers' senior management, (iv) mandating any particular type of organizational structure, or (v) the standardization of rating symbols.

There is one area, however, in which DBRS does not find the third component to be sufficient: transparency. In order for the marketplace to assess the credibility and reliability of an agency's credit ratings, the public must have access to basic information about how those ratings were arrived at. The IOSCO Code recognizes this fact when it states:

The CRA should publish sufficient information about its procedures, methodologies and assumptions . . . so that outside parties can understand how a rating was arrived at by the CRA. . . .<sup>15</sup>

Because users of credit ratings rely on an existing awareness of CRA methodologies, practices, procedures and processes, the CRA should fully and publicly disclose any material modification to its methodologies and significant practices, procedures, and processes. . . .<sup>16</sup>

Likewise, the public must have basic information about how a rating agency manages conflicts of interest if the marketplace is to judge whether that agency's credit ratings are truly independent.<sup>17</sup> In this regard, the IOSCO Code provides:

The CRA should adopt written internal procedures and mechanisms to (1) identify, and (2) eliminate, or manage and disclose, as appropriate, any actual or potential conflicts of interest that may influence the opinions and analyses the CRA makes or the judgment and analyses of the individuals the CRA employs who have an influence on ratings decisions. The CRA's code of conduct should also state that the CRA will disclose such conflict avoidance and management measures.<sup>18</sup>

DBRS respectfully submits that a similar degree of transparency should be required under the third component of Rule 3b-10.

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<sup>15</sup> IOSCO Code, § 3.5.

<sup>16</sup> *Id.*, § 3.10.

<sup>17</sup> Because every credit rating agency faces some type of actual or potential conflict of interest, it is not possible to exclude conflicted agencies from the definition of NRSRO.

<sup>18</sup> IOSCO Code, § 2.6.

### Designation Process

Although the proposed rule defines the term "Nationally Recognized Statistical Rating Organization," it does not address the process by which a credit rating agency attains that status. The Proposing Release states that an entity that meets the rule's definitional standards would automatically be an NRSRO; but the Release goes on to recognize that greater certainty about an agency's status may be required by those entities who use credit ratings for regulatory purposes.<sup>19</sup> In order to provide this certainty, the Commission proposes to continue to make its staff available to designate NRSROs through a no-action letter process.<sup>20</sup> This approach differs from the one the Commission took in 1997, when it last proposed to define what it means to be an NRSRO.<sup>21</sup> The earlier rule proposal, which was never adopted, provided a formal application process for agencies seeking NRSRO status.

Based on its own experience, DBRS submits that the no-action letter process is opaque and cumbersome, and should be replaced with a formal application process that allows for notice and the opportunity for public comment. Applicants who are not granted an NRSRO designation should be notified of the reasons for their rejection so that they may improve their operations in the specified areas and increase their chances of submitting a successful application in the future. DBRS believes that these measures will increase the transparency of the designation process and enhance investor confidence.

Regardless of whether a formal application or informal no-action letter process is used, DBRS agrees that it is important to establish a time period within which a decision regarding NRSRO designation will be made. The selected period should be short enough to promote efficiency, but long enough to permit a thorough review of the application or no-action letter request. DBRS further believes that measuring this decision period only from the date on which an entity has submitted all required information is problematic; depending on the timing of requests for additional information, the application or no-action letter process could drag on for years. In order to avoid this problem, DBRS respectfully suggests that a decision regarding NRSRO designation should be made by either 90 days from the date on which the entity submits all required information or 180 days from the date that the application/request for no-action relief is filed, whichever is earlier.

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<sup>19</sup> *Proposing Release* at 55, 70 Fed. Reg. at 21318.

<sup>20</sup> That is, the staff will continue to issue letters stating that they will not recommend enforcement action against persons who use a firm's credit ratings for purposes of the Exchange Act net capital rule.

<sup>21</sup> At that time, the Commission proposed to define the term NRSRO by way of an amendment to the net capital rule. Rel. No. 34-39457 (December 17, 1997), 62 Fed. Reg. 68018 (December 30, 1997).



Moreover, once an NRSRO designation is conferred on a rating agency, that designation should remain in effect unless and until it is withdrawn for cause. The Proposing Release suggests that given "changing market conditions," the staff will begin including expiration dates in the NRSRO no-action letters it issues.<sup>22</sup> DBRS respectfully submits that adding expiration dates to NRSRO designations would do more harm than good.

First, the whole point of establishing an NRSRO designation process is to afford certainty to those who use credit ratings for regulatory purposes. That certainty would be diminished if NRSRO designations were of limited duration. Broker-dealers could find themselves out of net capital compliance or money market funds could be forced to sell off parts of their portfolios simply because the clock strikes twelve for an agency on whose credit ratings these parties rely.<sup>23</sup> Users of credit ratings would be forced to establish complex systems to monitor the current status of relevant NRSROs, whose designations might all expire at different times. Even if the NRSROs were diligent about reapplying for their designations, the capital markets could be thrown into disarray if requests for redesignation became trapped in a logjam at the SEC.

Furthermore, forcing rating agencies to continuously reapply for NRSRO designation could create a barrier to entry for smaller firms, who may find it difficult to shoulder the costs of all the extra applications or no-action requests. Another barrier to entry could be erected if the applications of new firms get stuck in a queue behind the reapplications of existing designees. Nor can the burden on the Commission staff of processing all these additional filings be ignored. As history has shown, evaluating NRSRO designation requests is a labor-intensive exercise.

On the other side of the equation, DBRS submits that nothing is to be gained by making NRSRO designations routinely expire. NRSROs who agree to comply with the proposed oversight framework will already be providing evidence of their policies and procedures, historical performance data, financial statements and other information to the SEC staff on an ongoing basis. This information will enable the staff to monitor a rating agency's continued eligibility for NRSRO status. Depending on the circumstances, a rating agency could lose that status if it fails within a reasonable time to correct material deficiencies identified by the SEC staff. Under these circumstances, no additional benefit would accrue from requiring routine NRSRO redesignations.

One final point merits discussion. The Proposing Release notes that when issuing an NRSRO no-action letter, the staff conditions the letter on the rating agency's not representing

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<sup>22</sup> *Proposing Release* at 59, 70 Fed. Reg. at 21319.

<sup>23</sup> *See Id.* at 6-7, 70 Fed. Reg. at 21307.

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to the public that the Commission considers the agency to be an NRSRO.<sup>24</sup> DBRS respectfully requests the Commission to rethink this practice. In order to know which credit ratings can be used for regulatory purposes, market participants must know which rating agencies are NRSROs. As noted above, having an official designation of that status provides a measure of certainty to credit rating users. Forbidding rating agencies from notifying the public of the agencies' NRSRO status deprives the marketplace of that certainty, and has an anti-competitive effect on newer or less well-known designees. Transparency regarding a particular agency's NRSRO status is even more important if a designation is limited by market sector or geographic area. While DBRS is sensitive to the Commission's desire not to be seen as vouching for the quality of an agency's credit ratings, we nonetheless believe that rating agencies should be free to make their NRSRO status known to the public.<sup>25</sup>

### Conclusion

DBRS supports the Commission's proposed definition of the term "Nationally Recognized Statistical Rating Organization," but respectfully requests that the discussion of what an agency would have to show to meet that definition be refined in certain respects to more closely align with industry best practices such as those reflected in the IOSCO Code. DBRS further suggests that clarification regarding the designation process be provided in accordance with the comments set forth herein. We would be happy to supply additional information to the Commission or the staff if you so desire.

Very truly yours,

/s/

Kent Wideman  
Group Managing Director,  
Financial Institutions & Policy

cc: (By Hand)  
Hon. William H. Donaldson  
Hon. Paul S. Atkins  
Hon. Roel C. Campos  
Hon. Cynthia A. Glassman  
Hon. Harvey J. Goldschmid  
Annette L. Nazareth

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<sup>24</sup> *Proposing Release*, note 121.

<sup>25</sup> Any such statement could be coupled with a disclaimer to the effect that NRSRO designation does not reflect the Commission's endorsement of the rating agency or the quality of that agency's credit ratings.