June 9, 2005

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC  20549-0609

*Re: Definition of Nationally Recognized Statistical Rating Organization (File Number S7-04-05)*

Dear Mr. Katz:

Financial Executives International's (FEI) Committee on Corporate Finance (CCF) appreciates the opportunity to comment on the Securities and Exchange Commission's proposed rulemaking that would define the term "nationally recognized statistical rating organization" ("NRSRO"). The proposed definition is comprised of a three-part, conjunctive test as follows: An NRSRO would be defined as an entity (i) that issues publicly available credit ratings that are current assessments of the creditworthiness of obligors with respect to specific securities or money market instruments; (ii) is generally accepted in the financial markets as an issuer of credible and reliable ratings, including ratings for a particular industry or geographic segment, by the predominant users of securities ratings; and (iii) uses systematic procedures designed to ensure credible and reliable ratings, and prevent the misuse of nonpublic information, and has sufficient financial resources to ensure compliance with those procedures.

The Commission states that it is seeking comment on the various components of the definition, as well as on the interpretations provided by Commission staff. The issues raised by the Commission in the proposed rulemaking are important. In the interest of efficiency, we will focus our comments on the major questions raised in the proposed rule.

**Publicly Available Credit Ratings:** The Commission asks how it should determine whether an NRSRO is making its credit ratings available on a widespread basis. The

Commission states that it is interpreting “publicly available,” as used in the definition, to mean that credit ratings used for regulatory purposes under Commission rules must be disseminated “on a widespread basis at no cost.”

We urge the Commission to require NRSROs to make their ratings available either by Internet or by phone. The final rulemaking should specify the acceptable methods for making the ratings public. We do not necessarily agree with the Commission’s interpretation that such ratings should be available at no cost. This implies that the cost of ratings must always be borne by the issuers. As an alternative, we would suggest that the term “publicly available” can also include a nominal fee or subscription service whereby users of securities ratings would help offset the cost of generating such ratings.

On a related note, we believe NRSROs should be required to publicly disclose, at least annually, their breakdown of ratings by rating level (i.e., the percentage of their ratings that are AAA, AA, A, etc.), and the number of ratings the breakdown covers. They should also disclose their default rates by rating category for historical periods. This information would enable investors to see how NRSROs compare with each other.

**Issue-Specific Credit Opinions:** The Commission asks whether a credit rating agency that does not rate specific securities or money market instruments should qualify for NRSRO recognition. In its discussion of this issue, the Commission notes that the risk of loss on different debt instruments of the same issuer can vary considerably depending on the terms written into a security’s legal documentation. Therefore, applying a single “issuer” rating to all an issuer’s outstanding debt instruments could be misleading.

We concur with the Commission’s analysis of this issue, and encourage the Commission to limit NRSRO status to credit rating agencies that rate specific securities or money market instruments rather than only providing “issuer” ratings.

**Current Credit Opinions:** The Commission asks whether it should provide additional interpretation regarding what it means for a credit rating agency’s credit ratings to be “current assessments.” The Commission interprets “current assessments” to mean that a credit rating agency’s public credit ratings reflect its opinion as to the creditworthiness of a security or money market instrument as of the time the rating was issued and until the rating is changed or withdrawn.

Under this interpretation, the Commission states that a credit rating agency could meet the “current assessment” element if it follows procedures designed to ensure that its ratings are reviewed and, if necessary, updated on the occurrence of material events, including significant sector or issue-specific events.

We believe that disclosure – not regulation – is the appropriate method for addressing the issue of timeliness. By simply requiring credit rating agencies to date every rating, review, and outlook, the Commission would enable investors to judge for themselves how current a company’s credit rating is. Requiring credit rating agencies to update their ratings whenever a “material event” occurs becomes problematic when one tries to define what is meant by “material event.” Broadly defined, it would prove extremely onerous for the credit rating agencies as they would be forced to constantly update their ratings. Narrowly defined, it would permit material events to occur without triggering the updated review, and would therefore lead investors to believe that a company's creditworthiness had not changed when in fact it may have.

We believe one simple, bright-line rule would make sense: NRSROs should be required to update their ratings at least annually. This would ensure that published credit ratings are never grossly out of date.

**General Acceptance in the Financial Markets:** The Commission asks, among other questions, whether the views of issuers should be a relevant consideration in determining whether a credit rating agency satisfies the "general acceptance" criteria. In its discussion of this issue, the Commission notes that it makes sense to link the evaluation of a credit rating agency's ratings to the views of the predominant users of securities ratings. Predominant users include financial market participants who hold large inventories of proprietary debt securities, preferred stock, and commercial paper, such as broker-dealers, mutual funds, pension funds, and insurance companies.

We believe issuers and qualified investors should also be classified as predominant users, and their views should be taken into consideration when weighing whether a credit rating agency satisfies the "generally accepted" criteria. Issuers and qualified investors maintain pension funds; possess –at times – significant cash investments; and oversee 401(k) funds. Taken together, these items comprise a significant part of the debt market, and therefore require issuers and qualified investors to be heavily involved in the markets. In addition, issuers and qualified investors interact with the rating agencies on a regular basis, and as a result possess significant insight and knowledge about the rating agencies. It would therefore seem prudent to solicit the views of both groups when evaluating rating agencies under this component of the definition.

**Limited Coverage NRSROs:** The Commission asks whether a credit rating agency should be recognized as an NRSRO if it issues credible and reliable ratings within a limited sector or geographic area. In its discussion, the Commission states that a credit rating agency that has developed a general acceptance in the financial markets could meet the NRSRO definition. In such instances, their market acceptance was based on the credibility and reliability of their ratings.

We believe agencies that provide limited sector coverage and limited geographic area coverage should be eligible for NRSRO status. Rating agencies that focus on a specific sector or industry should be eligible provided that the entire industry or sector is covered, and provided that the agency discloses its limited focus.

Likewise, credit rating agencies that provide limited geographic coverage should be eligible for NRSRO recognition provided they disclose their limited focus. While we recognize that most industries today are global in nature – which would mitigate against permitting rating agencies to focus on specific geographic areas – we nevertheless believe that disclosure is the key. So long as investors understand that a rating agency is providing ratings for a specific geographic area only, they will be able to assess the credibility and reliability of such ratings.

**Analyst Experience and Training:** The Commission asks for comment on the appropriate subjective criteria that a credit rating agency should use in assessing the experience and training of an analyst to meet the proposed NRSRO definition.

In this instance, we believe bright-line rules clarifying the education, training, and experience requirements of both staff and credit committee members are appropriate. Staff and credit committee members should be required to have a minimum number of continuing education credits every year; they should also be required to have a minimum level of risk-based training. Lastly, analysts should be required to disclose the number of years they have covered a particular issuer. Such requirements would assure the investing public that analysts possess an appropriate understanding of the issues impacting a company's creditworthiness.

**Number of Ratings per Analyst:** Here, the Commission asks whether a credit rating agency's ratings may become less reliable as the number of issues per analyst increases. In its discussion of the issue, the Commission states that a credit rating agency should be able to demonstrate to users of its securities ratings that its analysts are capable of continuously monitoring and assessing relevant developments relating to their ratings. Thus, the number of ratings per analyst could be an important consideration for users of securities ratings in assessing whether a credit rating agency uses systematic procedures designed to ensure credible and reliable ratings.

We view mandatory disclosure as the appropriate method for addressing this issue. Rating analysts should simply be required to disclose the number of companies and industries they rate. We further believe that rating agencies should be required to disclose their analyst rotation policies – if any – and the amount of time that an analyst has served as the lead analyst on a company that he or she is rating. These disclosures should enable investors to evaluate the credibility and reliability of various analysts' ratings.

**Contacts with Management:** The Commission asks whether a credit rating agency seeking to meet the definition of NRSRO should address the method and extent to which it involves an issuer's senior management in the rating process. The Commission posed a similar question in its 2003 Concept Release, and received differing viewpoints. Several commenters indicated that obtaining senior management's views could enhance a credit rating agency's ability to assess the quality and credibility of an issuer's management and better understand the issuer's operational and financial condition. Others worried that requiring contact with senior management could act as a barrier to entry for smaller credit rating agencies that cannot compel issuers to engage in a dialogue.

We believe it is extremely important that NRSROs maintain close contact with an issuer's management and staff. The subjective component of the rating is perhaps the most important part, and cannot be properly completed without close contact with the issuer's management and staff. However, we acknowledge that requiring contact with issuer management could serve as a barrier to entry for smaller rating agencies. We also acknowledge that issuer management might be less inclined to speak with credit rating agencies issuing lower ratings. We therefore believe the appropriate solution is disclosure: rating agencies should be required to disclose when their analysts last held substantive meetings with senior management, who they met with, and where the meeting took place. The market would then decide how much importance to place on such contact, and therefore how credible the subjective portion of the rating is.

**Conflicts of Interest:** The Commission asks what specific conflicts of interest should be addressed in a credit rating agency's procedures and how they should be addressed. The Commission further asks whether a credit rating agency that engages in activities that present potential or actual conflicts of interest should be excluded from the definition of NRSRO. The Commission notes that reliance on issuer fees by a credit rating agency could lead to conflicts of interest and the potential for rating inflation.

We believe a simple bright-line rule similar to the restrictions included in Title 2 of the Sarbanes-Oxley legislation would serve best: Rating agencies should not be permitted to provide both advisory, fee-based services and rating services to an issuer. This restriction should eliminate any concerns regarding rating inflation. In addition, we believe that NRSROs, their related entities, and their Officers and Directors should be required to disclose <u>all</u> of their business dealings with issuers, not just the fee-based services they provide. Finally, we believe credit rating agencies should be required to identify the types of conflicts of interest that arise in its business; its procedures designed to address and minimize or avoid those conflicts; and how the firm monitors and verifies compliance with those procedures.

**Misuse of Nonpublic Information:** The Commission asks whether a credit rating agency should be required to demonstrate that it has systematic procedures designed to prevent the misuse of material nonpublic information. The Commission notes that some credit rating agencies, as part of their analysis, maintain contact with senior management of the issuers they rate. In the course of these contacts, an issuer may provide an analyst with nonpublic information such as contemplated business transactions or estimated financial information. There is a potential that this information could be used by a credit rating analyst or others for improper purposes. In response, the Commission proposes that to meet this component of the NRSRO definition, a credit rating agency should adopt procedures governing the receipt and use of nonpublic information that applies to all employees.

We agree that NRSROs need to demonstrate that they have adequate procedures and practices in place to prevent the misuse of nonpublic information. Perhaps NRSROs should be required to implement and maintain firewalls to ensure that nonpublic information is both segregated and secure. In addition, we think a bright-line rule is also in order: the SEC, or another government authority, should certify these processes and procedures annually.

**Financial Resources:** Here, the Commission asks whether a credit rating agency should be required to make its audited financial statements readily available to users of securities ratings in order for such users to assess whether a credit rating agency has sufficient financial resources to satisfy the third component.

Once again, we support a disclosure requirement, and specifically urge the Commission to require credit rating agencies to disclose information relating to the percentage of revenue it receives from particular issuers or subscribers as compared to the credit rating agency's total revenues. Such information would prove useful to users of securities ratings, as it would help "paint a picture" of the company issuing these ratings. For example, if a credit rating agency generated substantial revenue from a relatively small group of issuers, a user of that rating agency's ratings might question the objectivity and/or accuracy of the ratings given to that small group of issuers.

**Statistical Models:** The Commission asks whether a credit rating agency that relies solely or primarily on statistical models should be able to meet the proposed NRSRO definition. The Commission notes that commenters on the 2003 Concept Release generally agreed that computerized statistical models may be helpful in the credit rating process, but that a credit rating agency that solely uses statistical models should not qualify as an NRSRO.

We believe that sole reliance on statistical models should not be allowed by NRSROs. It is our belief that the interaction with management and general understanding of the issuer's business and financial risks are far more critical in determining a rating than anything generated from a statistical model. For example, an issuer's financial culture of "aggressive," "moderate," or "conservative" is much more important than any metric (e.g., funds to debt ratio). Furthermore, we believe that whenever NRSROs use statistical models to help develop their ratings, they should be required to disclose any instances where ratings are inconsistent with the quantitative measures used.

**Provisional NRSRO Status:** The Commission asks whether its proposed NRSRO definition and approach for promoting competition address the competitive concerns raised by commenters supporting provisional NRSROs. In its discussion of the issue, the Commission notes that the 2003 Concept Release sought comment on whether to consider a provisional NRSRO status for credit rating agencies that comply with NRSRO recognition criteria but lack national recognition. Commenters supporting provisional NRSROs indicated that permitting such recognition could promote competition among credit rating agencies by facilitating the entry of high-quality but lesser-known credit rating agencies. Commenters opposing the idea expressed concern that permitting two classes of NRSROs would likely cause confusion in the marketplace.

The Commission now wonders whether a better approach would be to award provisional status to credit rating agencies that confine their activities to limited sectors of the debt market or to limited geographic areas.

We believe the Commission's initial approach – to award provisional status to credit rating agencies that meet all of the criteria but lack national recognition – better serves the purpose of promoting competition among credit rating agencies. Recognizing high quality rating agencies that only lack national recognition would lower the barriers to entry, and would enable such rating agencies to develop the recognition they require to qualify for full NRSRO status. Provided such provisional status is fully disclosed to users, there is no reason to believe that a provisional classification will create marketplace confusion.

In summary, CCF encourages the Commission to support – whenever possible – disclosure requirements rather than "cookie cutter" regulation. We firmly believe that requiring credit rating agencies to disclose pertinent information to users of securities ratings will enable those users to weigh the credibility and reliability of such ratings. Much of the credit rating process involves judgment, which we believe cannot effectively be "regulated." Letting the markets evaluate the credibility of credit rating agencies would seem more prudent from a user's perspective and less onerous from the credit rating agencies' perspective.

CCF appreciates the opportunity to comment on the proposed rulemaking. Should you have any questions regarding our comments, please contact Mark Prysock at 202-626-7804.

Sincerely,

Dennis Ling
Chairman
FEI Committee on Corporate Finance

cc: The Honorable William H. Donaldson
The Honorable Paul S. Atkins
The Honorable Roel C. Campos
The Honorable Cynthia A. Glassman
The Honorable Harvey J. Goldschmid
Annette L. Nazareth, Director, Division of Market Regulation