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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. S7-21-04, Proposed Rule: Asset-Backed Securities

Dear Mr. Katz:

On May 3, 2004, the Securities and Exchange Commission (the "**Commission**") requested comment on a proposed set of rules on the registration, disclosure and reporting requirements for asset-backed securities ("**ABS**") (the "**ABS Release**") under the Securities Act of 1933, as amended and the Securities Exchange Act of 1934, as amended (together, the "**Act**"). Moody's Investors Service ("**Moody's**") supports the Commission's goal of increased disclosure for investors and greater transparency for all parties within the framework of a comprehensive regulatory regime for ABS. Although we believe that many of the proposed rules will benefit the ABS market, we take the opportunity here to respond in part to two sets of the questions asked by the Commission that concern the operation of rating agencies in the ABS market.

1. ***Should we continue to require an investment grade requirement for Form S-3 eligibility? Are any modifications to that requirement necessary? Should alternatives be considered, such as investor sophistication, minimum denomination or experience criteria? If so, what criteria should be considered?***[1]

The investment grade rating eligibility requirement in Form S-3 has been a longstanding feature of the mechanics of issuing securities in the ABS market. In order to be eligible for issuance under Form S-3, a security must be an "investment grade security," which means "at the time of sale, at least one nationally recognized statistical rating organization … has rated the security in one of its generic rating categories which signifies investment grade…" (underscore added).

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1 ABS Release, III. A. 3. c. "Questions regarding Form S-3 eligibility"

We assume that the investment grade rating requirement is in essence a bright line test for allowing sponsors to avoid the more lengthy Commission review of the Form S-1. That is to say, if the shelf registration has received an investment grade rating from a nationally recognized statistical organization ("**NRSRO**"), then for Commission purposes the securities issued off of that shelf are of a high enough quality that they do not require the same level of intensive scrutiny by the Commission.

As the Commission is presently conducting a comprehensive review of the requisite criteria for and the process of designating NRSROs,[2] it is unclear whether or to what extent the regulatory infrastructure in which NRSROs operate will change. We have previously discussed our views on the associated benefits and limitations in utilizing ratings as a tool in regulation. We have also offered our perspective on designating only certain of the rating agencies whose ratings may be used for legal or regulatory purposes. Therefore, we will not restate our positions here and will only refer the Commission to our response to the Commission's Concept Release.[3]

If the Commission were to decide to abandon the NRSRO system in the near future, this particular section of our response would no longer be relevant. However, should the Commission choose to maintain the NRSRO regime, we would ask it to remain mindful of rating shopping in the ABS market. In the asset-backed market, rating shopping describes instances where a sponsor refuses to engage in discussions with and provide information to a rating agency that may give a less favorable perspective on the issuance's creditworthiness and instead the sponsor "takes its business" to other agencies that provide higher ratings.[4] Therefore, and to put it bluntly, in the ABS market:

> *the issuer could take its business elsewhere <u>unless</u> the rating agency provides a higher rating.*

As the Commission is likely aware, over the past several years, investors and the market as a whole have responded to some extent to the problem of rating shopping. While securities have grown increasingly more complicated, and investors have become increasingly more sophisticated and demanding, most sponsors presently obtain two ratings and publish in the prospectus the lower of the two ratings attained. This development has helped curtail the sponsor's ability to shop for the single highest investment grade rating available and thereby satisfying its regulatory requirement.

In line with the practices which have developed in the ABS marketplace since the inception of the Form S-3 eligibility requirements, and the historical problems with rating shopping in the ABS market, Moody's would recommend that the Commission consider the following options in its review of the rating requirement bright line test:

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[2] File No. S7-12-03, Concept Release: Rating Agencies and the Use of Credit Ratings Under the Federal Securities Laws, ("**Concept Release**"), posted on Commission website.

[3] Moody's Investors Service, Response to The Securities and Exchange Commission's Concept Release: Rating Agencies and The Use of Credit Ratings Under the Federal Securities Laws, July 28, 2003, posted on Commission website.

[4] By way of comparison, although some degree of rating shopping does exist in the corporate finance market, it is not at the same level as in the ABS market because reliable information about corporates is made more readily available to the public. Therefore, even without the full participation of the corporate issuer, it is possible that a rating opinion may be formulated and published. Unsolicited ratings are one means of curtailing rating shopping. However, because of the generally hostile reaction of both the regulatory and issuer communities against assigning unsolicited ratings, Moody's has limited its practice of publishing ratings on issuers who have not requested a rating.

> - Eliminate the use of rating as a bright line test for the Form S-3 eligibility criteria, thereby eliminating the incentive to shop for ratings simply to satisfy a regulatory requirement; or alternatively,
> - Reflective of the developing market practice, require for Form S-3 eligibility an investment grade rating which is the lower of two ratings.

Again, we would note that significant changes in the designation criteria or the industry's structure could make our recommendations if not flawed then inappropriate.

2. Should additional disclosure regarding ratings or the rating process be required? For example, should disclosure of fees paid to rating agencies by required? Should we require an explanation of what an NRSRO rating addresses and the characteristics the rating does not address?[5]

Because ratings have become an important means of conveying information in the ABS market, the independence of rating agencies and the objectivity of rating opinions are important. Yet, it is the issuing entities that pay the majority of credit rating agency fees, exposing the industry to latent conflicts of interest.[6] We assume, therefore, that the Commission has requested comments on the disclosure of rating agency fees and overall rating product because such increased transparency could arguably enable the investor to assess the rating agencies ability to adequately and independently speak to the creditworthiness of asset-backed securities.

a. Additional Disclosure May Lead to Rating Agencies Being Categorized as "Participant in Distribution"

As we have discussed in our submission to the Concept Release, while we recognize the utility of ratings in the regulatory fabric, we believe that a ratings have inherent attributes as well as limitations. For example,

- A rating is not a performance guarantee.
- A rating is not a recommendation to buy or hold a security.
- Moody's ABS ratings assess the likelihood that the terms of the security, as structured, will be met.
- A rating is only as good as the information which we has been provided, and is greatly dependent on the quality of data and information received from the issuing entity.

Moody's appreciates why the Commission would request comments on the need for greater disclosure about ratings and rating agencies in registration documents. However, we are concerned that greater disclosure in prospectuses of the rating process may cause rating agencies to be viewed as participants in a distribution for purposes of the federal securities laws. In

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5 ABS Release III. B. 8. e. "Questions regarding other proposed basic disclosure items."

6 It is important to note that Moody's is not obligated to publish a rating once it is engaged by an issuing entity to assess its securities. The agreement between Moody's and the issuing entity is simply to analyze the securities under consideration. It is Moody's sole prerogative to publish either a rating or research based on that analysis.

particular, we are concerned that rating agencies which perform an entirely different role, could become subject to the full extent of the Act's mandates similar to issuers, underwriters and other controlling persons.

Therefore, should the Commission decide that greater disclosure is needed in the prospectus on the role and the process of rating agencies we would request that the Commission also make clear that rating agencies are independent opinion providers and neither prepare prospectuses nor participate in the various marketing or sales of the securities. Moody's proposes that the Commission reiterates its views on important matters to be considered when disclosing securities ratings, including the useful, but limited, nature of ratings, and which are neither recommendations to invest nor performance guarantees.[7]

b. Disclosure of Rating Agency Fees

In responding to this issue, we would like to first clarify the two types of fees that Moody's is generally paid in rating asset-backed securities.

- An initial up-front transaction fee; which is normally paid by an issuer outside the deal cash flows at or around the time of the closing of the rated transaction.
- A surveillance fee; which is paid on an on-going basis during the life of the transaction and may be paid from the proceeds of the assets securitized prior to payments to be made to investors.

i. Disclosure of Upfront Fee

Presently, the rating agencies operate in an environment where the specific fees charged issuers tend not to be published. Therefore, not only are investors and other issuers unaware of the exact fees charged on a transactional basis, but also competitor rating agencies are not privy to such pricing information. Disclosure of fee information would arguably increase market transparency, which Moody's broadly supports. However, Moody's would caution that complete transparency of all competitors pricing would incline rating agencies to compete on the basis of price for service, rather than quality of product.

Rating agencies help improve market transparency and efficiency when they provide objective forward looking opinions that are predictive tools in assessing credit risk. Therefore, for rating agencies to effectively fulfill this role, they should compete on the basis of the quality (predictive content) of their ratings rather than their price. That is to say, rating agencies should compete vigorously and constantly to improve our analytical approaches and to respond to market innovations. Because of the concentrated nature of the industry, disclosing initial transaction fees may alter the nature of competition in the rating agency industry by potentially turning the focus of competition to price rather than methodology or performance.

For issuers, the financial consequences of rating fees are often much less material than the financial consequences of a higher rating for the same or lower credit enhancement level. Moreover, rating fees tend to be a fraction of the overall fees associated with a particular asset-backed transaction. Rating shopping could have a negative impact on the market unless effectively mitigated because the primary potential risk to investor protection is not that the rating agency fees were too high, but rather that its ratings were too high.

Moody's believes that if a rating agency were to "get business" at the expense of the objectivity of its opinions, it will risk gravely damaging its reputation in the market as an independent

[7] See Item 10 of Regulation S-K (17 CFR 229.10 (c)).

opinion provider, which would in turn undermine its standing with investors and its franchise value. In the medium to long run, we believe that market forces will constrain a rating agency's ability to sell "too high" ratings, because it will not be able to maintain credibility with the investor community. However, the potential of short to medium term harm to the market caused by rating shopping remains a dilemma for the Commission's consideration.

Consequently, Moody's would recommend that:

- If in requiring additional disclosure the Commission is aiming to identify instances of potential conflicts of interest, the Commission could consider obligating disclosure of the measures developed by the rating agencies which safeguard the agencies' independence, integrity and objectivity; alternatively
- The Commission could require, in addition to the investment grade rating assigned, disclosure of all other NRSROs which were contacted prior to issuance regardless of whether a rating was ultimately assigned.

ii. Monitoring / Surveillance Fees

Moody's believes that investors should be informed about all claims on the issuer's assets that rank prior to their own claim. Moody's supports the Commission requiring that there be more disclosure to investors of fees paid from the cash flows of the assets securitized, especially if such payments are made prior to those which are to be made to investors.

It is both reasonable and appropriate for the issuing entity to disclose surveillance fees or other monitoring fees that are charged out of the proceeds of the assets securitized prior to payments that are to be made to investors.

We thank the Commission for the opportunity to participate in the comprehensive regulatory initiative represented by the ABS Release. We look forward to further discussions in the future.

Sincerely,

/s/ Brian M. Clarkson

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MOODY'S INVESTORS SERVICE