Annual Report on Nationally Recognized Statistical Rating Organizations

As Required by Section 6 of the Credit Rating Agency Reform Act of 2006

U. S. Securities and Exchange Commission

September 2009

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REPORT ON NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATIONS

As Required by Section 6 of the Credit Rating Agency Reform Act of 2006

I. INTRODUCTION

The U.S. Securities and Exchange Commission ("Commission") is providing this report under Section 6 of the Credit Rating Agency Reform Act of 2006 ("Rating Agency Act")).[1] Section 6 of the Rating Agency Act requires the Commission to submit an annual report to the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Financial Services of the House of Representatives that, with respect to the year which the report relates:

- Identifies applicants for registration as nationally recognized statistical rating organizations ("NRSROs") under Section 15E of the Securities Exchange Act of 1934 ("Exchange Act");
- Specifies the number of and actions taken on such applications; and
- Specifies the views of the Commission on the state of competition, transparency, and conflicts of interest among NRSROs.

On June 5, 2007, the Commission approved the rules implementing a registration and oversight program for NRSROs under the Rating Agency Act – the rules became effective that same month. During the year ended June 25, 2008, the Commission registered the first 10 NRSROs.

In response to the credit market turmoil, the Commission took a series of actions with the goal of further enhancing the utility of NRSRO disclosure to investors, strengthening the integrity of the ratings process, and more effectively addressing the potential for conflicts of interest inherent in the ratings process for structured finance products. In June 2008, in the first of three related actions, the Commission proposed a series of amendments to its existing rules to regulate the conflicts of interests, disclosures, internal policies, and business practices of credit rating agencies registered as NRSROs.[2] The second action taken by the Commission was to propose a new rule that would require NRSROs to distinguish their ratings for structured finance products from other classes of credit ratings by publishing a report with the rating or using a different

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[1] See Pub. L. No. 109-291 (2006). The Rating Agency Act became effective on June 26, 2007. The annual report published on June 2008 related to the period from June 26, 2007 to June 25, 2008. See "Annual Report on Nationally Recognized Statistical Rating Organizations", June 2008, http://www.sec.gov/divisions/marketreg/ratingagency/nrsroannrep0608.pdf. Consequently, the year to which this report relates begins on June 26, 2008 and ends on June 25, 2009.

[2] See "Proposed Rules for Nationally Recognized Statistical Rating Organizations", June 16, 2008, http://www.sec.gov/rules/proposed/2008/34-57967.pdf, ("June 16, 2008 Proposing Release").

rating symbol.[3] These rulemaking actions were designed to address concerns about the integrity of the credit rating procedures and methodologies of NRSROs in the light of the role they played in determining credit ratings for securities collateralized by or linked to subprime residential mortgages. A summary of these two actions can be found in the annual report published in June 2008. The third action proposed was to remove references to NRSRO credit ratings from Commission rules, a step that was designed to reduce undue reliance on credit ratings and result in improvements in the analysis that underlies investment decisions.[4]

In February 2009, the Commission adopted, with revisions, a majority of the rule amendments proposed in the first action.[5] In conjunction with the adoption of these new measures, the Commission proposed an additional amendment which would require NRSROs to disclose ratings history information for 100% of all issuer-paid credit ratings.[6] Finally, on the same date, the Commission re-proposed an amendment that would prohibit an NRSRO from issuing a rating for a structured finance product paid for by the product's issuer, sponsor, or underwriter unless the information about the product provided to the NRSRO is made available to other NRSROs.[7]

In August 2007, the Commission's staff initiated examinations of the three largest credit rating agencies to review their role in the recent turmoil in the subprime mortgage-related securities markets. On July 8, 2008, the Commission authorized the issuance of a staff report summarizing the issues identified in those examinations.[8] The Commission staff found that these rating agencies struggled significantly with the increase in the number and complexity of subprime residential mortgage-backed securities ("RMBS") and collateralized debt obligations ("CDOs") deals since 2002. The examinations uncovered that the procedures for rating RMBS and CDOs were not well documented. Furthermore, significant aspects of the rating process were not always disclosed or even documented by the firms, and issues were identified in the management of conflicts of interest.

This report provides an overview of the rules proposed and adopted by the Commission during the year to which this report relates, a summary of the staff findings

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3 See June 16, 2008 Proposing Release.

4 See "References to Ratings Of Nationally Recognized Statistical Rating Organizations", July 1, 2008, http://www.sec.gov/rules/proposed/2008/34-58070.pdf, ("July 1, 2008 Proposing Release, 34-58070"), "Security Ratings", July 1, 2008, http://www.sec.gov/rules/proposed/2008/33-8940.pdf, ("July 1, 2008 Proposing Release, 33-8940"), and "References to Ratings of Nationally Recognized Statistical Rating Organizations", July 1, 2008, http://www.sec.gov/rules/proposed/2008/ic-28327.pdf, ("July 1, 2008 Proposing Release, IC-28327").

5 See "Amendments to Rules for Nationally Recognized Statistical Rating Organizations", February 2, 2009, http://www.sec.gov/rules/final/2009/34-59342.pdf, ("February 2, 2009 Adopting Release").

6 See "Re-proposed Rules for Nationally Recognized Statistical Rating Organizations", February 2, 2009, http://www.sec.gov/rules/proposed/2009/34-59343.pdf, ("February 2, 2009 Re-proposing Release").

7 See February 2, 2009 Re-proposing Release.

8 See "Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies", July 2008, http://www.sec.gov/news/studies/2008/craexamination070808.pdf, ("July 2008 Staff Report").

from the examinations of certain NRSROs, published on July 8, 2008, and addresses each of the items specified in Section 6 of the Rating Agency Act.

II. COMMISSION'S PROPOSED AND ADOPTED RULES

The following sections provide a description of the adopted rule amendments and pending proposed rule amendments. The Commission notes, with respect to pending rule proposals, any decisions about whether to adopt final rules will be made after full consideration of the comments received on the proposals. Further, final rules may differ from proposals in response to comments and other considerations.

A. Adopted Rule Amendments to Increase Transparency and Accountability at Credit Rating Agencies

On February 2, 2009, the Commission adopted a series of measures to increase transparency and accountability at NRSROs in order to address concerns about the integrity of their credit rating procedures and methodologies. The new requirements are designed to address practices identified, in part, by the Commission staff during its examination of the three largest NRSROs. In particular, the requirements are intended to increase the transparency of the NRSROs' rating methodologies, strengthen the NRSROs' disclosure of ratings performance, prohibit the NRSROs from engaging in certain practices that create conflicts of interest, and enhance the NRSROs' recordkeeping and reporting obligations to assist the Commission in performing its regulatory and oversight functions. The new rules:

- Prohibit an NRSRO from issuing a rating where the NRSRO or a person associated with the NRSRO has made recommendations as to structuring the same products that it rates.

- Prohibit anyone at an NRSRO who has responsibility for participating in determining credit ratings or for developing or approving procedures or methodologies used for determining credit ratings from negotiating the fee paid for a rating.

- Prohibit gifts from those who receive ratings to those who rate them, apart from items provided in the context of normal business activities, such as meetings, that have an aggregate value of over $25.

- Require NRSROs to publish performance statistics for one, three and ten years within each rating category, in a way that facilitates comparison with their competitors in the industry.

- Require disclosure of whether and how information about verification performed on the assets underlying a structured product is relied on in determining credit ratings.

- Require disclosure of whether and how assessments of the quality of originators of assets underlying a structured product play a part in the determination of credit ratings.

- Require disclosure of how frequently credit ratings are reviewed; whether different models are used for ratings surveillance than for initial ratings; and whether changes made to models are applied retroactively to existing ratings.

- Require NRSROs to make an annual report of the number of ratings actions they took in each ratings category.

- Require documentation of the rationale for any material difference between the rating implied by a quantitative model that is a substantial component in the process of determining a credit rating of a structured product and the final rating issued.

- Require documentation, for each outstanding credit rating, of all rating actions and the date of such actions from the initial credit rating to the current credit rating.

- Require documentation of any written communications received from persons not associated with the NRSRO that contain complaints about the performance of a credit analyst.

- Require NRSROs to make publicly available on a six month delay, a random sample of 10% of the rating action histories of credit ratings paid for by the obligor being rated or by the issuer, underwriter, or sponsor of the security being rated ("issuer-paid credit ratings") in each class of credit ratings for which it is registered and has issued 500 or more issuer-paid credit ratings.

B. Proposed Rule Amendments to Increase Transparency and Competition

In conjunction with the adoption of the final rule amendments to its existing rules governing the conduct of NRSROs, discussed above, on February 2, 2009, the Commission proposed additional amendments designed to address further concerns about the integrity of the credit ratings procedures and methodologies at NRSROs. The Commission proposed an amendment that would require the public disclosure of credit rating histories, subject to a 12 month delay, for all outstanding credit ratings determined by an NRSRO, on or after June 26, 2007, paid for by the obligor being rated or by the issuer, underwriter, or sponsor of the security being rated. The purpose of the proposed amendment is to provide users of credit ratings, investors and other market participants and observers with more effective raw data with which to compare how NRSROs subject to the rule initially rated an obligor or security and, subsequently, adjusted those ratings,

including the timing of the adjustments. The Commission preliminarily believes that requiring the disclosure of the ratings action history of each issuer-paid credit rating could create the opportunity for market participants to use the information to develop performance measurement statistics that would supplement those required to be published by the NRSROs themselves in Form NRSRO.

Finally, on the same date, the Commission re-proposed an amendment to its conflict of interest rule that would prohibit an NRSRO from issuing a rating for a structured finance product paid for by the product's issuer, sponsor, or underwriter unless the information about the product provided to the NRSRO is made available to other persons. NRSROs that are hired by arrangers to perform credit ratings for structured finance products would need to disclose to other NRSROs (and only other NRSROs) the deals for which they were in the process of determining such credit ratings. The arrangers would need to provide the NRSROs they hire to rate structured finance products with a representation that they will provide information given to the hired NRSRO to other NRSROs (and only other NRSROs). NRSROs seeking to access information maintained by the NRSROs and the arrangers would need to furnish the Commission with an annual certification that they are accessing the information solely to determine credit ratings and will determine a minimum number of credit ratings using the information.

The purpose of the re-proposed amendment is to increase the number of ratings extant for a given structured finance security or money market instrument and, in particular, promote the issuance of ratings by NRSROs that are not hired by the arranger. This could provide users of credit ratings with a broader range of views on the creditworthiness of the security or money market instrument and potentially expose an NRSRO that was unduly influenced by the "issuer-pay" conflict into issuing higher than warranted ratings.

C. Proposed Rule Changes to Remove References to NRSRO Credit Ratings from the Commission's Rules

On July 1, 2008, the Commission proposed amendments to existing Commission rules that rely on credit ratings. The proposed amendments, in many cases, would remove or revise such references. The proposals also responded to recommendations issued by the President's Working Group on Financial Markets, the Financial Stability Forum and the Technical Committee of the International Organization of Securities Commissions (IOSCO).[9] Consistent with these recommendations, the Commission is considering whether the inclusion of requirements related to ratings in its rules and forms has, in effect, created the appearance of an "official seal of approval" on ratings that could adversely affect the quality of due diligence and investment analysis. The

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[9] See President's Working Group on Financial Markets, "Policy Statement on Financial Market Developments" (March 2008), available at www.ustreas.gov ("PWG Statement"); "The Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience", April 2008, available at www.fsforum.org ("FSF Report"); Technical Committee of the International Organization of Securities Commissions, "The Role of Credit Rating Agencies in Structured Finance Markets - Final Report", May 2008, available at www.iosco.org.

Commission's proposals are designed to lessen reliance on credit ratings and promote independent analysis in making investment decisions.

The proposed rules were published in three releases. In the first release, the Commission proposed to amend various rules and forms under the Securities Exchange Act of 1934 ("Exchange Act") administered by the Commission's Division of Trading and Markets that rely on NRSRO ratings. The proposal would remove references to NRSROs in the following rules and forms: Rule 3a1-1, Rule 10b-10, Rule 15c3-1, Rule 15c3-3, Rules 101 and 102 of Regulation M, Regulation ATS, Form ATS-R, Form PILOT and Form X-17A-5 Part IIB. [10]

In the second release, the Commission proposed amendments to Regulation S-K, and rule and form requirements under the Securities Act of 1933 ("Securities Act") and the Exchange Act that are administered by the Commission's Division of Corporation Finance. In Regulation S-K, the Commission proposed to amend Items 10, 1100, 1112, and 1114. Under the Securities Act, the Commission proposed to amend Rules 134, 138, 139, 168, 415, 436, Form S-3, Form S-4, Form F-1, Form F-3, Form F-4 and Form F-9. The Commission also proposed to amend Schedule 14A under the Exchange Act.[11]

In the third release, the Commission proposed to amend four rules under the Investment Company Act of 1940 ("Investment Company Act") and one rule under the Investment Advisors Act of 1940 ("Investment Advisors Act") that are administered by the Commissions Division of Investment Management and that rely on NRSRO ratings. The Commission proposed amendments to Rules 2a-7, 3a-7, 5b-3 and 10f-3 under the Investment Company Act and amendments to Rule 206(3)-3T under the Investment Advisors Act.[12]

III. REPORT ON ISSUES IDENTIFIED IN THE COMMISSION STAFF's EXAMINATIONS OF SELECT CREDIT RATING AGENCIES

On July 8, 2008, the Commission released findings from extensive 10-month staff examinations of three credit rating agencies – Fitch Ratings, Inc., Moody's Investors Service, Inc. and Standard & Poor's Ratings Services – regarding their role in the turmoil in the subprime mortgage-related securities markets. The focus of the examinations was the rating agencies' activities in rating subprime RMBS and CDOs linked to subprime residential mortgage-backed securities. The staff found:

- There was a substantial increase in the number and in the complexity of RMBS and CDO deals since 2002, and some of the rating agencies appear to have struggled with the growth.
- Significant aspects of the ratings process were not always disclosed.

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10 See July 1, 2008 Proposing Release, 34-58070.

11 See July 1, 2008 Proposing Release, 33-8940.

12 See July 1, 2008 Proposing Release, IC-28327.

- Policies and procedures for rating RMBS and CDOs can be better documented.

- The rating agencies are implementing new practices with respect to the information provided to them.

- The rating agencies did not always document significant steps in the ratings process, including the rationale for deviations from their models and for rating committee actions and decisions, and they did not always document significant participants in the ratings process.

- The surveillance processes used by the rating agencies appear to have been less robust than the processes used for initial ratings.

- Issues were identified in the management of conflicts of interest and improvements can be made.

- The rating agencies internal audit processes varied significantly.

The report summarized generally the remedial actions the staff recommended, including that each NRSRO:

- Evaluate whether it has sufficient staff and resources to manage its volume of business and meet its obligations under the Exchange Act and the rules applicable to NRSROs.

- Review disclosure of the ratings process and the methodologies used to rate RMBS and CDOs to ensure full compliance with SEC rules. NRSROs should review whether policies governing the timing of disclosure of a significant change to a process or methodology are reasonably designed to comply with applicable SEC disclosure requirements.

- Determine whether written policies and procedures used to determine credit ratings for RMBS and CDOs are fully documented.

- Review current policies and practices for documenting the credit ratings process and the identities of RMBS and CDO ratings analysts and committee members.

- Determine if adequate resources are devoted to surveillance of outstanding RMBS and CDO ratings.

- Review practices, policies and procedures for mitigating and managing the "issuer pays" conflict of interest.

- Review policies and procedures for managing the securities ownership conflict of interest to determine whether these policies are reasonably designed to ensure that employees' personal trading is appropriate and in compliance with applicable requirements.

- (as to two of the NRSROs examined) Review whether internal audit functions, particularly in the RMBS and CDO ratings areas, are adequate and whether they provide for proper management follow-up.

IV. STATUS OF REGISTRANTS AND APPLICANTS

Ten credit rating agencies have applied for and been granted registration as NRSROs. The registered credit rating agencies and the dates of their registration are:

NRSRO	Date of Registration
A.M. Best Company, Inc. ("A.M. Best")	September 24, 2007
DBRS Ltd. ("DBRS")	September 24, 2007
Fitch, Inc. ("Fitch")	September 24, 2007
Japan Credit Rating Agency, Ltd. ("JCR")	September 24, 2007
Moody's Investors Service, Inc. ("Moody's")	September 24, 2007
Rating and Investment Information, Inc. ("R&I")	September 24, 2007
Standard & Poor's Ratings Services ("S&P")	September 24, 2007
Egan-Jones Rating Company ("EJR")	December 21, 2007
LACE Financial Corp. ("LACE")	February 11, 2008
Realpoint LLC ("Realpoint")	June 23, 2008

There was one application received during the period covered by the second annual report. The application was withdrawn after the period covered by the report and prior to the end of the 90-day period prescribed in the Rating Agency Act for the Commission to grant the application or initiate proceedings to determine whether it should be denied.

V. COMMISSION'S VIEW ON COMPETITION

A. Summary of Select Statistical Information

As discussed above, the Commission has granted NRSRO registration to 10 credit rating agencies. The first seven firms (A.M. Best, DBRS, Fitch, JCR, Moody's, R&I, and S&P) applied for registration as NRSROs in June of 2007 under the new registration and oversight program adopted by the Commission that month. Subsequently, the Commission granted three additional credit rating agencies NRSRO registration (EJR, LACE, and Realpoint). The following sections summarize certain information reported by each NRSRO on its Form NRSRO.

1. Ratings Outstanding by NRSRO

The table below reports the number of outstanding ratings reported by each NRSRO in its Form NRSRO annual certification for the year 2008. For each NRSRO, the table sets forth the number of outstanding ratings for the five classes of ratings identified in Section 3(a)(62) of the Exchange Act: (1) financial institutions, brokers, or dealers; (2) insurance companies; (3) corporate issuers; (4) issuers of asset-backed securities;[13] and (5) issuers of government securities, municipal securities, or securities issued by a foreign government ("sovereign securities").[14]

Outstanding Credit Ratings Reported by NRSROs on Form NRSRO by Ratings Class

NRSRO	Financial Institutions	Insurance Companies	Corporate Issuers	Asset-Backed Securities	Government, Municipal & Sovereign Securities	Total Ratings
A.M. Best	3	6,009	2,710	54	0	8,776
DBRS	18,040	110	7,080	7,470	10,560	43,260
EJR	62	46	803	14	9	934
Fitch	83,649	4,797	14,757	77,480	491,264	671,947
JCR	155	31	544	71	71	872
LACE	18,000	100	2,000	0	300	20,400
Moody's	84,773	6,277	31,126	109,261	880,880	1,112,317
R&I	100	32	600	210	100	1,042
Realpoint	0	0	0	9,200	0	9,200
S&P	47,300	6,600	26,900	198,200	976,000	1,255,000
Total Ratings	252,082	24,002	86,520	401,960	2,359,184	3,123,748
HHI	2,686	2,467	2,636	3,550	3,539	3,347

Of the ten credit rating agencies registered with the SEC as NRSROs, seven operate predominantly under the issuer-pay model.[15] The remaining three operate predominantly under the subscriber-pay model.[16] The NRSROs operating under the

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13 As the term is defined in 17 CFR 229.1101(c).

14 There are a variety of ways of tabulating the number of outstanding ratings and different methods can result in different outcomes, particularly in the class of ratings of government securities. For example, a public finance issue which has multiple series with different maturity dates can be counted as a single rating or, alternatively, each series can be counted separately. At the request of the staff, Moody's recalculated the number of public finance ratings it has outstanding by counting each rating for a security with a different maturity date separately in order to place the number it reports on a more comparable basis to the numbers reported by certain other NRSROs. Moody's reported to the staff that the approximate number of ratings in the class of government securities, based on this method, was approximately 880,880. Moody's reported 192,953 ratings in the class of government securities on its Form NRSRO.

15 A.M. Best Company, Inc., DBRS Ltd., Fitch, Inc., Japan Credit Rating Agency, Ltd., Moody's Investors Service, Rating and Investment Information, Inc., Standard and Poor's Ratings Services.

16 Egan-Jones Rating Company, LACE Financial Corp., Realpoint LLC.

issuer-pay model have determined approximately 99% of the total currently outstanding credit ratings issued by NRSROs.[17]

Market concentration is generally measured by economists using the Herfindahl-Hirschman Index (HHI), which is a measure of the size of firms in relationship to the industry and an indicator of the amount of competition among them. It is calculated by squaring the market share of each firm competing in the market and then summing the resulting number. The HHI is measured on a scale of 0 to 10,000 and approaches zero when a market consists of a large number of firms of relatively equal size. The HHI increases both as the number of firms in the market decreases and as the disparity in size between those firms increases. According to the U.S. Department of Justice, markets in which the HHI is between 1,000 and 1,800 points are considered to be moderately concentrated, and those in which the HHI is in excess of 1,800 points are considered to be concentrated.[18]

The HHI for all NRSRO ratings outstanding is 3,347, which is the equivalent of (10,000/3,347) 3 equally sized firms. Three NRSROs (Fitch, Moody's, and S&P) issued approximately 97% of all outstanding ratings across all categories reported. The concentration of outstanding ratings for these three NRSROs is high across all five categories, but does vary across those categories. For instance, Fitch, Moody's, and S&P account for over 99% of all outstanding ratings for government securities, but less than 74% of all ratings for insurance companies. For reasons, including those discussed below in section V.C., concentration needs to be considered together with other factors to identify the level of competition.

Among these three large NRSROs, concentration is not consistent across rating classes. For credit ratings related to financial institutions, Fitch and Moody's each had almost twice as many outstanding ratings as did S&P. Moody's and S&P were the two dominant issuers of credit ratings for corporate issuers.

Among the other NRSROs, DBRS and LACE report having the two largest numbers of outstanding credit ratings for financial institutions (18,040 and 18,000 respectively or approximately 7% each of all ratings in the category) while A.M. Best reports the largest number of outstanding ratings for the insurance company category (6,009 for 25% of all ratings in this category). DBRS reports the largest number of outstanding ratings for the corporate sector (7,080 for 8.2% of all ratings within this category).

After credit ratings for government, municipal and sovereign securities, the next highest level of concentration is in the provision of credit ratings for asset-backed securities.[19] Specifically, of the over 401,960 outstanding ratings in this credit rating class, all but 17,019 are issued by Fitch, Moody's, and S&P. Among the other NRSROs,

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17 According to Forms NRSRO made public by NRSROs.

18 http://www.usdoj.gov/atr/public/testimony/hhi.htm.

19 Fitch, Moody's, and S&P issued 2,348,144 of the total 2,359,184 credit ratings for government, municipal and sovereign securities and issuers.

Realpoint reports having the largest number of outstanding credit ratings for asset-backed securities (9,200 for 2.3% of all ratings in the category).

The HHI for all credit ratings outstanding has declined from 3,778 reported in the first annual report to 3,347 this year.[20]

2. Number of Credit Analysts employed at each NRSRO

The table below reports the total number of credit analysts and credit analyst supervisors employed at each NRSRO as reported by each NRSRO in Exhibit 8 of its Form NRSRO.

Credit Analysts and Credit Analyst Supervisors Employed at Each NRSRO

NRSRO	Credit Analysts	Credit Analyst Supervisors
A.M. Best	144	50
DBRS	62	24
EJR	12	3
Fitch	1,057	305
JCR	59	23
LACE	8	4
Moody's	1,124	126
R&I	80	8
Realpoint	15	7
S&P	1,081	228
Total	3,642	778

The three largest credit rating agencies report employing 3,262 credit analysts or approximately 90% of the total number of credit analysts employed by all of the NRSROs. Among the other NRSROs, A.M. Best reported employing the largest number of credit analysts (144 or approximately 4% of the total number of credit analysts).

3. NRSRO Financial Results

Exhibit 12 to Form NRSRO requires each NRSRO to provide information as to the amount of revenue generated from various credit rating services and a separate computation of total revenue from all other services. In addition, Exhibit 11 to Form NRSRO requires each NRSRO to furnish the Commission with audited financial

[20] The decline is primarily due to the increase in the number of Moody's ratings reported in the class of government securities as a result of the change in the method of counting public finance ratings discussed in footnote 14. Without that change, the HHI is 3,723 which is only slightly lower than last years HHI. In addition, one NRSRO which previously reported outstanding ratings based on the number of rated issuers is now reporting the number of rated issues resulting in an increase in its outstanding ratings across all classes of ratings for which it assigns ratings.

statements for the past three fiscal or calendar years. An NRSRO will not be required to make any of this information publicly available pursuant to Section 15E(a)(3) of the Exchange Act and Rule 17g-1(i) thereunder.

The total revenue reported by all of the NRSROs was approximately $3.8 billion dollars.[21] The HHI for total revenues reported by NRSROs is 3,267 which is the equivalent of 3.1 equally sized firms. The HHI for earnings reported by NRSROs is 3,924 which the equivalent of 2.55 equally sized firms. The HHI for earnings is higher than the HHI for revenue because the firms which reported the largest amounts of revenue also tended to have higher after-tax profit margins.

B. NRSRO Products and Other Credit Analytic Products

Ratings produced by credit rating agencies, including NRSROs, are generally letter-based symbols intended to reflect assessments of credit risk for various entities issuing debt obligations in public markets. These credit assessments are designed to measure and predict the probability of default, or the expected loss, a measure which also includes an assessment of loss given default, for an individual debt obligation or for an obligor. These assessments, in most cases, reflect a variety of quantitative and qualitative factors which vary based on sector. In addition, rating agencies may employ different rating scales for different regions, sectors, jurisdictions or types of securities. For example, the rating scale a rating agency employs to assign short term obligations may differ from the rating scale it uses for long term obligations. Ratings are described by the credit rating agencies as intended to reflect only credit risk, not other valuation factors such as liquidity or currency risk. Thus, while bond yields are strongly correlated with credit ratings, ratings are not the sole determinant of prices.

Demand for credit ratings exists from investors, both individual and institutional, who value an independent assessment of the relative or absolute credit risk of a particular debt obligation or obligor. As such, credit ratings serve a certification function in the marketplace, providing issuers with higher ratings and less costly access to debt markets.[22] In many cases, investment managers and financial institutions are required by regulations, including Commission rules, to use ratings to establish investment risk standards for their portfolio holdings.[23] Parties can write contracts that create obligations

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21 The fiscal year end used by different NRSROs as a basis for their reporting varied from September 2008 to March 2009.

22 See, e.g., Partnoy (1999), or Boot, et al. (2006). Kerwer (2002) and Sinclair (2000) argue that credit ratings agencies create value through standardizing the credit assessment process. Frank Partnoy, 1999, "The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Ratings Agencies," Washington University Law Quarterly, 77 (3), 619-714. Arnoud W.A. Boot, Todd T. Milbourn and Anjolein Schmeits, 2006, "Credit Ratings as Coordination Mechanisms," Review of Financial Studies, 19 (1), 81-118. Deiter Kerwer, 2002, "Ratings Agencies: Setting a Standard for Global Financial Markets," Economic Sociology European Electronic Newsletter, 3 (3), 40-46. Timothy J. Sinclair, "Reinventing Authority: Embedded Knowledge Networks and the New Global Finance," Environment and Planning C: Government and Policy, 18 (4), 487-502.

23 See, e.g., European Central Bank, "Market Dynamics Associated with Credit Ratings: A Literature Review," Occasional Paper Series No. 16, 2004.

based on a change in ratings – the use of so-called "ratings triggers" (see additional discussion in following section).

In addition to NRSROs and other credit rating agencies, the staff is aware of other relevant providers of credit research and analysis.[24] Credit models and assessments by third-party providers may be used by investors as indicators of value or price for a given debt obligation. Where available, third-party providers of credit analytics and internal models are natural competitors to NRSROs for all non-regulatory uses, and may serve as a check on NRSRO ratings quality or substitutes for non-regulatory uses if they provide more accurate or useful ratings.

Economists point to several factors that have increased the demand for credit ratings in recent years.[25] Structural changes in financial markets have increased the number of participants, increased their anonymity, and increased the complexity of their investment strategies. At the same time, financial disintermediation shifted credit from banks to capital markets, leading to the creation of increasingly complex financial instruments through securitization. The increasing complexity likely created additional reliance by investors on NRSRO ratings as they provided a single summary measure of the credit risks of difficult to evaluate financial instruments. At the same time, banking and finance regulators around the world have increased their reliance on NRSRO ratings.

As noted above, NRSROs are one type of credit rating agency providing third-party credit assessments to the market. When users of credit assessments for non-regulatory purposes also need NRSRO ratings for regulatory purposes, they may choose to purchase only NRSRO ratings so as to avoid purchasing both. The economic case for purchasing a non-NRSRO credit assessment may be even more difficult if the credit rating agency is a newer entrant, without the same established level of reputation even when that assessment is valuable to the investor.

C. Regulatory and Economic Factors that Potentially Affect Competition in the Credit Rating Industry

The Findings section of the Rating Agency Act noted that "the 2 largest credit rating agencies serve the vast majority of the market."[26] Further, the Senate Report accompanying the Rating Agency Act described the largest two NRSROs (Moody's and S&P) as a "duopoly" or "partner-monopoly."[27] Information obtained from NRSROs about the number of ratings they have outstanding, the number of credit analysts and their financial results, presented above suggests that in combination with Fitch, these two entities still are dominant market players.

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24 See, e.g., Arturo Estrella, "Credit Ratings and Complementary Sources of Credit Quality Information", Basel Committee on Banking Supervision Working Papers, August 2000.

25 See, e.g., Fabian Dittrich, 2007, "The Credit Rating Industry: Competition and Regulation", Doctoral Dissertation, Universitat zu Koln, Koln, Germany and Isabelle Gras, 2003, "The Power to Rate," REGEM Analysis No. 6.

26 See Section 2 of the Rating Agency Act (Pub. L. No. 109-291 (2006)).

27 See Senate Report, 109-326, p.1.

Economists note that the credit rating industry has exhibited a high level of concentration throughout much of its history, dating from the early twentieth century.[28] Analysts have cited the regulatory use of ratings as a factor that has created barriers to entry and led to concentration in the credit rating industry.[29] Financial regulators including the Federal Reserve Banks, the Office of the Comptroller of the Currency and state banking and insurance departments have used credit ratings to assist them in their oversight of financial institutions since the 1930s. Early ratings-dependent rules included requirements to mark to market lower rated bonds and restrictions on purchase of speculative securities. In the 1950s, the National Association of Insurance Companies imposed higher capital requirements on the lower rated bonds of insurance companies.[30]

The Commission first used the term NRSRO in 1975 in the net capital rule for broker-dealers (Rule 15c3-1) as an objective benchmark to prescribe capital charges for different types of debt securities. Since then, the Commission has used the designation in a number of regulations. Although the use of the term NRSRO was originated for a narrow purpose in the Commission's own regulations, ratings by NRSROs today are used widely as benchmarks in federal and state legislation, and rules issued by other financial regulators.

Congress has incorporated the NRSRO concept into a wide range of financial legislation. For example, when Congress defined the term "mortgage related security" in Section 3(a)(41) of the Exchange Act as part of the Secondary Mortgage Market Enhancement Act of 1984, it required, among other things, that such securities be rated in one of the two highest rating categories by at least one NRSRO. Further, in 1989, Congress added the NRSRO concept to the Federal Deposit Insurance Act, prescribing that corporate debt securities are not "investment grade" unless they are rated in one of the four highest categories by at least one NRSRO.[31]

Finally, a number of other federal and state laws and regulations today employ the NRSRO concept. For example, the U.S. Department of Education uses ratings from NRSROs to set standards of financial responsibility for institutions that wish to participate in student financial assistance programs under Title IV of the Higher Education Act of 1965, as amended (Title IV). In addition, several state insurance codes rely, directly or indirectly, on NRSRO ratings in determining appropriate investments for insurance companies. Most recently, credit ratings have been used to determine the

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28 See, e.g., Richard Sylla, "A Historical Primer on the Business of Credit Ratings" and Lawrence J. White, "The Credit Rating Industry: an Industrial Organization Analysis" both papers in "Ratings, Rating Agencies and the Global Financial System (The New York University Salomon Center Series on Financial Markets and Institutions)", edited by Richard M. Levich, Giovanni Majnoni, and Carmen Reinhart, 2002.

29 See, e.g., Partnoy (1999), White (2001).

30 See, e.g., Richard Cantor and Frank Packer, "The Credit Rating Industry", FRBNY Quarterly Review, Summer-Fall, 1994.

31 See "Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets As Required by Section 702(b) of the Sarbanes-Oxley Act of 2002", http://www.sec.gov/news/studies/credratingreport0103.pdf, January, 2003.

eligibility of assets for a number of the programs established by the Federal Reserve and the Department of the Treasury in response to the credit crisis. [32]

Credit ratings are also used widely by financial regulators outside the United States.[33] According to a Basel Committee on Banking Supervision (BCBS) study published in 2000, eleven out of twelve countries that are members of the BCBS used the ratings of credit rating agencies in financial regulatory supervision.[34] The Basel II framework, which has been implemented by members of the European Union, relies on the ratings of credit rating agencies recognized as External Credit Assessment Institutions (ECAI) in order to calculate bank capital requirements within its standardized approach for credit risk measurement. [35]

Economies of scale and sunk costs may be economic factors which may favor the larger long established rating agencies. Large rating agencies can allocate the costs of analytical software, administrative, legal, compliance, marketing and support staff, among other costs, across a wider range of ratings providing a more efficient cost base. In addition, these rating agencies have large sunk costs in the form of developed ratings, methodologies and procedures and ratings outstanding which new entrants must create from scratch.[36]

The importance of reputation is another economic factor that is often cited by analysts.[37] When the quality of a firm's product is difficult to assess at the time of purchase, consumers often use the quality of prior products produced by the firm as a benchmark for their purchasing decision.[38] A firm that has a long history of producing quality products develops a reputational asset which allows it to command a higher price. The value of this reputational asset can provide an incentive for the firm to continue to produce high quality products.[39]

Credit ratings are an example of a product whose quality, at time of purchase, is particularly difficult to evaluate. In most cases, credit ratings are estimates about the probability of default or expected loss for a given debt obligation or obligor. Defaults are expected to occur rarely and are highly sensitive to macroeconomic forces which may be

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32 See, e.g., "Term Asset-Backed Securities Loan Facility: Terms and Conditions", May, 2009, http://www.newyorkfed.org/markets/talf_terms.html.

33 See The Joint Forum, "Stocktaking on the use of credit ratings", June 2009, available at www.iosco.org ("June 2009 Joint Forum Report").

34 See Arturo Estrella, "Credit Ratings And Complementary Sources Of Credit Quality Information", Basel Committee On Banking Supervision Working Papers No. 3, August 2000.

35 See, Basel Committee on Banking Supervision, "International Convergence of Capital Measurement and Capital Standards: A Revised Framework - Comprehensive Version", June 2006.

36 See, e.g., Herwig M. Langohr, "The Credit Rating Agencies and Their Credit Ratings", address given to the Bond Market Association in Paris in February 2006.

37 See, e.g., Dittrich (2007).

38 See, e.g., Carl Shapiro, "Premiums for High Quality Products as Returns to Reputations", Quarterly Journal of Economics 98(4): 659-79, November 1983.

39 See, e.g., Benjamin Klein and Keith Leffler, "The Role of Market Forces in Assuring Contractual Performance", Journal of Political Economy, Vol. 89, No. 41, 1981.

difficult to forecast. The accuracy and consistency of ratings produced by a given rating agency may only be revealed over an extended period. Because it is difficult to evaluate a particular credit rating easily, establishing and maintaining a reputation for ratings accuracy, a process which can take years, is very important for any credit rating agency.

A rating agency's reputation can be damaged by a failure to continue to assign ratings accurately. The assignment of high credit ratings to many RMBS and CDO securities in recent years followed by the scope and magnitude of subsequent downgrades during the current credit crisis has resulted in a loss of confidence among investors in the reliability of credit ratings issued by the largest NRSROs in this sector. This lack of confidence in the accuracy of NRSRO ratings has been a factor in the broader dislocation in the credit markets. In the wake of these events, the NRSROs that rated subprime RMBS and CDOs have come under intense criticism and scrutiny, although their market share does not seem to be affected by any diminished reputation.

"Network externalities" may also play a role in the credit rating industry. Network externalities which are often considered in connection with such products as computer operating systems or video recorders exist when the value of a product increases as more people use it.[40] Network externalities can create a significant obstacle to entry for a new entrant in an industry where these effects are strong. In these types of industries, a company may make a product which has superior attributes to an entrenched competitor and still fail to win market share. The procedures and methodologies of a rating agency create a standardized way of looking at credit risk and one function of the rating is to facilitate communication about credit risk among market participants.[41] Another function of credit ratings is to facilitate comparisons between credit instruments within a sector and potentially across sectors. Market participants may consider how widely the ratings of a particular rating agency are used by other investors and the breadth of coverage a rating agency provides as factors in determining the usefulness of its ratings.[42]

A wide range of private contractual agreements which reference the ratings of particular rating agencies create another barrier to entry for new entrants.[43] These include, for example, minimum ratings requirements that specify the ratings of specific rating agencies in the investment management contracts of institutional fund managers and the investment guidelines of fixed income mutual fund managers, pension plan sponsors, and endowment fund managers. In addition, fixed income indices used to evaluate the

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40 See, e.g., Michael L. Katz and Carl Shapiro, "Network Externalities, Competition, and Compatibility", The American Economic Review, Vol. 75, No. 3, pp. 424-440, June 1985. For application to credit rating industry see Langohr (2006), Jerome S. Fons, "White Paper on Rating Competition and Structured Finance", January 2008.

41 See, e.g., Kerwer (2002).

42 See, e.g., Langhohr (2006), Fons (2008).

43 See, e.g., Richard Cantor, Owain ap Gwilym, Stephen Thomas, "The Use of Credit Ratings in Investment Management in the U.S. and Europe", The Journal of Fixed Income, Vol. 17, No. 2, Fall 2007; H. Kent Baker and Sattar A. Mansi, "Assessing Credit Rating Agencies by Bond Issuers and Institutional Investors", Journal of Business Finance & Accounting, Volume 29, Numbers 9-10, November/December 2002; G. Timothy Haight, George Engler and Kenneth J. Smith, "An Examination of the Characteristics of College Endowment Funds", Journal of Investing, Fall 2006.

performance of investment managers often have inclusion characteristics which refer to the ratings of specific rating agencies. The effect of these contractual agreements can be to increase the demand and liquidity for securities bearing the ratings of specific providers.

In addition, ratings triggers are commonly found in bank loan agreements, guaranteed investment contracts, and the credit support annexes and other provisions of derivatives contracts.[44] When ratings triggers are present, a decline in the rating of an issuer or obligor below a certain level can alter the obligations of parties to an agreement, for example, providing a counterparty to a derivatives contract with the right to demand collateral or lenders the right to demand repayment of a loan. The ratings of specific rating agencies are often specified in such agreements. The extensive use of credit ratings in private contracts has enhanced the importance of credit ratings to the marketplace.

Barriers that prevent some NRSROs from obtaining information needed to assign ratings may also limit competition, particularly with respect to structured finance products. Generally, when the issuer-paid model is employed, the information relied on by the hired NRSROs to rate structured finance products is non-public. This makes it difficult for other NRSROs to rate these securities. As a result, the products frequently are issued with ratings from only one or two NRSROs and only by NRSROs that are hired by the issuer, sponsor, or underwriter. In addition, investors may also tend to place greater weight on an opinion that is based, in part, on access to privileged information.[45]

D. The Status of Competition among NRSROs

Since the enactment of the Rating Agency Act and the adoption of the Commission's rules thereunder, ten firms have registered as NRSROs with the Commission. The first seven firms applied for registration as NRSROs in June of 2007 under the new registration and oversight program adopted by the Commission that month. Subsequently, the Commission granted three additional credit rating agencies NRSRO registration. The ratings available from these three newest NRSROs increase the total number of available outstanding credit ratings that can be relied upon for regulatory purposes by about 30,500. In addition, the three newest NRSROs operate primarily under the subscriber-pay compensation model, providing users of ratings an alternative to the issuer-pay model employed by the seven NRSROs which applied for registration in June 2007.

Although the credit ratings of the two largest NRSROs now represent a smaller proportion of all NRSRO ratings, the Commission is unable to discern from this data the impact of NRSRO registration on the demand for or the provision of credit ratings for several reasons. First, the registration and oversight program implemented by the Commission under the Rating Agency Act that requires disclosure of information about

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44 See, e.g., Moody's Special Comment , "2008 Rating Trigger Trends in the U.S. Life (Re)Insurance Industry", January, 2009.

45 See, e.g., Philippe Jorion, Zhu Liu, and Charles Shi, "Informational Effects of Regulation FD: Evidence from Rating Agencies", Journal of Financial Economics, May 2005.

outstanding ratings for NRSROs is less than two years old. In addition, the credit crisis, while potentially creating additional long term demand for providers of credit ratings and research has reduced debt issuance in a number of sectors. Consequently, there is insufficient history to evaluate the impact that being registered as an NRSRO has had on obtaining additional business.

Second, comparing the number of outstanding ratings of the long established NRSROs and newly registered NRSROs may not provide a complete picture. The large NRSROs may have a significantly longer history of issuing ratings and their reported outstanding ratings include ratings for debt obligations (and obligors) that may have been rated long before the establishment of the newer entrants. Consequently, a comparison of the number of ratings being determined for more recent issuances may provide a better gauge of how well newer entrants are competing with more established firms.

Third, as noted above, all seven of the NRSROs which applied for registration in June 2007 operate primarily on an issuer-pay compensation model, whereas the three newer NRSROs primarily rely on a subscriber-pay compensation model. For the earlier-registered NRSROs, each outstanding rating was provided based on the demand by a paying client (the issuer) for that individual rating. Increases and decreases in total number of outstanding ratings reflect trends in securities issuances and the demand for the specific rating by identifiable clients from that NRSRO.

The subscriber-pay compensation model is a different economic model. Subscriber-pay NRSROs typically attract customers who want access to at least some of their credit ratings. Investors and other market participants purchase the right to access the pool of credit ratings issued by these NRSROs and are not necessarily users of all credit ratings provided. Thus, a client of a subscriber-pay NRSRO may request a rating on an individual security or those securities of a specific issuer or class of issuers, but a reported increase in the number of securities rated by the NRSRO as part of its regulatory filings does not necessarily demonstrate that those additional credit ratings were specifically demanded by investors or that they are being relied upon by market participants widely.

E. Assessing the Impact of Additional Competition

As noted above, the Senate Report accompanying the Rating Agency Act stated that the statute's purpose was to "improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency, and competition in the credit rating industry."[46] The Senate Report also noted that competition would "provide investors with more choices, higher quality ratings, and lower costs."[47] Competition can lead to credit ratings that are of higher quality to investors along some dimension (e.g., more accurate, more timely) or ratings that are of equivalent quality and reputation but at a lower price.

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46 See Senate Report, 109-326, p. 1.

47 See Senate Report, 109-326, p. 7.

Increasing the number of entities that can be treated as NRSROs for purposes of laws and regulations using that term, by itself, may not have a significant effect on competition. The newer NRSROs, by showing themselves (or causing the long established NRSROs) to provide ratings that are superior in either quality or price, could create additional competition. As discussed above, because of the importance of reputation, the difficulty in establishing a reputation quickly, and other economic factors, it may take some time before the impact of increased competition can be observed. Gaining acceptance in the market for a new NRSRO may be even more difficult when investors and their agents rely upon written policies and procedures requiring the use of ratings provided by just two or three of the currently market-dominant NRSROs. Altering such policies and procedures would require affirmative actions on the part of investors. In addition, while the Rating Agency Act and the Commission's registration and oversight program have made it easier for smaller entrants to become NRSROs, certain regulations, both in the United States and internationally, only recognize the largest credit rating agencies – a subclass of the NRSROs.[48]

As described above, the provisions of Section 15E(h) of the Exchange Act and Rule 17g-5 require NRSROs to establish procedures to manage conflicts of interest, to disclose applicable conflicts of interest, and prohibit them from having certain conflicts of interest.[49] In the credit rating industry, conflicts of interest may arise from a number of activities, including the manner of compensation, the provision of consulting or advisory services, and business relationships and affiliations. Reducing the barriers to entry in the market for providing NRSRO ratings and, hence increasing competition, may, in fact, reduce conflicts of interest in substantive ways. This market disciplining mechanism will be less effective the more difficult it is for investors to determine the true credit quality of the rated debt security or obligor.

F. User Perspectives

On April 15, 2009, the Commission held a roundtable relating to its oversight of credit rating agencies. Discussion topics included issues related to recent SEC rulemaking initiatives, such as conflicts of interest, competition, and transparency. Roundtable participants included leaders from investor organizations, financial services associations, government agencies, credit rating agencies, and academia. Some of the proposals by roundtable participants included:

- Establish an independent credit rating agency oversight board with authority not only over the substance of the ratings process, conflicts, disclosure and pay, but also the transition away from regulatory reliance on ratings.[50]

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48 See June 2009 Joint Forum Report.

49 See 15 U.S.C 78o-7(h) and 17 CFR 240.17g-5.

50 See letter from Frank Partnoy, George E. Barrett Professor of Law and Finance, University of San Diego School of Law, San Diego, California, (File No. 4-579), dated April 15, 2009, ("Partnoy Letter").

- Establish a credit rating review board that would have to sign off on any rating before it took on regulatory significance or, alternatively, which would audit ratings after the fact to ensure rating agencies are sufficiently disclosing methodologies, the rating agencies' methodologies are sound and rating agencies are adhering to them.[51]

- Implement a model similar in nature to a utility where a small transaction fee would be instituted to support ratings.[52]

- A group of major institutional investors should set up their own rating agency, capitalized and paid for by the investors, working from their point of view and supplied with top talent and technology.[53]

- Require every rating provided by an NRSRO paid by the issuer be accompanied by a rating provided by an Investor Owned and Controlled Rating Agency (IOCRA) that is also paid for by the issuer. IOCRAs would be owned and operated by the largest, most sophisticated debt market investors.[54]

- Introduce a new compensation model where investors would choose which rating agencies are paid for ratings. In one alternative, initial rating fees would be deducted from proceeds of a new issue and directed to rating agencies by the buyer/owner of the bonds. Each investor would "designate" their pro rata portion of fees to one or more rating agencies. Any licensed rating agency would be eligible to rate a bond and the issuer would be required to provide all interested rating agencies with the information to rate their securities. Maintenance rating fees would be paid by the issuer along with coupon/amortization payments.[55]

- Require issuers to obtain a rating from a new entrant for every rating obtained from a long established NRSRO.[56]

- Require issuers to rotate the rating agency they use to provide their ratings every three years – analogous to the rotation process implemented for financial auditors.[57]

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51 See letter from Congressional Oversight Panel's Special Report on Regulatory Reform, submitted by Damon Silvers, AFL-CIO, (File No. 4-579), dated April 9, 2009.

52 See letter from James A. Kaitz, President and CEO, The Association for Financial Professionals. (File 4-579), April 15, 2009.

53 See letter from Alex J. Pollock, Resident Fellow, American Enterprise Institute, (File No. 4-579), dated April 15, 2009.

54 See letter from Joseph A. Grundfest and Eugenia Petrova, Stanford Law School and The Rock Center on Corporate Governance, (File No. 4-579), dated April 9, 2009.

55 See letter from Mayree Clark and Andrew Jones, (File No. 4-579), dated April 9, 2009.

56 See letter from Ethan Berman, RiskMetrics Group, (File No. 4-579), dated April 15, 2009, ("Berman Letter").

57 See Berman Letter.

- Remove NRSROs exemption from misstatements in registration statements in section 11 of the Securities Act of 1933 and their exemption from liability as experts under Securities Act Rule 436; and adopt legislation indicating that NRSROs are subject to private rights of action under specified statutory criteria. [58]

G. The Potential Impact on Competition of Newly Proposed NRSRO Amendments and Rule

The Rating Agency Act and the registration and oversight program for NRSROs implemented by the Commission in June 2007 under the Act are designed, among other things, to promote competition. For example, the registration process prescribed by the Rating Agency Act and Rule 17g-1 make it easier for credit rating agencies to become NRSROs and, thereby, to compete with long established NRSROs. In addition, the disclosure requirements of Form NRSRO make it easier for users of credit ratings to compare NRSROs and, therefore, for an NRSRO to distinguish itself from its peers. For example, the disclosure of performance statistics and the methodologies and procedures for determining credit ratings make it easier for users to assess the accuracy of an NRSRO's credit ratings and how well its procedures and methodologies are designed to achieve accuracy. Moreover, the disclosures of conflicts, the procedures for managing conflicts, and the procedures for protecting material, nonpublic information allow users of credit ratings to assess the steps an NRSRO has taken to ensure the integrity of its credit rating processes.

The new rules adopted by the Commission in February 2009 are designed, among other things, to promote competition. For example, under paragraph (d) of Rule 17g-2, as amended, NRSROs are required to publicly provide the histories of 10% of their issuer-paid credit ratings, in each class of ratings for which they have issued 500 or more such ratings and with a six month grace period.

In addition the adopted rules prescribe greater specificity with respect to the default and ratings transition statistics the NRSROs disclose in Form NRSRO. For example, NRSROs are required to calculate these statistics over specific time periods – 1, 3, and 10 years and across the different classes of credit ratings for which they are registered – as applicable: (1) financial institutions, brokers, or dealers; (2) insurance companies; (3) corporate issuers; (4) issuers of asset-backed securities; and (5) issuers of government securities, municipal securities, or sovereign securities. The class of government securities must be further separated into three additional classes: sovereigns, United States public finance, and international public finance.

These enhanced disclosures with respect to the performance of the NRSROs' credit ratings are designed to foster greater accountability of the NRSROs with respect to

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[58] See letter from Gregory W. Smith, General Counsel, Colorado Public Employees' Retirement Association, (File No. 4-579), dated April 8, 2009. Also, see Partnoy letter (Partnoy comments that rating agencies should not be exempt from securities fraud liability and should not enjoy any special privilege over other gatekeepers in Section11 of the Securities Act of 1933, Regulation FD, or elsewhere).

their credit ratings as well as competition among the NRSROs by making it easier for persons to analyze the actual performance of the credit ratings the NRSROs issue in terms of accuracy in assessing creditworthiness. Ultimately, this could make it easier for a smaller, newer NRSRO to demonstrate that it has a superior credit rating methodology and, thereby, enhance its reputation for issuing accurate ratings.

VI. COMMISSION'S VIEW ON TRANSPARENCY

One of the goals of the Rating Agency Act is to increase transparency in the credit rating industry. As discussed above, the provisions of Section 15E of the Exchange Act and Rule 17g-1 require NRSROs to publicly disclose their Form NRSROs and Exhibits 1 through 9, which contain information about their performance statistics; procedures and methodologies for determining credit ratings; procedures to prevent the misuse of material, non-public information; their organizational structure; their code of ethics (or explanation of why they do not have a code of ethics); their conflicts of interest; their procedures to manage conflicts of interest; information about their credit analysts; and information about their designated compliance officers. Prior to the implementation of the NRSRO registration and oversight program, certain credit rating agencies disclosed some of this information, particularly with respect to credit rating performance statistics and their procedures and methodologies for determining credit ratings. The NRSRO oversight program has increased the amount of information disclosed and concentrated the disclosure in a single location: Form NRSRO. The following is a list of the Internet Web site links where the Form NRSRO for each credit rating agency registered as an NRSRO currently can be obtained:[59]

A.M. Best Company, Inc.
http://www.ambest.com/nrsro/formnrsro.pdf

DBRS Ltd.
http://www.dbrs.com/intnlweb/jsp/search/listResults.faces

Egan-Jones Rating Company
http://www.egan-jones.com/publicdocs/Form%20NRSRO%20Nov%202007.doc

Fitch, Inc.
http://www.fitchratings.com/jsp/corporate/PolicyRegulation.faces?context=3&detail=4

Japan Credit Rating Agency, Ltd.
http://www.jcr.co.jp/english/nrsro/index.html

LACE Financial Corp.
http://www.lacefinancial.com/Out/documents/Disclosure.pdf

Moody's Investors Service, Inc.

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59 These are the Internet Web site addresses as of June 2009. The addresses may change over time.

http://www.moodys.com/cust/content/loadcontent.aspx?source=staticcontent/Free%20Pages/Regulatory%20Affairs/NRSRO.htm

Rating and Investment Information, Inc.
http://www.r-i.co.jp/eng/rating/nrsro/nrsro.html

Realpoint LLC
http://www.realpoint/ComplianceDocuments/NRSRO.pdf.

Standard & Poor's Ratings Services
http://www2.standardandpoors.com/portal/site/sp/en/us/page.topic/ratings_nrsro/2,1,1,6,0,0,0,0,0,0,0,0,0,0,0,0.html

The Commission believes that the requirement to make these disclosures has enhanced the transparency of the credit rating industry but that such transparency could still be enhanced further. Consequently, the amendments to the NRSRO rules adopted by the Commission on in February 2009 contain a number of new requirements designed to further increase the transparency of the credit rating processes of the NRSROs. The amendments to Exhibit 2 to Form NRSRO proposed by the Commission are designed to enhance the quality of the disclosures NRSROs make about their procedures and methodologies for determining credit ratings. The first adopted amendment requires an NRSRO to disclose whether it considers in its rating process for structured finance products steps taken to verify information about the assets in the pool backing the structured finance products. Underwriters and sponsors of structured finance products frequently take some steps to verify information provided by borrowers in loan documentation. Generally, they have been reluctant to provide the results of this verification to NRSROs for proprietary reasons. The amendment would not require that the NRSROs incorporate verification (or the lack of verification) into their ratings processes. Rather, it would require an NRSRO to disclose whether and, if so, how information about verification performed on the assets is relied on in determining credit ratings for structured finance products. For example, an NRSRO would need to disclose, as applicable: if it does not consider steps taken to verify the information; if it requires some minimum level of verification to be performed before it will determine a credit rating for a structured finance product; and how it incorporates the level of verification performed into its procedures and methodologies for determining credit ratings (e.g., if it compensates for the lack of verification by requiring greater levels of credit enhancement for the tranche securities).

The Commission believes this disclosure will benefit users of credit ratings by providing information about the potential accuracy of an NRSRO's credit ratings. The NRSROs determine credit ratings for structured finance products based on assumptions in their models as to how the assets underlying the instruments will perform under varying levels of stress. These assumptions are based on the characteristics of the assets (e.g., value of the property, income of the borrower) as reported by the arranger of the structured finance product. If this information is inaccurate, the capacity of the model to predict the potential future performance of the assets may be significantly impaired.

Consequently, information about whether an NRSRO requires that some level of verification be performed or takes other steps to account for the lack of verification or a low level of verification would be useful to users of credit ratings in assessing the potential for an NRSRO's credit ratings to be adversely impacted by bad information about the assets underlying a rated structured finance product.

The second amendment requires an NRSRO to disclose whether it considers qualitative assessments of the originator of assets underlying a structured finance product in the rating process for such products. Certain qualities of an asset originator, such as its experience and underwriting standards, may impact the quality of the loans it originates and the accuracy of the associated loan documentation. This, in turn, could influence how the assets ultimately perform and the ability of the NRSRO's models to predict their performance. Consequently, the failure to perform any assessment of the loan originators could increase the risk that an NRSRO's credit ratings may not be accurate. Therefore, disclosures as to whether the NRSRO performs any qualitative assessments of the originators would be useful in comparing the efficacy of the NRSRO's procedures and methodologies.

The third amendment requires an NRSRO to disclose the frequency of its surveillance efforts and how changes to its quantitative and qualitative ratings models are incorporated into the surveillance process. The goal is to provide to users of credit ratings information that would be useful in comparing the ratings methodologies of different NRSROs. For example, how often and with what models an NRSRO monitors its credit ratings would be relevant to assessing the accuracy of the ratings insomuch as ratings based on stale information and outdated models may not be as accurate as ratings of like products determined using newer data and models. Moreover, with respect to new types of rated obligors and debt securities, the NRSROs refine their models as more information about the performance of these obligors and debt securities is observed and incorporated into their assumptions. Consequently, as the models evolve based on more robust performance data, credit ratings of obligors or debt securities determined using older models may be at greater risk for being inaccurate than the newer ratings. Therefore, whether the NRSRO verifies the older ratings using the newer methodologies would be useful to users of credit ratings in assessing the accuracy of the credit ratings.

Finally, as noted above, under paragraph (d) of Rule 17g-2, as amended, NRSROs are required to publicly provide the histories of 10% of their issuer-paid credit ratings, in each class of ratings for which they have issued 500 or more such ratings and with a six month grace period. The goal is to increase transparency by providing users of credit ratings, investors, and other market participants and observers the raw data with which to compare how the NRSROs initially rated an obligor or security and, subsequently, adjusted those ratings, including the timing of the adjustments.

VII. COMMISSION'S VIEW ON CONFLICTS OF INTEREST

There are two business models used in the credit rating industry and each has potential inherent conflicts of interest. As discussed above, the business model of the

largest NRSROs is to receive compensation from obligors for rating the obligor or securities issued by the obligor (the "issuer-pay model"). This issuer-pay model creates a potential conflict in that an NRSRO, in order to gain favor with the issuer and retain its business, may determine a credit rating that is higher than the NRSRO's objective analysis would imply. This conflict potentially could be broader than a single issuer to the extent that an NRSRO determines higher credit ratings for a class of issuers in order to retain or attract business across all issuers in that class.

The other business model is the subscriber-pay model, which also is subject, albeit to a potentially lesser degree, to potential conflicts of interest. For example, a subscriber may hold a securities position (long or short) that potentially could be advantaged by an NRSRO upgrading or downgrading the position to the extent such rating action caused the market value for the security to increase or decrease. Furthermore, a subscriber may want to hold a particular security in an investment portfolio but may be constrained from doing so because its credit rating is lower than its internal investment guidelines, an applicable contract, or an applicable regulation permit. An upgrade of the credit rating of the security by the NRSRO could remove this impediment to investing in the security. This conflict exists only to the extent that the subscriber NRSRO is aware of the portfolio holdings of the subscriber. Moreover, this conflict is mitigated to the extent subscribers have different interests with respect to an upgrade or downgrade of a particular security.

The Commission took steps to address the potential conflicts in both business models when it adopted the rules implementing the registration and oversight program for NRSROs. As discussed above, the approach taken in the rules is to require the disclosure in Form NRSRO of the general types of conflicts that arise from the NRSRO's business activities. Additionally, the Commission prohibited an NRSRO from having certain conflicts of interest unless it discloses them and has procedures for managing them, and prohibited outright an NRSRO from having certain other conflicts of interest.

A number of studies have attempted to identify cases of "rating shopping" behavior, where, under the "issuer pay" business model, issuers seek to hire rating agencies that provide more favorable ratings. For example, according to one study of residential mortgage-backed securities transactions in the early to mid 1990s, rating agencies whose rating methodologies required lower levels of credit enhancement to reach a given rating level than competitors tended to increase their market share.[60] A more recent study of corporate ratings concluded that the presence of a new entrant could result in more "issuer-friendly" ratings.[61] Other analysts, however, have argued that the incentives for a rating agency to maintain its reputation outweigh the short term gain which can be achieved by issuing ratings of lower quality.[62]

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60 See Cantor and Packer (1994).

61 See Bo Becker and Todd Milbourn, "Reputation and Competition, Evidence from the Credit Rating Industry", Harvard Business School Working Paper 09-051, October 2008.

62 See, e.g., Steven L. Schwarcz, "Private Ordering of Public Markets: The Rating Agency Paradox", University of Illinois Law Review, Vol. 2002, No. 2, February 2002 and Daniel M Covitz and Paul Harrison, "Testing Conflicts of Interest at Bond Ratings Agencies with Market

The potential for conflicts of interest may be particularly acute in the structured product area, including RMBS and CDOs among others, where issuers are separate legal entities created and operated by a relatively concentrated group of sponsors, underwriters and managers (collectively "arrangers"). These products are highly complex and require specific and technical knowledge of financial engineering and valuation of the underlying assets. But the complexity of the products and the issuers' ability to control the flow of information about the underlying assets may lead to an outcome where one party to the transaction, the arranger, has more or better information about the transaction than the other party (the investor).[63] This informational imbalance, combined with very high concentration in NRSRO credit raters, increases the potential for conflicts of interest to impair market integrity. As discussed above, however, reputational risk provides incentives for firms to produce high quality ratings.

The staff's examinations of select credit rating agencies regarding their role in the turmoil in the subprime mortgage-related securities markets revealed, among other things, that the rating agencies examined appear to have failed to properly manage potential conflicts of interest.[64] Within this report, the staff of the Office of Economic Analysis ("OEA") noted that the conflicts created from the "issuer pay" model in rating structured finance products, particularly RMBS and related-CDOs, may have been exacerbated for a number of reasons which are summarized in the following four paragraphs.[65]

First, the arranger was often the primary designer of the deal and as such, had more flexibility to adjust the deal structure to obtain a desired credit rating as compared to arrangers of non-structured asset classes. As well, arrangers that underwrote RMBS and CDO offerings had substantial influence over the choice of rating agencies hired to rate the deals.

In addition, there was a high concentration in the firms conducting the underwriting function. The combination of the arrangers' influence in determining the choice of rating agencies and the high concentration of arrangers with this influence appears to have heightened the inherent conflicts of interest that exist in the "issuer pay" compensation model.

Pressure from arrangers could have also come in the form of requiring more favorable ratings or reduced credit enhancement levels. Such outcomes would reduce the cost of the debt for a given level of cash inflows from the asset pool.

Anticipation: Evidence that Reputation Incentives Dominate", FEDS Working Paper No. 2003-68, December 2003.

63 Economists typically refer to this outcome as the existence of information asymmetries. See, e.g., George A. Akerlof, "The Market for 'Lemons': Quality Uncertainty and the Market Mechanism", Quarterly Journal of Economics 84(3): 488–500, 1970.

64 See July 2008 Staff Report.

65 See July 2008 Staff Report, Section V, Observations by the Office of Economic Analysis.

Finally, high profit margins from rating RMBS and CDOs may have provided an incentive for a rating agency to encourage the arrangers to route future business its way Unsolicited ratings were not available to provide an independent check on the rating agencies' ratings, and the structures of these securities were complex, and information regarding the composition of the portfolio of assets, especially prior to issuance was difficult to obtain for parties unrelated to the transaction.

Analysts note that fees for structured finance transactions could, in some cases, could be significantly higher than fees for corporate structures of similar size.[66] The staff examinations revealed that revenues derived from RMBS ratings increased between 2002 and 2006 by a percentage that varied among these three firms from approximately 100% for the firm which had the lowest percentage growth in revenues to over 200% for the firm which had the highest percentage growth. For CDOs, during the same period, ratings revenue increased by a percentage that varied from approximately 200% for the firm which had the lowest percentage growth to over 800% for the firm which had the highest percentage growth.[67]

During the period covered by the second annual report, the Commission adopted amendments to prohibit three additional conflicts of interest outright. The first amendment prohibits an NRSRO from issuing a credit rating with respect to an obligor or security where the NRSRO, or a person associated with the NRSRO, made recommendations to the obligor or the issuer, underwriter, or sponsor of the security (that is, the parties responsible for structuring the security) about the corporate or legal structure, assets, liabilities, or activities of the obligor or issuer of the security.[68] This rule prohibits the NRSRO and, in particular, its credit analysts from making recommendations to obligors, issuers, underwriters, and sponsors such as arrangers of structured finance products about how to obtain a desired credit rating during the rating process. It also prohibits an NRSRO from issuing a credit rating where a person associated with the NRSRO, such as an affiliate, made such recommendations.

The second amendment prohibits the conflict of interest that arises when a fee paid for a rating is discussed or arranged by a person within the NRSRO who has responsibility for participating in determining credit ratings (including analysts and rating committee members) or for developing or approving procedures or methodologies used for determining credit ratings, including qualitative and quantitative models.[69] This proposal is designed to effectuate the separation within the NRSRO of persons involved in fee discussions from persons involved in the credit rating analytical process. The incentives of the persons discussing fees could be based primarily on generating revenues for the NRSRO; whereas the incentives of the persons involved in the analytical process should be based on determining accurate credit ratings. There is a significant potential for these distinct incentive structures to conflict with one another where persons within the NRSRO are engaged in both activities.

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[66] See, e.g., Fons (2008).

[67] See July 2008 Staff Report.

[68] See February 2, 2009 Adopting Release, 17 CFR 240.17g-5(c)(5).

[69] See February 2, 2009 Adopting Release, 17 CFR 240.17g-5(c)(6).

The potential consequences are that a credit analyst or person responsible for approving credit ratings or credit rating methodologies could, in the context of negotiating fees, let business considerations undermine the objectivity of the credit rating process. For example, an individual involved in a fee negotiation with an issuer might not be impartial when it comes to rating the issuer's securities. In addition, persons involved in approving the methodologies and processes used to determine credit ratings could be reluctant to adjust a model to make it more conservative if doing so would make it more difficult to negotiate fees with issuers. For these reasons, the Commission believes that this conflict should be prohibited.

The third amendment prohibits the conflict of interest relating to the issuance or maintenance of a credit rating where a credit analyst who participated in determining or monitoring the credit rating, or a person responsible for approving the credit rating, received gifts, including entertainment, from the obligor being rated, or from the issuer, underwriter, or sponsor of the securities being rated, other than items provided in the context of normal business activities that have an aggregate value of more than $25.[70] Persons seeking credit ratings for an obligor or debt security could use gifts to gain favor with the analyst responsible for determining the credit ratings and cause the analyst to be less objective during the credit rating process. In the case of a substantial gift, the potential to impact the analyst's objectivity could be immediate. With smaller gifts, the danger is that over time the cumulative effect of repeated gifts can impact the analyst's objectivity. Therefore, the amendment establishes an absolute prohibition on gifts with the exception of minor incidentals provided in business meetings.

VIII. CONCLUSION

As described above, the Commission took a number of actions during the year with respect to NRSROs. In the coming year, the Commission will continue to review NRSRO issues through its oversight function, including staff examinations of the NRSROs, and expects to consider whether to adopt any additional rules after a full consideration of all comments received.

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70 See February 2, 2009 Adopting Release, 17 CFR 240.17g-5(c)(7).