Elizabeth Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Credit Ratings Comment, File No. S7-24-09

The GlobalRating Group consists of three credit rating agencies in Russia, Kazakhstan and Armenia. RusRating (Russia), the first agency in the Group, was established in 2001 and was recognised in 2008 by the Central Bank of Russia for regulatory purposes.

We thank you for re-opening the comment period and for encouraging a wide spectrum of views.

The SEC delineates three concerns, which we paraphrase as follows:

- Semantic equalisation of ratings – investors do not realise that that the meaning of a rating depends upon the type of security to which it is assigned;
- Rating shopping – issuers inducing competition between rating providers, leading to degradation of quality;
- "Deification" of rating agencies – not critically assessing rating agency performance.

We do not believe that the proposed rule changes will induce the radical changes needed in the rating market, though the logic underlying them address real issues, because there is insufficient competition in the rating market.

Competition would be encouraged – and hence the rating market would be reformed – by establishing standards for ratings against which all market participants can be judged.

The SEC is rightly concerned with risk disclosure, and yet the focus of the proposed rules is the rating agencies. We recommend that the rules be refocussed on risk.

Ratings are a well-established mechanism for assessing and expressing risk. Changing the focus of regulation from ratings to risk will not remove the need for regulating the rating agencies. But it will provide an objective standard against which the economic benefits of rating agencies can be assessed, the products of ratings agencies can be judged, and new entrants to the rating business can be encouraged.

This could be achieved in various ways. We believe it is possible to accomplish this change without significant changes in existing rules and regulations; for example the SEC could:

- define the components of risk that must be regularly reported by the issuing agent for each type of security (some definitions are suggested below);
- rule that the components of risk which require mandatory disclosure are properly disclosed if the security has a rating appropriate to the type of security from an NRSRO;
- define the pathway for new companies to achieve NRSRO recognition in terms of establishing that their ratings for specified security types are disclosures of the risk standard for those securities, and that they are able to assign their ratings consistently;
- mandate for a company that has achieved NRSRO recognition the level of disclosure it must maintain when issuing a rating that meets the risk standards.

Implications of these recommendations:

- A company is not required ***in principle*** to have a rating from an NRSRO in order to provide to investors disclosure on risk, thus removing *in principle* the need for the SEC to mandate an NRSRO rating;
- Ratings will continue to be used by the market in much the same form as currently because empirical evidence for ratings being a good measure of risk exists and it will take time for some other form of risk disclosure to attain sufficient general acceptability for the SEC to accept its use;
- Implicit in risk being primary and ratings secondary, a rating agency will need to apply to the SEC for NRSRO recognition for its ratings, and hence the SEC may require from the NRSRO acceptance of a measure of legal accountability. If a rating agency does not wish to accept accountability and to offer its ratings purely as 'free speech', then it may decline the NRSRO designation.
- When a rating on a security has a defined meaning, namely it is a disclosure of a regulator-defined risk component, it becomes far easier for investors to discern when “rating shopping” occurs and to assess the impact of a change in rating on the quality of risk disclosure;
- “Rating shopping” will fall into the same category as “audit shopping” – an inevitable phenomenon when there is a market of providers, but it becomes a red flag about the quality of the specific rating, the motivation of the security issuer, and the reliability of the new rating agency. Rating shopping might also be reduced by mandating changes in rating agency, much like auditor rotations are mandated in some jurisdictions.

The remainder of this comment contains discussion of these points, commentary on other issues arising out of the SEC Document “Credit Rating Disclosure” **File No. S7-24-09** and positions put forward by commenters earlier in this debate:

- The meaning of ratings, and regulatory use of ratings
- The regulation of rating agencies
- Free speech and rating opinions
- Use of foreign ratings

The Use of Ratings for Regulatory Purposes

Focus on Risk

We take it as axiomatic that investors should be able to discover the risk associated with a financial security being offered for sale. The purpose of a credit rating is to assess the level of credit risk associated with a security. As the financial markets have developed, issuers have found themselves forced to disclose the level of risk associated with a security by publishing a rating.

It seems to us that the sequence of events historically was

1) ratings were developed as measures of risk for investors and
2) the SEC then adopted ratings issued by dominant agencies.

Consequently the focus of SEC rules has been on ratings and the agencies that assign them. At the same time, in the literature and in all discussions about financial efficiency it is risk, not ratings, that is primary.

This reversal in priority of regulation needs to be changed.

It is possible that an issuer may be able to demonstrate to the SEC that it is able to disclose risk components satisfactorily without the use of ratings. If it can do so, it should be allowed to do so. Offering alternatives to the rating agencies will further increase competitive pressure.

By separating risk disclosure from ratings, the SEC can mandate risk disclosure without mandating ratings. This should have several effects:

First, it removes the accusation that the SEC favours rating agencies. Until it can be demonstrated that other methods of risk measurement equal or excel ratings, the SEC is obliged to require ratings and hence to accredit rating agencies to provide them.

Second, the meaning of a rating can be clarified (see below) because it is directly linked to a risk disclosure standard.

Third, the barriers to entry for rating agencies are lowered because new companies can focus on providing ratings that match specific risk disclosure requirements, viz., ratings for particular industries, geographical areas, or product specialities.

Fourth, it sets a standard against which new methods of risk analysis, such as market-generated measures, can be compared.

Fifth, rating agencies will gradually be forced to seek registration of their ratings with the SEC, thus enabling the SEC to enforce requirements for continued registration.

The Meaning of a Rating

Although it is widely recognised that the word 'rating' covers several distinct meanings, it is commonly defined inconsistently in an attempt to achieve conceptual simplicity. This leads to confusion.

For example, in the fact sheet on the SEC website accompanying the request for comments we read:

> "Credit rating agencies are organizations that rate the creditworthiness of a company or a financial product, such as a debt security or money market instrument. These credit ratings are often considered by investors evaluating whether to purchase or sell securities."[1]

Yet unlike a 'company', a 'financial product' in of itself cannot be 'creditworthy'. A company may be sued and may undertake many different obligations, and hence can be creditworthy. By contrast a financial product is typically associated with a set of cash flows and brought into being by a contractual agreement between several parties.

The complexity of meaning is recognised in the SEC Document "Credit Rating Disclosure" **File No. S7-24-09B,** eg.,

> "Historically, credit ratings were intended to be a measure of the registrant's ability to repay its corporate debt. As the types of investment products expand and become more complex, however, the returns (including the prospect of repayment) on these securities often are dependent on factors other than the creditworthiness of the registrant." and so on.

This conceptual ambiguity leads some commenters to recommend different rating symbols for

1 http://www.sec.gov/news/press/2009/2009-200-factsheet.htm

different instruments.

It is also – we contend – the underlying reason for the confusion about ratings in the minds of all but the most sophisticated analysts, which in turn is a cause for the concern of the SEC.

The risk to which a creditor or owner of a security is exposed differs subtly, but significantly, depending on the rated entity, and hence so does the rating. The following is a selection of exposure types.

Rated Entity	Risk	Comment
Corporate	Likelihood that general debt obligations will not be repaid in full and on time	The probability of a general (and/or selective) default by the corporate and hence its standalone financial strength is the main factor to be assessed for a rating.
Debt instrument	Likelihood that the cash flows defined at the time the instrument is sold will not be paid to the owner of the security in full and on time	The financial strength of the issuer is important, but so is the presence of a guarantor (credit enhancement) and its rating, or the presence of reduced seniority (subordination). Thus a rating of a debt instrument may differ from the rating of the issuer. Moreover, if the risk of the instrument is more remote from the issuer (the presence of a guarantor), then the rating cannot directly be associated with the default probability of the issuer.
Asset-backed security	Likelihood that the cash flows associated with each tranche will not be paid to the owner of the tranche in full and on time	The financial strength of the issuer is irrelevant (as it is generally a Special Purpose Vehicle). Substantial effort is invested in assuring that the cash flows from the borrowers are isolated from the originating bank. The risk exposure of the tranche holder depends on how the behaviour of the borrowers as a group, and hence the cash flows generated by the pool, are affected by economic variables.
Insurance Company	Likelihood that obligations materialising due to insurance events will not be met in full and in good time.	Insurance companies have future contingent obligations to policy holders. Someone taking out insurance needs to know the financial strength of the company so as to estimate the risk that the policy obligations will be met when an insurance event occurs.
Bank deposits	Likelihood that deposits will not be returned in full and in the time contracted	A bank will meet all deposit demands so long as it has liquidity, which is not the same as having positive capital.
Other		This list is not exhaustive

A creditor or owner of a security is exposed to more than one type of risk. The risks in the table can all be categorised as 'credit' risks, hence the ratings assigned to the rated objects are 'credit ratings'. But there are other forms of risk, for example 'interest rate', 'open currency exposure', 'market movement' risks.

Suppose that the SEC makes a rule that a company issuing/organising a financial instrument must disclose (at the time of issue and during the life of the security) the associated risk as defined in the table above. For example, a company issuing a bond would need to disclose “the likelihood that the cash flows defined at the time the instrument is sold will not be paid to the owner of the security in full and on time”.

Since a credit rating assigned to a bond by a credible rating agency is a measure of just this risk, the company can fulfil the risk disclosure rule by publishing the rating assigned to the bond.

Should the issuer decide to swap rating agencies during the life of the bond, then it is still in compliance with the risk disclosure rule if it publishes the rating of the other agency. On the other hand, if the issuer ceases to publish a rating, then it is no longer in compliance with the rule, unless it can convince the SEC that some other measure of risk (perhaps some smoothed credit spread) is a an adequate measure of the credit risk of its bond.

It should be pointed out that if investors regard the dropping of a rating as a red flag, then market-generated measures of risk, such as credit spreads, will automatically show increased levels of risk and the issuer will be obliged to publish them.

The Role of Rating Agencies

We believe that the ever-growing reliance on rating agencies is not due solely to the dominance of two companies, nor to their (now jaded) ability to predict the future, but rather to the effects of the economies of specialization. It is cheaper and more effective for all market participants for certain agents to specialise in the assessment of risk.

Risk analysts can be talented, but none have divine powers. Rating agencies systematically apply well understood techniques which other companies (banks, brokers, academics etc) can apply equally well. However, it is remarkably inefficient if all investors, banks, brokers etc go through the same operations.

Just as it is possible for any accountant to go through the financial statements of a company, it is normal for one to be chosen as the auditor. The regulator sets standards to ensure that auditors perform in a way that protects and enhances the market. Despite the strongest regulation, there will always be lapses in audit quality due to error, fraud, or manipulation. Regulation cannot prevent lapses, but it can ensure that error, fraud or manipulation are rapidly discovered and punished.

It has been suggested that because all investors should be prudent about the money they manage – a universal truism – all investors should assess the risks of the investments. If this logic were to be held to be correct, then all investors should also undertake a full audit of the company's accounts rather than empowering an auditor. It is however prudent to ensure that the auditor that has been hired to conduct the compliance process is competent – something Madoff's investors failed to do.

Regulating Rating Agencies

The SEC already has statutory responsibilities under US law in regards to rating agencies. Further US legislation is anticipated. Although we have no competence to discuss US law, we offer some commentary as a result of policy debates in Russia regarding rating agency regulation.

Rating agencies – like auditors – are such important components of an efficient financial market that regulators need to ensure the agencies have mechanisms for trapping occurrences of fraud, manipulation or error. All rating agencies have publicly disclosed codes of conduct and risk management procedures. A regulator should test these procedures regularly.

Testing the compliance of the rating agencies with their own codes of conduct and risk management procedures does not involve the regulator with an assessment of the quality of the rating methodology itself.

Free Speech

Freedom of Speech is essential to a Rating Agency, namely,

- The freedom to say unpleasant things, eg., downgrade a company
- The freedom to speak the truth when there is only a perception, not proof, of deterioration.

We hold that free speech, when applied to a rating agency, must be taken in the context of a fiduciary relationship. Rating agencies highlight their industry knowledge and access to company decision-makers. They are experts in the assessment of risk. Their opinions, in the form of ratings, are explicitly marketed as measurements of risk. The marketing, the recognition of market insiders, and the explicit references to ratings in legislation separate ratings from other expressions of free speech.

It seems clear beyond doubt that investors trust ratings as a measure of risk. This trust creates a fiduciary duty between rating agencies and investors. Consequently, rating agencies must be held to a higher standard than other agents who publish opinions.

A higher standard would imply, we believe, that a rating agency should not have the freedom:

- to maintain silence when a change has occurred, e.g., not downgrading because the company is about to pay for a rating or not upgrading because a company has not paid for the rating;
- to tell a lie, eg., issuing a lower rating to an issuer who has not paid than it would have issued following its normal rating procedure;
- to make strong assertions without justification, eg., assigning extremely high ratings to derivatives based on models that have not stood the test of time, yet marketing the ratings as equivalent to ratings assigned to bonds according to procedures which have been demonstrated to be effective for decades.

Use of Foreign Ratings

Globalization means that US investors are increasingly coming into contact with companies whose main business environment differs from that in the USA.

Rating agencies in the countries of origin of foreign companies listing in US markets have a different insight into the risks faced by those companies.

We argue that it is in interests of US investors to understand how local rating agencies rate their compatriots and the reasoning underlying the ratings. It would not be difficult for the SEC to rule that in the case of a company with a public rating issued by a rating agency that is recognised by a regulator in the country where the company's principal business is located, the local rating should be disclosed when listing in the US as a part of the risk disclosure standards.

Global competition in the rating agency market would be enhanced if the SEC actually required a domestic rating (where a domestic regulator recognises them) as part of the risk disclosure standards, where a foreign company is publicly listing in the USA.

About us – the GlobalRating Group

The GlobalRating Group consists of three credit rating agencies in Russia, Kazakhstan and Armenia. RusRating (Russia), the first agency in the Group, was established in 2001and was recognised in 2008 by the Central Bank of Russia for regulatory purposes.

Between 2001 and 2008, RusRating's revenues were primarily from investors. The position reversed in 2008 both because Russian agencies became recognised, and hence obtained a 'regulatory license'[2], but also because the freezing of the international capital market and the need for cost reductions halved our revenues from 'investors'.

Since the financial markets in Russia and the CIS are in an early stage of development, we are a small company, we are ourselves in the earliest stages of development as a company, and we are a rating agency located outside the USA, our perspective differs from those of other commenters.

The current reviews of the regulation of credit rating agencies in the USA and the EU have a substantial, though intangible, effect on us because regulators in all countries are looking carefully at the decisions reached in the world's most developed economies. Moreover, the SEC has specifically asked for feedback concerning foreign rating agencies.

2Frank Partnoy, “How and Why Credit Rating Agencies Are Not Like Other Gatekeepers”, http://ssrn.com/abstract=900257