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December 14, 2009

Ms. Elizabeth M. Murphy, Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: *Concept Release on Possible Rescission of Rule 436(g) Under the Securities Act of 1933 (File No.: S7-25-09)*

Dear Ms. Murphy:

This letter is submitted by Standard & Poor's Ratings Services ("Ratings Services"), a nationally recognized statistical rating organization ("NRSRO") registered under Section 15E of the Securities Exchange Act of 1934, in response to the Securities and Exchange Commission's ("Commission") concept release ("Concept Release") on the possible rescission of Rule 436(g) under the Securities Act of 1933 (the "Securities Act").

The Commission has asked whether it should propose rescinding Rule 436(g), which "provides an exemption for credit ratings provided by nationally recognized statistical rating organizations ("NRSROs") from being considered a part of the registration statement prepared or certified by a person within the meaning of Section 7 and 11 of the Securities Act." (Concept Release, at 3). The Commission acknowledges that the rescission of Rule 436(g) could have a "potential significant impact" not only on NRSROs, but also on "other credit rating agencies, investors and the financial markets in general." *Id*. at 4. As detailed below, Ratings Services believes that rescinding Rule 436(g) would result in troubling and unintended consequences for the market, including reduced transparency due to issuers providing less information to investors. We also believe that the Concept Release is based on several misconceptions. For these reasons, Ratings Services believes it would be unwise for the Commission to dismantle the current regulatory regime with respect to this specific issue.

Ratings Services has separately provided comments on the Commission's proposed rules regarding Credit Ratings Disclosure, File No. S7-24-09 (October 7, 2009) (the "Proposed Rule"). Nonetheless, it is worth noting here that the significant issues highlighted herein regarding Rule 436(g) would likely be compounded if the Proposed Rule, which would require the disclosure of credit ratings in certain circumstances, were adopted *and* Rule 436(g) were rescinded.

We appreciate the opportunity to address these issues and look forward to working with the Commission on these and other matters.

Rescinding Rule 436(g) Would Lead to Adverse Market Consequences

We believe that rescinding Rule 436(g) would lead to harmful market consequences, not just to NRSROs but to the market at large.

Less Publicly-Available Information for Investors Due to Less Disclosure

For example, if the rule is rescinded and NRSROs decline to provide consent to having their ratings included in registration statements, or issuers determine that obtaining consents would unduly increase the costs or complicate the timing of an offering, many registered offerings would go forward without ratings included in registration statements. The likely effect of rescinding the rule, therefore, would be for investors to have less, not more, information available to them in making investment decisions. This, we submit, runs counter to the fundamental goals underlying the securities laws.

The results would be even worse if the Proposed Rule were also in effect. Specifically, if the Proposed Rule on mandatory disclosure is also adopted, registered offerings may go forward without *any* publicly-available ratings. This is because, under the Proposed Rule, it is unlikely that there could be publicly-available ratings for registered offerings without triggering the mandatory disclosure requirements. For example, the mandatory disclosure requirements are triggered every time a registrant, selling security holder, underwriter or member of the selling group discloses the rating orally to an investor that requests it or refers an investor to a website that discloses the rating. (Proposed Rule, at 18). Thus, if an NRSRO were unwilling to consent to the inclusion of its ratings in a registration statement, but nonetheless published its ratings and those ratings were inevitably "used" in connection with the registered offering, an issuer would be exposed to liability for its noncompliance with the Proposed Rule. To avoid this, issuers might look to avoid having ratings on their debt at all, with the result being less information for investors.

More Costly and Time-Consuming Registered Offerings

As a practical matter, requiring issuers to obtain consents from credit rating agencies would likely significantly interfere with the timing of registered offerings and raise the costs of conducting them – costs that, in many instances, may be ultimately passed onto investors.

It seems likely that prior to providing consent many NRSROs, cognizant of the duty to establish an affirmative due diligence defense, would insist on independently participating in the due diligence process, and reviewing and signing off on the disclosures in the registration statement and prospectus. Unlike the other parties whose consent is typically required – auditors, counsel, and providers of fairness opinions – all of whom today are directly involved in the offering process, NRSRO personnel are not part of the working group for the offering (as a matter of fact, it is clear from Rule 17g-5(c)(5) that the Commission prohibits the involvement of NRSRO personnel in structuring activities), and so the NRSRO cannot reasonably be expected to be in a position to provide its consent on as timely a basis as the other parties to the transaction.

These practical difficulties could be even greater in connection with shelf registration statements. That is because it is extremely unlikely that any NRSRO would give blanket consent in a shelf registration statement to the use of its ratings in connection with any offering that might in the future be conducted under the registration statement. An accountant may be able to say that it stands by, and will continue to stand by, its retrospective audit of an historical period, even if that audit is used in connection with future takedowns from the registration statement. But, because credit ratings are inherently forward-looking, there is no conceivable scenario under which an NRSRO will be able to say that at any future point in time its current assessment of the prospective creditworthiness of an issuer will not change. Thus, in order to establish the affirmative due diligence defense under Section 11, the NRSRO would be required to update its review at the time of each shelf takedown, in the same manner that underwriters typically update their due diligence. As a result, NRSRO consent would be needed on a transaction-by-transaction basis which would inevitably delay and complicate the offering process.

These increased costs and difficulties will likely make it more difficult, if not impossible, for smaller and medium sized companies in important emerging industries to access capital through public offerings. The increased responsibilities and potential liability associated with providing consent would also likely force NRSROs to charge more for credit ratings for registered offerings, which would also adversely affect smaller issuers.

<u>Fewer Registered Offerings</u>

In addition, the increased costs and difficulties for issuers seeking to raise capital in registered offerings will likely cause many issuers to shift away from registered, public offerings to private offerings that are not subject to the registration requirements of the federal securities laws. Specifically, offerings in which credit ratings are a customary component of the marketing process will likely migrate to the private Rule 144A market in which securities are initially sold only to qualified institutional buyers ("QIB"). After the six-month period under Rule 144 during which the securities would be tradeable in the QIB market, the securities would be freely tradeable in the broader market without the benefit of registration or the benefit of the enhanced credit rating disclosure contained in the Proposed Rule.[1] In the interim as this shift occurs, or to the extent investors insist on registered

[1] The proposed instructions to Item 202(g) of Regulation S-K attempt to address the eventuality that issuers will turn to the Rule 144A market, by providing that mandatory disclosure requirements will be nonetheless triggered if a rating "is used in connection with an unregistered offering of securities, and the securities offered privately are subsequently exchanged for substantially similar registered securities even if the credit rating was not used in connection with the registered exchange offering."

offerings, many debt offerings will be delayed or cancelled, disrupting many issuers' access to capital.

The Perceived Increase in Liability Associated with the Rescission of Rule 436(g) Would Lead to Additional and Detrimental Consequences for the Market

Strict liability under Section 11 of the Securities Act may be imposed regardless of whether the alleged violator engaged in fraudulent activity. This contrasts with the well-settled principles of law that statements of opinion are not actionable unless it can be proven that the speaker did not subjectively hold the opinion expressed.[2] In addition, subjecting NRSROs to potential liability for good faith "misstatements" and "omissions" under Section 11 would be directly at odds with the protection afforded to rating opinions under the First Amendment. Thus, from the outset, it is unclear how strict liability under Section 11 would or could apply to rating opinions.

In any event, it is inevitable that the rescission of Rule 436(g) would lead to second-guessing of rating judgments and increased litigation costs and uncertainty for rating agencies. Rating agencies would face these increased costs regardless of whether they are ultimately successful in defending themselves. The expense of forcing NRSROs to defend their ratings in courtrooms across the country could be significant and divert resources from ratings quality to litigation defense. This would be especially burdensome for smaller agencies. In addition, it would discourage new entrants into the ratings industry, thus undermining Congress's stated goal of increasing competition. Further, to the extent this increase in liability leads any NRSROs to decline to provide consent, the universe of rating agencies from which an issuer may choose for a registered offering would become smaller and competition in the ratings industry would be further weakened.

The rescission of Rule 436(g) would also likely result in additional consequences in the ratings industry and for the market. For example:

- ***NRSROs could adopt a one-dimensional approach***: Exposing NRSROs to Section 11 liability could lead to a more homogeneous approach to ratings among NRSROs, resulting in less diversity of opinion and strong disincentives for analytical innovation, thereby stifling a prime goal of increased competition in the industry. Faced with potential Section 11 liability, NRSROs across the board would have strong incentives

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However, since the 2007 revisions to Rule 144 shortening the holding period for non-affiliates to six months, it has become increasingly common in Rule 144A offerings for investors not to demand, and issuers not to provide, exchange registration rights. This trend will likely accelerate if Rule 436(g) is rescinded.

[2] *See, e.g., Virginia Bankshares, Inc*. v. *Sandberg*, 501 U.S. 1083, 1095 (1991) (statements of opinion are actionable "solely as a misstatement of the psychological fact of the speaker's belief in what he says.").

to adopt only those rating processes that courts have deemed "reasonable," even if they believe a different approach might be more appropriate analytically and provide more robust information for investors. As NRSROs adopt narrower, less diverse opinions, the market would be left with one uniform view of credit risk when making investment decisions and other financial judgments.

- ***The market would have access to fewer ratings:*** Increased liability exposure could also result in the scaling-back of ratings coverage, with the most profound impact felt by newer and smaller issuers, including those in emerging sectors critical to the future growth of our markets and economy. Faced with potential Section 11 liability, NRSROs would have strong incentives to provide consent only in connection with registered offerings of those entities and securities that are least likely to default or be downgraded or which have a long history of providing the highest quality data. As a result, issuers who do not meet these criteria, including those relatively new to the debt markets, may have a difficult time getting consent and, therefore, greater difficulty accessing capital in registered offerings.

- ***NRSROs may avoid downgrades to limit potential liability***: Ratings are forward-looking opinions. As such, they sometimes change as economic or market conditions fluctuate or as updated facts about a rated entity or security become available. Some rated securities inevitably default; others are downgraded as new facts surface. If NRSROs could be sued every time an obligor or security is downgraded or defaults on the theory that the prior rating must have been wrong, they would have a strong incentive to avoid downgrading ratings, even if circumstances warrant, in order to avoid potential legal exposure. For example, an NRSRO may be concerned that a subsequent rating action would be viewed by plaintiffs as an admission that the initial rating was "incorrect." Thus, even if an NRSRO believed a downgrade was warranted, there would be a powerful incentive for it to let the initial rating stand, depriving investors and the market of the most up-to-date assessment of the credit risk of the issuer.

- ***Rating scales may become compressed*:** Increased liability exposure may also lead to the distortion of initial ratings. Specifically, to minimize the likelihood of downgrades and litigation, NRSROs would have strong incentives to issue lower ratings in the first instance even if their best judgment might suggest a higher rating. As initial ratings trend downward, rating scales would become compressed, making it more difficult for investors to differentiate among credits.

Other Unintended Effects of Rescinding Rule 436(g)

There is a significant risk that rescinding Rule 436(g) could also weaken the overall due diligence process in a registered offering. Specifically, requiring NRSROs to "expertize" a portion of the registration statement could potentially encourage underwriters and other direct participants in the registered offering to assert a "reliance" defense based on ratings as an excuse for having failed to conduct their own due diligence. This is because the Section 11 affirmative defense for an underwriter, director or officer who signed the registration statement will shift from an obligation to show that "he had, *after reasonable investigation*, reasonable ground to believe . . . that the statements therein were true" to the standard that applies to "expert" statements, *i.e.*, that "he had no reasonable ground to believe . . . that the statements therein were untrue."

Specifically, rescinding Rule 436(g) and asserting that credit ratings are expertized "material facts" would put credit ratings in the same category as audited financial statements. Offering participants do not affirmatively investigate the accuracy of audited financial statements, but instead rely on the auditor's opinion that the financial statements are fairly presented according to generally accepted accounting principles. If a credit rating suggested that the rating agency believed a security was at relatively low risk of default, and the credit rating were expertized for Section 11 purposes, the underwriter and other offering participants with Section 11 liability may assert that they had no duty to investigate whether the security did in fact present a low risk of default.

The Concept Release is Based a Number of Material Misconceptions

We also believe that the Concept Release rests on several material misconceptions about NRSROs and the market generally. For example, the Concept Release presupposes that the Commission "would no longer need to provide a means to encourage disclosure about credit ratings" if, as provided in the Proposed Rule, the SEC requires the disclosure of credit ratings. This assertion, however, ignores the very real likelihood that one or more NRSROs may not provide consent to have their ratings included in a registration statement, or may only consent with respect to certain issuers or asset classes. Indeed, when the SEC first raised the possibility of including ratings in registration statements in 1977, various NRSROs "indicated that they would not provide consents." (Concept Release, at 8). Accordingly, the exemption under Rule 436(g) was initially adopted in part due to the Commission's concern "that registrants would not voluntarily disclose security ratings in their registration statements because of the liability concerns of the NRSROs who provided the ratings." (Concept Release, at 14). Rescinding Rule 436(g) now would raise the same fundamental concerns recognized by the Commission over 20 years ago when the rule was first adopted.[3]

[3] According to the Concept Release, "[a]t this stage," the SEC does not believe it should "require consents regarding disclosure of preliminary ratings or unused final ratings." (Concept Release, at 19 n. 52). If the SEC changes its position, some may argue that a consenting credit rating agency could be subject to potential Section 11 liability for any preliminary rating included in a registration statement. The consequences highlighted herein with regard to perceived increases in liability would

Moreover, since that time, it does not appear that non-NRSROs – *i.e.*, rating agencies that have never been covered under the Rule 436(g) exemption and thus have always been required to provide consent – have typically (if ever) granted consent to the inclusion of their ratings in registration statements.

The Concept Release is also based on the mistaken premise that Rule 436(g) is no longer warranted because the landscape of liability for NRSROs has somehow changed since 1982 when the rule was initially adopted. Specifically, the Commission notes in the Concept Release that "when Rule 436(g) was adopted, the Commission believed that the liability that was already applicable to NRSROs was sufficient for the protection of investors." (Concept Release, at 15). Ratings Services is unaware of any difference between the potential liability exposure of NRSROs then and now. Indeed, at this time, NRSROs face numerous onerous litigations rooted in a wide range of theories. Moreover, since the enactment of the Credit Rating Agency Reform Act in 2006 – which was not in existence when Rule 436(g) was initially adopted – NRSROs are subject to even more accountability through comprehensive regulation by the Commission.

The Concept Release is also based on the Commission's determination that investors look to NRSROs as "experts" and "that it may be appropriate for . . . the liability scheme for experts to apply to them." (Concept Release, at 15). The Concept Release even attempts to analogize the opinions provided by rating agencies to those provided by, for example, auditors. *Id*. These statements raise important concerns. First, they ignore that rescinding Rule 436(g), and requiring registrants to identify NRSROs in registration statements as "experts," would promote increased, not lessened, reliance by investors on credit ratings. More fundamentally, however, they ignore the core differences between rating opinions and the opinions provided by Section 11 "experts" such as accountants, appraisers, lawyers, *etc.* Specifically, unlike audit opinions, which speak to an entity's historical financial condition, results of operation and cashflows, ratings are predictive opinions about the likelihood of future events. As such, the question of whether a rating could contain an untrue statement of material fact – *i.e.,* the basic concept underlying liability under Section 11 of the Securities Act – is inconsistent with the inherent forward-looking and non-factual nature of ratings. Moreover, because of their forward-looking nature, ratings present many more opportunities for after-the-fact second guessing by private litigants. But these are not the only relevant differences. More particularly, when an accountant issues a statement about an issuer's compliance with GAAP, the expectation and intention is that the issuer is actually compliant, *i.e.*, that the accountant's statement is "correct." On the other hand, rating agencies are offering opinions about the relative credit quality of a universe of issuers and/or securities, some of which (it is understood from the beginning) will inevitably be downgraded and, in some cases, default as issuers encounter financial difficulties, the markets they operate

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apply with even more force if NRSROs faced possible liability for preliminary ratings. The likely result would be that most, if not all, rating agencies would decline to consent.

in shrink or economies go into recession. Thus, simply as a function of the nature of ratings, rating agencies are inherently more vulnerable to the threat of liability from investors – even when they did nothing wrong – than auditors or other "experts" under current law. For these reasons, Ratings Services believes that it is inappropriate to subject rating agencies to Section 11(a)(4) liability.

Distinguishing Between NRSROs and non-NRSROs

Finally, the Commission has requested comment on the scope of Rule 436(g) and specifically, the appropriateness of treating NRSROs differently from credit rating agencies that are not NRSROs in terms of requiring consents. (Concept Release, at 6).

Although it may indeed be appropriate to treat NRSROs differently from non-NRSROs because, *inter alia*, NRSROs alone are subject to Commission oversight, Ratings Services appreciates the Commission's concern that this differential treatment "may contribute to competitive disadvantages." (Concept Release, p. 17). In light of the significant consequences that would result from the rescission of Rule 436(g), we believe that a better alternative to address this issue would be to expand Rule 436(g) to include all credit rating agencies. This would foster increased competition among rating agencies and provide investors with a more varied spectrum of opinions on the creditworthiness of registered securities.

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Again, we at Ratings Services appreciate the opportunity to comment on the Concept Release. Please feel free to contact me or Rita Bolger, Senior Vice President and Associate General Counsel, Global Regulatory Affairs, at (212) 438-6602, with any questions regarding our comments.

Sincerely yours,

Deven Sharma
President
Standard & Poor's

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