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December 14, 2009

By Electronic Mail

Ms Elizabeth M. Murphy
Secretary
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) (the "Concept Release")

Dear Ms Murphy:

I. INTRODUCTION

Moody's Investors Service ("**MIS**") appreciates the opportunity to provide comments to the Securities and Exchange Commission ("**Commission**") on the Concept Release, which asks whether the Commission should rescind Rule 436(g) under the Securities Act of 1933 ("**Securities Act**"). In a separate letter (the "**Related Comment Letter**"), we also are submitting comments on the proposed amendments to rules ("**Proposed Disclosure Rules**" or "**Proposed Rules**") that would require disclosure of information about credit ratings and credit rating agencies ("**CRAs**") in registration statements and on certain forms.

In the Concept Release, the Commission considers a new system in which issuers would be required to disclose detailed information about credit ratings in connection with registered offerings and Nationally Recognized Statistical Rating Organizations ("**NRSROs**") would lose the safe harbor from liability under Section 11 of the Securities Act provided by Rule 436(g). We understand that the Commission believes that, in light of the CRA industry's growth and development and out of a desire to protect investors while recognizing the role that ratings play in the offer and sale of securities, it may no longer be appropriate to exempt an NRSRO from liability under Section 11 of the Securities Act when an issuer discloses an NRSRO credit rating in a registration statement.

We support the goal of protecting investors and believe that Rule 436(g) contributes to its achievement. As we explain more fully below, we believe that Rule 436(g) has helped protect CRA independence and promoted rating opinions that are diverse, nuanced and precise. It has allowed CRAs to strive for ratings that are stable and focused on long-term time horizons. Rule 436(g) has encouraged CRAs to publish credit ratings that are ***not*** highly qualified opinions written for lawyers instead of investors. It has lowered the costs of capital market transactions, facilitated the efficient allocation of capital, and permitted broad rating coverage of issuers. In our view, eliminating Rule 436(g) would reverse or dilute many of these positive developments, and we therefore believe that the safe harbor should be retained for the following reasons:

- Credit rating opinions are unique and differ from other opinions because they are both probabilistic and predictions about the future. In our view, they do not fit within the statutory reach of Section 7 of the Securities Act.
- Subjecting NRSROs to liability as experts under Section 11 of the Securities Act would contravene both the First Amendment and the Securities Act.
- The original reasons for creating the Rule 436(g) safe harbor for NRSROs remain compelling. For example, NRSROs are subject to substantial anti-fraud liability and are now subject to a comprehensive oversight regime tailored specifically for CRAs.
- Eliminating Rule 436(g) likely would not enhance investor protection or ratings quality and could degrade both.
- The Commission could address its concern about the disparate treatment of NRSROs and CRAs that are not NRSROs by extending the reach of Rule 436(g) to the latter group.
- Additional public policy reasons exist for maintaining Rule 436(g). For example, exposing NRSROs to Section 11 liability could increase the risk of over-reliance on ratings and make it more difficult for NRSROs to manage conflicts of interest.

II. DETAILED ANALYSIS

In the Concept Release, the Commission explains that it is considering rescinding Rule 436(g) in light of market developments and its Proposed Rules, which would require issuers to disclose detailed information about credit ratings and CRAs when they use credit ratings in connection with registered offerings. In support, the Commission refers to four primary reasons as potentially justifying the rescission of Rule 436(g). Specifically, the Commission believes that:

- NRSROs present themselves to the market as "experts" and the credit ratings they issue are not so different from the opinions provided by "experts" to whom the Rule 436(g) safe harbor does not extend.
- The original reasons the Commission adopted Rule 436(g) may no longer provide an adequate basis for the safe harbor.
- Eliminating the NRSRO safe harbor could help protect investors because holding NRSROs more accountable in the courts could improve ratings quality.
- Rule 436(g) may give NRSROs a competitive advantage because non-NRSRO CRAs are not included in the safe harbor.

In addition, the Commission has indicated that it does not believe that abolishing the Rule would increase reliance on credit ratings or change the fundamental nature of what a credit rating is.

In presenting our contrary view that Rule 436(g) should remain in place, we address each of the views the Commission has articulated in support of its belief that Rule 436(g) may no longer be appropriate. In Part A below, we address the Commission's view that NRSROs hold themselves out as experts and should therefore be required to take on the same type of liability as other experts that are quoted in registration statements. We discuss the nature of credit ratings, how the credit analysis that informs the rating is different from the analysis that "experts" engage in, and why CRAs should not be held liable as Section 7 experts if their ratings are disclosed in registration statements. In Part B, we describe the First Amendment and administrative law constraints to rescinding Rule 436(g). In Part C, we detail our view that the reasons that the Commission created Rule 436(g) remain equally valid today. In Part D, we explain that eliminating the safe harbor from expert liability likely would not help investors or the quality of ratings. Rather, NRSROs would be motivated to publish credit ratings that are more volatile and defensive, which would lead to more procyclical markets, as well as adversely affecting the transparency and efficiency of capital markets and making it more difficult for less well-known and creditworthy issuers to raise needed capital. In Part E, we explain that any competitive advantages NRSROs have over CRAs that currently do not benefit from the safe harbor could be addressed by including those CRAs within its scope. In Part F, we speak to additional public policy arguments in support of Rule 436(g). In particular, we believe that exposing NRSROs to liability under Section 11 could lead to over-reliance on credit ratings by market participants and make it more difficult for NRSROs to manage conflicts of interest.

A. Expert Liability is Not Consistent with the Nature of Credit Ratings

We believe that it is inappropriate to treat any CRAs as experts for purposes of Section 11 of the Securities Act.

i. What is a Credit Rating?

A credit rating is a current *opinion of relative future credit risk*. It is not a statement of fact – or even a prediction of fact. It is not a statement or prediction that can be proved as "right" or "wrong" at the time that it is made. Only unknown future events can determine the predictive value of that opinion. To illustrate this point, an analogy can be drawn between credit ratings and recession forecasts by economists. When economists make these predictions, the future must occur before it can be determined if the economist's forecast proves to be accurate.

There is no exact science for credit ratings. If the future could be predicted in that manner, CRAs would issue only two ratings: "will default" and "won't default". Instead, credit ratings are expressed on a nuanced rating scale. MIS's rating scale, for example, consists of 21 points, along with modifiers for reviews and outlooks.

Importantly, credit ratings are probabilistic, reflecting only relative likelihood of default and loss in the event of default, not a guarantee of performance. This means that, by definition, CRAs are predicting that a certain percentage of securities within each rating category – even in the highest rating categories – is expected to default. CRAs, however, do not predict which specific bonds within a category are expected to default. Rather, credit ratings communicate that the higher the rating category, the lower the expected frequency of default. Thus, without Rule 436(g), NRSROs would be exposed to liability for "false statements" even if they had correctly predicted the frequency with which securities would default in each rating category.

Nor can credit ratings be proved "correct" or "incorrect" simply by the occurrence or non-occurrence of the event upon which the rating opines. Subsequent default on a bond that was rated Aaa upon issuance does not "prove" that the original rating was wrong, any more than punctual payment of a bond initially rated Caa proves that that rating was flawed. After the fact, the historical usefulness of a rating *system* (as opposed to any individual rating opinion) can be measured by the degree to which ratings were correlated with actual default experience over time.

This point is well illustrated by drawing an analogy between credit rating predictions and life insurance actuarial predictions. For instance, an actuary would predict that, in the next five years, a 25 year-old non-smoker will be less likely to die than an 80 year-old smoker; nonetheless, in the next five years, some 25 year-old non-smokers will die, while some 80 year-old smokers will survive. Similarly, a rating analyst is predicting that a Ba1 bond will be more likely to default than a Aaa bond; nonetheless, some Aaa bonds will default, while most Ba1 bonds will not default. Neither occurrence would mean that the original predictions were "wrong". Just as the life insurance company should not be sued under a strict liability standard if an insured 25 year-old smoker dies one year later or if an insured 80 year-old smoker lives to be 100, the CRA should not be sued under a strict liability standard if a Aaa bond defaults or a Ba1 bond does not default. That Ba1 rating is ***not*** a recommendation to ***not*** buy a bond, just as the actuarial prediction that in the next five years, an 80 year-old smoker will be more likely to die than a 25 year-old smoker is ***not*** a recommendation to ***not*** insure the 80 year-old smoker. The usefulness of the prediction that 25 year-old non-smokers are less likely to die than 80 year-old smokers can only be measured over time by looking at aggregate data, not by judging any one, individual outcome. Likewise, the realized performance of a rating system[1] will itself be determined by the average quality of the rating opinion provided, as well as by the volatility and correlation of the unanticipated influences on credit risk that occurred during the measurement period.[2]

ii. How Credit Rating Opinions Differ from Other Opinions

We believe that credit ratings are not the kind of third party statements that are covered by Section 7 of the Securities Act. Section 7 states, in part, "[i]f any accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, is named as having prepared or certified any part of the registration statement, or is named as having prepared or certified a report or valuation for use in connection with the registration statement, the written consent of such person shall be filed with the registration statement".

Experts take many forms and undertake different duties, but, in each case, the experts referenced in the Securities Act fall into one of three categories. The first category certifies an issuer's representation contained in a registration statement. An auditor certifies that the issuer's financial statements are presented fairly in all material respects. An engineer certifies the issuer's estimate as to the amount of natural resources extractable from its properties. Environmental engineers certify the accuracy of an issuer's clean-up

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1 MIS regularly updates its reports on the historical performance of its ratings. *See*, for example, MIS's Special Comments entitled, "The Performance of Moody's Corporate Bond Ratings: September 2009 Quarterly Update" and "The Performance of Structured Finance Ratings: Mid-Year 2009 Report". The conceptual framework behind these performance reports is discussed in a Special Comment entitled, "Measuring The Performance of Corporate Bond Ratings," published in April, 2003. These documents and many other reports on ratings performance are available at www.moodys.com.

2 Theoretically, an assessment of risk can be wrong. For example, it obviously would be an incorrect assessment of risk to state that the odds are one in three of getting "heads" on the toss of a fair coin. However, no outcome on a single toss of the coin can prove that the statement about risk was incorrect. That statement can be proven wrong only by demonstrating that the assessment of risk was based on a misunderstanding of the nature of a fair coin. Similarly, in the rating context, to take an extreme example for purposes of illustration, the assignment of a rating to one company's bonds based on a review of another, unrelated company's financial statements could be wrong in the sense that it would not have been based on the correct foundation.

calculations. An actuary certifies an insurance issuer's estimated reserves for future losses. A lawyer certifies that the issuer's actions are legal or that the transaction proposed by the issuer will have the legal effect represented by the issuer. A valuation expert certifies that the issuer's impairment analysis is correct, or that the price the issuer is paying, or receiving, is fair. In contrast, a CRA certifies no opinion or representation of the issuer. An issuer does not opine on the likelihood of its default. Securities analysts and CRAs do.

The second category of experts prepares part of the registration statement. Just as CRAs do not certify any representations of the issuer, they do not prepare any portion of the registration statement.[3]

The third category of experts falling within the scope of Section 7 prepares or certifies a report "for use in connection with a registration statement". While issuers may use credit ratings in the context of a registered offering, the CRA's overall purpose in assigning a credit rating is to provide information to the market, not to prepare a report for use in connection with a registered offering. MIS assigns ratings and publishes credit research about thousands of entities and instruments that are not the subject of registered offerings. In addition to publishing credit ratings of debt securities, MIS assigns corporate loan ratings, issuer counterparty ratings, and bank and insurance financial strength ratings, among other things.

Rule 436(g), therefore, has served its purpose in recognizing the inapplicability of Section 7 to third party commentary.

Independent of proper statutory construction and interpretation, there are separate policy reasons for retaining a rule clarifying that CRAs do not fall within the scope of Section 7 (and thereby are not subject to Section 11). The Congressional purpose behind Section 7 is clear. If an issuer uses a third party agent to validate publicly its conclusions, it must obtain that party's consent *because* of the liability imposed for being named. Imposing some measure of liability upon such an agent is appropriate in order to help ensure independence and rigor in the validation. CRAs, however, do not act as the issuer's agent. Indeed, credit rating opinions differ from the expert opinions subject to these statutory provisions. We believe that highlighting these fundamental differences further demonstrates why Rule 436(g) is as appropriate today as it was nearly thirty years ago.

First, as detailed above, credit ratings certify nothing the issuer discloses, nor do they validate any estimates made by the issuer, unlike the reports and opinions provided by *all* other experts subject to this provision.

Second, ratings are inherently and completely forward-looking, rather than backward-looking, in nature. For instance, auditors, engineers, and lawyers look backwards, or at present facts, in order to certify disclosures by the issuer. By contrast, credit ratings assigned by CRAs are predictive opinions that apply well into the future, over the life of the debt.

To further illustrate this point, while financial auditors conduct a largely backward-looking review in which they test and verify historical data, CRAs issue predictive opinions about inherently uncertain future outcomes – namely, the probability of default and amount of loss, given default. Credit ratings would behave like audit opinions only if CRAs limited the nature of ratings to be simply current, point-in-time views of solvency (*e.g.*, an opinion that Company A is solvent as of the offering date). We do not believe that the Commission or market participants want CRA opinions to be so limited. Similarly, when lawyers

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3 Importantly, CRAs are impartial observers of the registration process. *See* Part A.1 of the Related Comment Letter. Please also see Part C.2 in the Related Comment Letter for a more detailed discussion of how the Proposed Disclosure Rules would undermine CRA independence by transforming CRAs from consumers of information into participants in the process.

offer their opinion on the legality of a transaction or the tax consequences of a deal, they are expressing a view about a *current* situation based on a very particular set of instant facts and established legal principles, taking into account present authoritative sources such as legislation, rules and historical judicial precedents. That legal opinion is a statement analyzing current legal principles, *not* a prediction, for example, of future changes in law.[4] The opinion, when made, can be deemed right or wrong.

Credit rating analysts cannot rely on solid precedents to guide their opinions: no such standard exists in the debt markets. While rating analysts may review historical data, those data do not have precedential value since what happens in the past may or may not repeat itself. Nor is there any way of knowing when the rating opinion is expressed whether it will prove to be "accurate" or "inaccurate".

The only experts whose function is in any way similar to that of a CRA on this point are actuaries, who predict future losses. The important difference with actuaries, however, is that they validate the estimates of internal actuaries. Since issuers do not make representations about the likelihood, relative to other issuers, that they will default on their obligations, there is nothing for a CRA to validate or prepare for them. Moreover, actuaries are not held liable for failing to predict a future pandemic or the invention of a life-extending drug.

Third, credit ratings are independent opinions that are not determined in accordance with an industry "standard".[5] In contrast, auditors, engineers, actuaries, valuation experts, and even lawyers apply a common set of professional standards *with the expectation of reaching common conclusions*. For instance, the goal of accounting standards such as the generally accepted accounting standards (or GAAP) is that four accounting firms auditing the same company generally all reach the same conclusion. In other words, one does not expect much diversity in opinion among these experts and neither the market nor regulators would applaud diverging opinions from these experts.

In contrast, multiple CRAs may well express multiple, different opinions on the same question (namely, the appropriate credit rating for a single debt issue). Importantly, this diversity of CRA opinions is expected by regulators and the market alike. The Commission and Congress have sought to promote competition in the CRA industry because they believe the dissemination of diverse opinions will enhance ratings quality. A robust marketplace that values diversity of ideas encourages CRAs to compete based on the quality of their opinions. The idea is that these diverse opinions about the inherently uncertain future lead to competition among CRAs to produce the most predictive opinions. The substance of CRA methodologies and models is not regulated and CRAs are expected to compete with each on the basis of, among other things, the quality of their different rating methodologies and models.

Promoting the dissemination of diverse credit opinions, however, is at odds with eliminating Rule 436(g). Without Rule 436(g), CRAs would be punished for this diversity because, with the benefit of hindsight, some market participants would inevitably conclude that certain CRAs reached the "wrong" opinion and should be held accountable under the law. In other words, if expert liability is imposed on

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4 *See*, *e.g.*, Committee on Legal Opinions, Third Party Legal Opinions Report, Including the Legal Opinion Accord, of the Section on Business Law, American Bar Association, 47 Bus. Law 167, 196 (1991) ("An opinion letter speaks as of its date. An opinion giver has no obligation to update an opinion letter for subsequent events or legal developments.").

5 We note that while credit ratings are not determined according to an industry standard, the International Organization of Securities Commissions publishes a *Code of Conduct Fundamentals for Credit Rating Agencies* ("**IOSCO Code**"). The IOSCO Code, however, is limited to procedural issues. The IOSCO Code does not include provisions addressing the substance of credit ratings, credit rating methodologies or credit rating models.

CRAs, then that diversity of opinion strongly implies that one of the competing opinions carries liability for being "wrong". This scenario would undermine CRA independence and objectivity by forcing a consensus view in order to avoid being the CRA that is "wrong". Put another way, the ironic result of rescinding Rule 436(g) would be to motivate CRAs to reach the same opinion, out of concern about possible litigation. That would be a very unfortunate outcome for market participants.

Fourth, credit rating opinions are nuanced in ways that others are not. They are more scalable, for example. An audit firm, on the other hand, can offer only one of two views: either the financial statements are presented in accordance with GAAP (and therefore "pass") or are not (and therefore "fail"). Similarly, lawyers opine that something is either legal or not legal. Fairness opinions provide that something is either fair or not fair. By contrast, CRAs opine on the relative probability of future default, and loss in the case of such default. Unlike pass/fail, legal/not legal, fair/not fair opinions, credit ratings are expressed on a nuanced rating scale. MIS's rating scale, for example, consists of 21 points, along with modifiers for reviews and outlooks. In addition to credit ratings, MIS also publishes credit rating opinions that set out, among other things, the key elements underlying its rating opinion.

If Rule 436(g) were eliminated, CRAs would be motivated to adjust their credit ratings and rating scales, resulting in rating opinions that are less nuanced, less granular and more qualified, so that when the future unfolded, the CRA was more protected from liability. CRAs likely would heavily involve lawyers in the publication of a rating to add appropriate disclaimers to protect against litigation. Rating opinions would be written by lawyers for lawyers instead of by credit analysts for investors.

Finally, CRAs are more like securities analysts than "experts" subject to the Securities Act. Securities analysts issue research reports, based on their own models and powers of observation and analysis. Unless the securities analyst is affiliated with the underwriter or member of the selling group for an offering, it is not an agent of the issuer and its opinions are not subject to Section 11 of the Securities Act.

In short, credit ratings verify or certify nothing, nor do they serve as a substitute for work required by the issuer. Their role in the market is unique. Like other market commentators, CRAs do not perform a function in the offering process that fits within the "expert model" provided for in Section 7.

B. Imposing Section 11 Liability on CRAs Would Contravene the Constitution and the Securities Act

As outlined in the Introduction, the Commission is contemplating a new regime in which issuers would be required to disclose detailed information about credit ratings in connection with registered offerings and NRSROs would lose the safe harbor from Section 11(a)(4) "expert" liability provided by Rule 436(g). The result – subjecting NRSROs and other CRAs to the strict liability scheme of Section 11 – would clearly violate the First Amendment. We respectfully refer the Commission to Professor Laurence Tribe's and Thomas Goldstein's comments in this regard, which are being submitted separately and provide a full discussion of the concerns that are briefly summarized here.[6]

All CRAs, including NRSROs, have always been, and remain, fully exposed to potential liability under Section 10(b) of the Securities Exchange Act of 1934 ("**Exchange Act**") and common law fraud claims

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[6] For further general discussion of the applicability of First Amendment protections to ratings, *see* the testimony of Eugene Volokh (Professor of Law, UCLA School of Law) before the House Financial Services Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, *Approaches to Improving Credit Rating Agency Regulation* (May 19, 2009) available at www.house.gov/apps/list/hearing/financialsvcs_dem/volokh.pdf.

for the knowing or reckless dissemination of false statements. However, it is well-settled that CRAs, like other providers of opinions and information of public concern, cannot be held liable for mere negligence. *See*, *e.g.*, *County of Orange v. McGraw Hill Cos., Inc.*, 245 B.R. 151, 155 (C.D. Cal. 1999) (requiring proof of "actual malice," *i.e.*, knowledge of at least probable falsity to hold CRA liable); *Compuware Corp. v. Moody's Investors Service*, Inc., 22 R.F.D. 124, 127 (E.D. Mich. 2004) (same); *In re Enron Corp. Securities, Derivative & "ERISA" Litigation*, 511 F. Supp. 2d 742, 825 (S.D. Tex. 2005) (same).

Such open-ended liability for mistaken judgments or other errors would expose CRAs, which publish ratings on tens of trillions of dollars of publicly offered debt securities, to a specter of unlimited liability that either would silence them entirely or, at minimum, put a crippling "chill" on their freedom of expression. This is an outcome abhorrent to the First Amendment's insistence on the free flow of information, especially given that the ratings disseminated by NRSROs are *opinions*, which are given particular constitutional protection. *See Compuware Corp. v. Moody's Investors Service, Inc.*, 499 F.3d 520 (6th Cir. 2007) (a Moody's Investors Service's rating "is a predictive opinion, dependent on a subjective and discretionary weighing of complex factors" and therefore incapable of being proven true or false); *Jefferson County School Dist. No. R. 1 v. Moody's Investors Service, Inc., supra*, 175 F.3d 848, 856 (10th Cir. 1999) (Moody's Investors Service's opinion on bond issuer's future outlook is "protected expression of opinion"). Indeed, even those academics critical of the NRSROs, such as Columbia Law School Professor John Coffee, have warned against imposing a negligence liability standard. *See* the testimony of John Coffee before the Senate Banking, Housing & Urban Affiars Committee, *Examining Proposals to Enhance the Regulation of Rating Agencies*, Panel II (Aug. 5, 2009) ("I don't think there should be a cause of action per negligence. I don't think misjudgments should produce litigation.").

Under the contemplated regime, CRAs would not be subjected to a negligence standard but, rather, to an even *lower* standard – strict liability – that is even more antithetical to the First Amendment. Under the Securities Act, an investor's only burden would be to prove that a CRA made "misstatements". To avoid liability, the CRA would have to prove that it acted with due care. This liability scheme – which would effectively make CRAs the insurers of the entire investment community – simply cannot be reconciled with constitutional principles.

Rescinding Rule 436(g) together with adopting the Proposed Disclosure Rules would also be invalid because that scheme would conflict with Sections 7 and 11 of the Securities Act. The Commission only has the power to adopt rules that effectuate the statute Congress adopted. *Chevron v. Natural Resources Defense Council*, 467 U.S. 837 (1984). In Sections 7 and 11, Congress explicitly provided that civil liability is to be imposed only on those experts who "consent" to the use of their reports in registration statements. The term "consent" necessarily connotes a voluntary choice. *See, e.g.*, THE OXFORD ENGLISH DICTIONARY 760-61 (2d ed. 1989) ("consent" is "voluntary agreement to or acquiescence in what another proposes or desires"). The purpose of this statutory requirement is obvious: in order to ensure that Section 11's awesome civil liability would be imposed only against those *directly*[7] involved in the securities' sales, Congress placed acceptance of liability – and its corresponding burdens and benefits – in the hands of the experts it aimed to regulate. In doing so, Congress enacted a careful balance that ensured the Securities Act would "protect the public with the least possible interference to honest business". H.R. REPORT NO. 73085, at 1 (1933).

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7 As explained in footnote 3, CRAs are not direct participants in this process.

The regime contemplated by the Commission would be invalid because it would obliterate the element of voluntariness that is at the heart of the statutory scheme. If the Proposed Rules are adopted, an issuer may only "use" a rating that it discloses in the registration statement. Under Section 7 of the Securities Act, that disclosure may be made only if the CRA "consents". The inevitable effect of the Proposed Rules would be that issuers of debt securities would only use the services of a CRA – either by soliciting ratings or subscribing to a ratings service – *only* on the condition that the CRA agree that the rating could be disclosed in a registration statement, now or at some time in the future. That agreement would subject the CRA to liability under Section 11. The CRA's only likely alternative would be to go out of business. Because this change in policy by the Commission would obviate the CRA's opportunity to make a *voluntary* choice whether to permit the use of its opinion in the registration statement, the Proposed Rules combined with the rescission of Rule 436(g) would enact a regulatory regime directly contrary to Congress's design. The Commission, however, "may not exercise its authority 'in a manner inconsistent with the administrative structure Congress enacted into law.'" *FDA v. Brown & Williamson Tobacco Corp.*, 529 U.S. 120, 125 (2000) (quoting *ETSI Pipeline Project v. Missouri*, 484 U.S. 495, 517 (1988)); *accord Ragsdale v. Wolverine Wide World, Inc.*, 535 U.S. 81, 91 (2002).

C. Original Reasons for Adopting Rule 436(g) Still Provide Sufficient Basis for Maintaining Rule

We believe that the original reasons for creating the safe harbor exist as strongly today as when Rule 436(g) was first adopted.

First, the Commission indicated in its 1981 Rule Proposal ("**1981 Release**") discussing Rule 436(g) that NRSROs "are already subject to substantial liability under the antifraud provisions of the federal securities law so that they now must adhere to the highest professional standards in determining a security rating". In the Concept Release, the Commission states that while NRSROs remain subject to Section 10(b) of the Exchange Act, NRSROs are "held liable infrequently," relying on an April 2009 paper by Professor Frank Partnoy, *Rethinking Regulation of Credit Rating Agencies: An Institutional Investor Perspective*.

We believe there is no basis for the suggestion that NRSROs are any less subject today to "substantial liability" under both Section 10(b) and state antifraud laws than they were in 1981. Nor is there evidentiary support for the notion that the legal system as it exists today will not provide sufficient incentives (in addition to those driven by reputational concerns) for NRSROs to maintain the highest professional standards. The factual record, which is not reflected in the Concept Release, is entirely to the contrary.

While it may be true that NRSROs have been "held liable infrequently" in the decades since 1981, there is nothing to support Professor Partnoy's erroneous assertion that this is because NRSROs "have been effectively exempt from civil liability". On the contrary, the logical, indeed obvious, explanation for the historical dearth of judgments against NRSROs is simply that, given their inarguably strong performance over this time period, very few investors or other market participants had reason to believe that there were even arguable grounds for a claim. In fact, we are aware of only two investor claims under Section 10(b) that were brought against CRAs between 1981 and 2007. In *neither* case, contrary to Professor Partnoy's inaccurate summary of CRA litigation, did the court find that the CRA was in any way protected from liability for knowing or reckless conduct by the First Amendment or any other law. Instead, the courts applied exactly the same pleading standard as that applicable to all other defendants, dismissing the claim in one case on *non-constitutional* grounds and refusing to dismiss that claim in the other.[8]

In short, there is simply no reason to doubt that Section 10(b), and similar state laws, have provided a fully available and potentially effective remedy for alleged misconduct by NRSROs during the decades since 1981.

This conclusion has been confirmed dramatically by the numerous class actions and other lawsuits alleging Section 10(b) claims and other causes of actions against NRSROs that have been filed in state and courts across the country since mid-2008. *None* of the Section 10(b) or corresponding state law claims in these cases has been dismissed, and no court has ruled that these claims are subject to any special limitations simply because they are brought against NRSROs. Indeed, in the only one of these lawsuits where the court has so far ruled on a motion to dismiss, *Abu Dhabi v. Morgan Stanley*, 2009 WL 2828018 (S.D.N.Y. Sept. 2, 2009), the court declined to dismiss a claim for common law fraud (the state analogue of Section 10b), and that claim is now in full discovery. Significantly, NRSROs are being sued under Section 10(b) and/or similar state common laws in at least eleven of the pending CRA litigations, which involve alleged investment losses totaling *billions* of dollars.

Thus, the fact that NRSROs are already under ample threat of crushing liability from the existing laws, particularly Section 10(b), clearly remains a strong additional rationale for continuing to protect NRSROs from the specter of unlimited, strict liability under Section 11. Indeed, even the litigation costs to which NRSROs are already exposed separate and apart from ultimate liability, present a powerful incentive to maintain the highest standards.[9]

Second, the Commission has stated that another reason it adopted Rule 436(g) was because at the time, NRSROs typically submitted to regulatory oversight under the Investment Advisers Act ("**Advisers Act**"). While, as noted by the Commission in this Release, NRSROs no longer register under the Advisers Act, NRSROs are now subject to the Credit Rating Agency Reform Act of 2006 ("**Reform Act**").[10] The Reform Act and the rules adopted by the Commission to implement it provide for a comprehensive oversight regime tailored specifically to the CRA industry and the issues it faces with respect to the independence, quality and transparency of the rating process. Thus, this original justification for Rule 436(g) is even more potent today.

Third, in the 1981 Release, the Commission reasoned that the rule would be appropriate because the disclosure of ratings in registration statements raised "practical and legal issues," including the fact that

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8 *See In re National Century Financial Enterprises, Inc. Investment Litigation*, 580 F. Supp. 2d 630, 644 (S.D. Ohio 2008) (dismissing claim against MIS because complaint contained no specific allegations indicating knowing or reckless conduct); *LaSalle Nat'l Bank v. Duff & Phelps Credit Rating Co.*, 951 F. Supp. 1071 (S.D.N.Y. 1996) (finding sufficient allegations, under older pleading standard, to allege claim against Duff & Phelps CRA). Moreover, contrary to Professor Partnoy's assertions, and popular perception, only *two* cases against CRAs – neither involving Section 10(b) – have actually been dismissed based on application of the First Amendment, and in one of those, *Compuware Corp. v. Moody's Investors Service, Inc.*, 499 F.3d 520 (6th Cir. 2007), dismissal was granted only after years of discovery and after the court found that MIS had not even acted negligently, let alone with "actual malice".

9 In this connection, it is worth noting that even when NRSROs have ultimately prevailed on lawsuits in the past, the cases have been long and costly. For example, the litigation process in *Compuware Corp.*, *supra*, lasted nearly five years.

10 To be clear, NRSROs used to voluntarily register under the Investment Advisers Act and now voluntarily register under the Reform Act.

NRSROs could – and had stated that they would – "refuse[] to consent" to such disclosure. In this regard, as addressed above, Congress has mandated under the Securities Act that experts have this right to consent *because* of the liability imposed under Section 11 for giving that consent. CRAs would still have the right to withhold consent to the disclosure of their ratings in the registration statement if Rule 436(g) were eliminated.[11]

In addition, when the Commission has pondered rescinding rules, or imposing a new regulatory regime, it usually has done so as a remedial measure to prevent abuse. The Commission's recent reviews of NRSRO activity have not identified any instances of fraud or similar abuses. Consequently, the possible rescission of Rule 436(g) would not accomplish a remedial purpose.[12]

D. Rescinding 436(g) Likely Would Not Improve Investor Protection or Ratings Quality

We believe that exposing NRSROs to liability as experts likely would not improve investor protection or ratings quality, and could harm both.

First, imposing expert liability on NRSROs likely would lead to a contraction in rating coverage and a corresponding contraction in the availability of credit, especially for smaller entities (*e.g.*, local governments and high yield issuers). These fewer ratings, in turn, would migrate disproportionately to larger, more creditworthy issuers that were willing and able, for example, to pay inevitably increased costs. Creating this scenario appears at odds with other actions taken by the Commission and other authorities to expand access to credit. MIS, for example, typically does not decline to rate an issuer due to concerns about its creditworthiness. If Rule 436(g) were rescinded, however, CRAs would be motivated to assign fewer ratings and be more selective about which issuers they rated in order to manage the increased liability risks. This seems inconsistent with what investors want since they value the breadth of ratings coverage that globally active CRAs provide because such breadth enables investors to compare and rank credit quality across a wide range of issuers, from the most creditworthy to the least creditworthy, and across a wide range of industry sectors, asset classes and jurisdictions.

Not only would CRAs likely reduce the number of rated issuers, there likely would be fewer CRAs issuing rating opinions. Moreover, if Rule 436(g) were eliminated, a "race to the bottom" could result. Less scrupulous individuals might be encouraged to make money in the short term by investing as little as possible in their rating process to keep costs down, all the while knowing that the CRA would close its doors once it received its first court judgment that it was not adequately insured to pay. By contrast, CRAs that were interested in producing high quality ratings might be discouraged from entering or remaining in the business because, regardless of how much effort they expended to produce reliably predictive opinions, the

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11 As explained throughout this letter, as well as in Professor Tribe's and Mr. Goldstein's letter, if Rule 436(g) were rescinded *and* the Proposed Disclosure Rules were adopted, the practical consequence would be to effectively force NRSROs to consent to the use of their ratings or be forced out of business.

12 Moreover, in Rule 436(g), the Commission recognized that NRSRO ratings are not "a part of the registration statement prepared or certified within the meaning of Section 7 and 11 of the [1933 Securities] Act". For the reasons given above, we believe that determination is correct. If the Commission were now to take the opposite position, that change would impermissibly be contrary to the text and purposes of the statute (*see Chevron v. National Resource Defense Council*, 467 U.S. 837 (1984)) or at the very least would constitute an impermissible, unexplained reversal of the Commission's prior interpretation of the statute (*see F.E.C. v. Fox Television Stations*, 129 S.Ct. 1800 (2009)).

CRA would face lawsuits whenever any issuer they rated defaulted.[13] The more inevitable are future adverse judgments, the fewer reasons to invest in producing high quality ratings to avoid those judgments.

Second, if NRSROs lost the Rule 436(g) safe harbor and the Proposed Disclosure Rules were adopted, they would likely respond by changing the nature of their ratings, which would negatively affect both investors and the market while also hurting ratings quality. In this regard, we understand that while the Commission acknowledges that "rescinding Rule 436(g) may have significant impact on the market and on market participants," the Commission does not believe that rescinding the rule would "change the fundamental nature of what a credit rating is". We believe that the Commission may be underestimating the market impact of eliminating Rule 436(g) and that NRSROs would likely alter fundamental attributes of their credit ratings. In our view, these two points are inextricably linked.

To explain, Rule 436(g) and current liability standards give NRSROs breathing room to have the courage of their convictions regarding their credit opinions no matter how unpopular those views may be. Imposing expert liability on NRSROs would motivate them to issue rating opinions based on caution rather than candor. The need for caution would run both ways: long investors could sue NRSROs for every case of default, while issuers and short investors could sue for every case of non-default. To balance these conflicting interests, NRSROs would have incentives to assign "defensive" ratings, publishing the "safest" ratings rather than the highest quality ratings. NRSROs would be less likely to rate through credit cycles – an important hallmark of high-quality credit ratings. They would be more likely to sacrifice ratings stability in favor of ratings volatility. Investors and regulators have found value in the *combination* of accuracy and stability, and Rule 436(g) allows NRSROs to strive for that goal.

Without the Rule 436(g) safe harbor, however, NRSROs would instead be compelled to react to every market change – no matter how temporary. NRSROs would be forced to focus on short-term time horizons and rely on quantitative models at the expense of qualitative and stable ratings. They likely would abandon the practice of publishing "Outlooks" and "Watchlists" so that they could instead concentrate on reacting as quickly as possible to frequent market fluctuations. This new focus would have terrible consequences not only for investors and issuers, but also for the authorities responsible for regulating systemic risk. This scenario also would dilute the value of an initial rating, which is at the heart of the Proposed Disclosure Rules, because that initial rating would become increasingly volatile. Credit ratings would likely become more like audit opinions in that CRAs would be encouraged to provide simply their *current* view of an issuer's solvency. For example, CRAs might publish an opinion that Company A was solvent as of the offering date, which we do not believe is the desire of the Commission or market participants.

By necessity, NRSROs would become more reactive to negative information: at any hint of bad news, they would be motivated to downgrade their ratings or risk unlimited liability. Ratings would become mechanical and not reflective of an NRSRO's true opinion. Instead, ratings would reflect opinions that were "safe" from a litigation perspective. This volatility is the opposite of what investors would want if they want CRAs to provide truly forward-looking views. Moreover, conservative or defensive ratings driven by a heightened fear of liability would likely make the cost of capital more expensive and impede the markets, which, in turn, would harm investors.

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[13] The Commission has similarly noted that increasing NRSRO liability may undermine competition because CRAs, particularly smaller, less-established CRAs, may decide they are unable to bear the risk of liability and thus exit the industry.

Stability would not be the only rating attribute at risk if Rule 436(g) were rescinded:

- NRSROs would be less likely to publish views that were controversial, different from those of others, or different from what market participants wanted to hear.
- NRSROs also would be motivated to compress their rating scales and provide less precise and less nuanced ratings, which would be less useful for investors. This compression would make the allocation of capital less efficient because investors would have less precise information about issuers and would not know who would make best use of their funds.
- Imposing expert liability on NRSROs would also change a process designed to be driven by credit analysis into a process dominated by legal conservatism. This shift likely would result in a greater volume of legal disclaimers and a lower volume of actual credit analysis. These disclosures would be written by lawyers for lawyers to ward off litigation, as opposed to being written by credit analysts for investors to help them gauge credit risk.

Certainly, self-censorship, less granular ratings, and excessive disclaimers would not improve ratings quality.

Ultimately, with NRSROs sharing the same incentives to publish ratings that were defensive, more volatile and unstable, as well as less controversial, independent and nuanced, credit ratings likely would become less diverse because what was "safe" for one NRSRO would be safe for *each* NRSRO. As explained above, regulators and the market value diversity of CRA opinions because diversity encourages competition based on ratings quality.

On a related note, the Commission seeks comment on whether NRSROs would stop issuing ratings permanently. In this regard, we do not believe that NRSROs would immediately close their doors, but they would need to change their ratings to survive the likely onslaught of litigation. Moreover, at some point, the increased litigation could likely overwhelm the industry and prevent NRSROs from existing, as they do now.[14] This is because, as explained in Part A above, NRSROs are predicting that a certain percentage of securities within each rating category – even in the highest rating categories – are expected to default. To illustrate, MIS, by example, rates tens of trillions of dollars of debt. MIS is predicting that a certain amount of this rated debt will default. Taking away the Rule 436(g) safe harbor means that when those expected defaults occurred, MIS very likely would be subject to costly litigation, even if MIS's ratings appropriately ranked the relative creditworthiness of issuers. Defending even that percentage of lawsuits could drive MIS – and other NRSROs – out of business.

E. Competitive Disadvantages

In our view, to the extent the safe harbor creates competitive disadvantages, the better solution is to level the playing field by expanding Rule 436(g) to include *all* CRAs, whether or not they are NRSROs, as the Commission proposed in 2008.[15] The overwhelming majority of the reasons behind Rule 436(g) apply equally to both types of CRAs. It is also worth noting, as a practical matter, that non-NRSROs CRAs' credit ratings typically are not included in registration statements and therefore such CRAs are less likely to need the protection of the safe harbor in order to freely express their opinions.

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14 As we note above, this pressure could be greater for smaller CRAs. Moreover, rescinding Rule 436(g) could also encourage newer CRAs with less professional intentions.

15 *See* Security Ratings, Commission Release No. 33-8940 (July 1, 2008).

F. Other Public Policy Arguments

We believe that there are additional public policy arguments against imposing expert liability on NRSROs:

First, we understand that the Commission does "not believe that requiring registrants to obtain consents from NRSROs and treating NRSROs as experts under federal securities laws should increase reliance on credit ratings". In our view, imposing increased liability on NRSROs likely would increase incentives for investors to over-rely on credit ratings by investors for a few reasons. Investors may be encouraged to believe that, if the CRA is subject to strict liability for its rating, the CRA considered *all* elements of risk for an investor. In this regard, however, credit ratings, however, address only credit risk and not other risks as market value risk, liquidity risk or price volatility.

NRSROs will be seen as easy targets and effective insurers of investment risk. Investors will be encouraged to believe that if the rating proves "wrong," they can seek a return on their investment through the court system. This view, in turn, will discourage investors from making their own study and evaluation of each security that is under consideration for sale and using ratings as just one of several inputs in their decision-making process. Creating such a scenario is inconsistent with the Commission's and other authorities' efforts to reduce the risk of over-reliance on ratings.

Second, rescinding Rule 436(g) could make it more challenging for CRAs to manage conflicts of interest. We have repeatedly expressed our view that the only parties likely to pay for ratings – whether issuers, investors or governments – are parties directly interested in the outcomes.[16] So long as CRAs compete for business, potential conflicts of interest will exist. Attempts to influence CRAs' credit opinions could – and historically have – come very democratically from all sectors. Each model needs to – and does – have policies and procedures in place to manage these inherent conflicts.

As noted above, under current liability standards, CRAs can freely express their opinion without fear of retribution for expressing unpopular views, which is an important factor in managing such conflicts. If, however, NRSROs lost their safe harbor from expert liability, then in an investor-pay context, investors could be given leverage to push for a given rating or bring suit under the Securities Act. And, in the issuer-pay context, issuers could apply the same pressure.

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Once again, we appreciate the opportunity to comment on the Concept Release. We would be pleased to discuss our comments further with the Commission or its staff.

Sincerely,

Michel Madelain
Chief Operating Officer
Moody's Investors Service

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[16] *See*, for example, Statement of Raymond W. McDaniel, CEO and President, Moody's Investors Service, Before the United States Securities and Exchange Commission (April 15, 1009), which is available on moodys.com.