
Annual Report on Nationally Recognized Statistical Rating Organizations

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



U.S. Securities and Exchange Commission

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REPORT ON NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATIONS

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

I. INTRODUCTION

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

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

This report provides an overview of the rules and rule amendments that the Commission proposed and adopted during the period from June 26, 2009 to June 25, 2010, and addresses each of the items specified in Section 6 of the Rating Agency Act.²

¹ See Pub. L. No. 109-291 (2006). On June 5, 2007, the Commission approved the rules implementing a registration and oversight program for NRSROs under the Rating Agency Act. The rules became effective that same month. During the year-long period beginning on June 26, 2007 – the effective date of the Rating Agency Act – and ending on June 25, 2008, the Commission registered the first ten NRSROs. The annual report published in June 2008 related to this period from June 26, 2007 to June 25, 2008. See “Annual Report on Nationally Recognized Statistical Rating Organizations,” June 2008, <http://www.sec.gov/divisions/marketreg/ratingagency/nrsroannrep0608.pdf>. The annual report published in September 2009 related to the period from June 26, 2008 to June 25, 2009. See “Annual Report on Nationally Recognized Statistical Rating Organizations,” September 2009, <http://www.sec.gov/divisions/marketreg/ratingagency/nrsroannrep0909.pdf>.

² The Commission notes that subsequent to this reporting period the President signed into law on July 21, 2010 the Dodd-Frank Wall Street Reform and Consumer Protection Act (PL 111-203) (the “Dodd-Frank Act”). Although this report does not discuss the details of the Dodd-Frank Act, because its enactment falls outside of the reporting period, the Dodd-Frank Act entails significant changes. For example, Title IX, Subtitle C, of the Dodd-Frank Act amends the Securities Exchange Act of 1934 (“Exchange Act”) to impose new self-executing requirements with respect to NRSROs and mandates that the Commission adopt rules in a number of areas. Further, Section 932 of the Dodd-Frank Act requires the Commission to establish an Office of Credit Ratings and also eliminated the safe harbor from expert liability in Rule 436(g) under the Securities Act of 1933. Section 939A of the Dodd-Frank Act provides that each federal agency shall remove any

II. COMMISSION RULES AND OTHER ACTIONS RELATING TO NRSROs

The Commission issued the following releases during the reporting period:

- Notice Regarding the Requirement to Use eXtensible Business Reporting Language Format to Make Publicly Available the Information Required Pursuant to Rule 17g-2(d) of the Exchange Act, Exchange Act Release No. 3460451 (August 5, 2009). The Commission provided notice that an NRSRO subject to the disclosure provisions of paragraph (d) of Rule 17g-2 can satisfy the requirement to make publicly available ratings history information in an HBRL format by using an XBRL format or any other machine-readable format, until such time as the Commission provides further notice.
- Order Providing NRSROs a Temporary Exemption from the Requirement in Rule 17g-2(d) (Incorporating the Provisions of Rule 17g-2(a)(8)) of the Securities Exchange Act of 1934 that CUSIP Numbers be Displayed, Exchange Act Release No. 34-60473 (August 10, 2009). The Commission provided NRSROs with a 30-day exemption from the requirement of Rule 17g-2(d) that the CUSIP for each rated security be included with the ratings action information.
- Final Rule: Amendments to Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 61050 (November 23, 2009), 74 FR 63832 (December 4, 2009). The Commission adopted amendments to paragraph (d) of Rule 17g-2 and paragraphs (a), (b), and (e) of Rule 17g-5. The amendments to 17g-2 require an NRSRO to disclose ratings action histories for all credit ratings initially determined on or after June 26, 2007 in an interactive data file that uses a machine-readable format. The amendments to 17g-5 require an NRSRO that is hired by issuers, sponsors, or underwriters (*i.e.*, the arrangers) to determine an initial credit rating for a structured finance product to (1) disclose to non-hired NRSROs that have furnished the Commission with a certification that the arranger is in the process of determining such a credit rating and (2) to obtain representations from the arranger that the arranger will provide information given to the hired NRSRO to the non-hired NRSROs that have furnished the Commission with the certification.
- Proposed Rules for Nationally Recognized Statistical Rating Organizations Exchange Act Release No. 61051 (November 23, 2009), 74 FR 63866 (December 4, 2009). The Commission proposed amendments and rule would require an NRSRO: (1) to furnish a new annual report describing the steps taken by the firm's designated compliance officer during the fiscal year with respect to compliance reviews, identifications of material compliance matters,

reference to or requirements in regulations regarding credit ratings and substitute in such regulations such standard of creditworthiness as each agency shall determine as appropriate.

remediation measures taken to address those matters, and identification of the persons within the NRSRO advised of the results of the reviews; (2) to disclose additional information about sources of revenues on Form NRSRO; and (3) to make publicly available a consolidated report containing information about revenues of the NRSRO attributable to persons paying the NRSRO for the issuance or maintenance of a credit rating. The Commission also solicited comments regarding alternative measures that could be taken to differentiate NRSROs' structured finance credit ratings from the credit ratings they issue from other types of financial instruments through, for example, enhanced disclosures of information.

- Order Granting Temporary Conditional Exemption for Nationally Recognized Statistical Rating Organizations from Requirements of Rule 17g-5 under the Securities Exchange Act of 1934 and Request for Comment, Exchange Act Release No. 34-62120 (May 19, 2010). On May 19, 2010, the Commission issued an order conditionally exempting, with respect to certain credit ratings, NRSROs from requirements in Rule 17g-5(a)(3) that apply whenever an issuer, sponsor, or underwriter hires an NRSRO to determine an initial credit rating for a security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction. Under the order, an NRSRO was exempted from compliance with Rule 17g-5(a)(3) until December 2, 2010, with respect to credit ratings where: (1) the issuer of the structured finance product was a non-U.S. person; and (2) the NRSRO had a reasonable basis to conclude that the structured finance product would be offered and sold upon issuance, and that any arranger linked to the structured finance product would effect transactions of the structured finance product after issuance, only in transactions that occur outside the U.S.³

III. STATUS OF REGISTRANTS AND APPLICANTS

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

<u>NRSRO</u>	<u>Date of Registration</u>
A.M. Best Company, Inc. ("A.M. Best")	September 24, 2007
DBRS Ltd. ("DBRS")	September 24, 2007
Fitch, Inc. ("Fitch")	September 24, 2007
Japan Credit Rating Agency, Ltd. ("JCR")	September 24, 2007
Moody's Investors Service, Inc. ("Moody's")	September 24, 2007
Rating and Investment Information, Inc. ("R&I")	September 24, 2007
Standard & Poor's Ratings Services ("S&P")	September 24, 2007

³ On November 23, 2010, the Commission issued a new order extending this temporary conditional exemption until December 2, 2011. See Order Extending Temporary Conditional Exemption for Nationally Recognized Statistical Rating Organizations from Requirements of Rule 17g-5 under the Securities Exchange Act of 1934 and Request for Comment, Exchange Act Release No. 34-63363 (November 23, 2010).

Egan-Jones Rating Company (“EJR”)
LACE Financial Corp. (“LACE”)
Realpoint LLC (“Realpoint”)

December 21, 2007
February 11, 2008
June 23, 2008

On December 24, 2009, Dagong Global Credit Rating Co., Ltd. (“Dagong”), a credit rating agency based in Beijing, China, submitted to the Commission its application for registration as an NRSRO. Dagong subsequently consented to two extensions of time for the Commission to act on its application. On April 14, 2010, the Commission issued an order pursuant to Section 15E(a)(2)(A)(ii) of the Exchange Act instituting proceedings to determine whether Dagong’s application for registration as an NRSRO should be denied.⁴ In these proceedings, grounds for denial under consideration included:

- (1) whether Dagong has a sufficient connection with U.S. interstate commerce to register as an NRSRO, and thereby invoke the regulatory and oversight authority of the Commission; and
- (2) whether Dagong’s application for registration should be denied pursuant to Section 15E(a)(2)(C)(ii)(II) on the grounds that, if registered as an NRSRO, Dagong would be subject to having its registration suspended or revoked under Section 15E(d)(1) of the Exchange Act, because in light of requirements in its home jurisdiction, Dagong would be unable to comply with provisions of the U.S. securities laws and rules, including, in particular, Section 17 of the Exchange Act and Rules 17g-2 and 17g-3 thereunder.

Although this proceeding was pending before the Commission as of the end of the period covered by this Report, on September 22, 2010 the Commission issued an order denying Dagong’s application for registration as an NRSRO.⁵ The Commission found that at this time Dagong is unable to comply with the Exchange Act’s recordkeeping, production, and examination requirements. Because the Commission found that Dagong cannot comply with these requirements, it did not reach the issue of whether Dagong at this time has sufficient connection with U.S. interstate commerce to register as an NRSRO and invoke the Commission’s regulatory and oversight authority.

IV. COMMISSION’S VIEW ON COMPETITION

A. Summary of Select Statistical Information

As discussed above, the Commission has granted NRSRO registration to ten credit rating agencies. The first seven firms (A.M. Best, DBRS, Fitch, JCR, Moody’s, R&I, and S&P) applied for registration as NRSROs in June of 2007 under the new

⁴ Order Instituting Administrative Proceedings Pursuant to Section 15E(2)(A)(ii) of the Securities Exchange Act of 1934 and Notice for Hearing, Exchange Act Release No. 61906 (Apr. 14, 2010), 75 FR 20645 (Apr. 20, 2010).

⁵ Order Denying Application for Registration as a Nationally Recognized Statistical Rating Organization, Exchange Act Release No. 62968 (Sept. 22, 2010).

registration and oversight program adopted by the Commission that month. Subsequently, the Commission granted three additional credit rating agencies NRSRO registration (EJR, LACE, and Realpoint). The following sections summarize certain information reported by each NRSRO on its Form NRSRO.

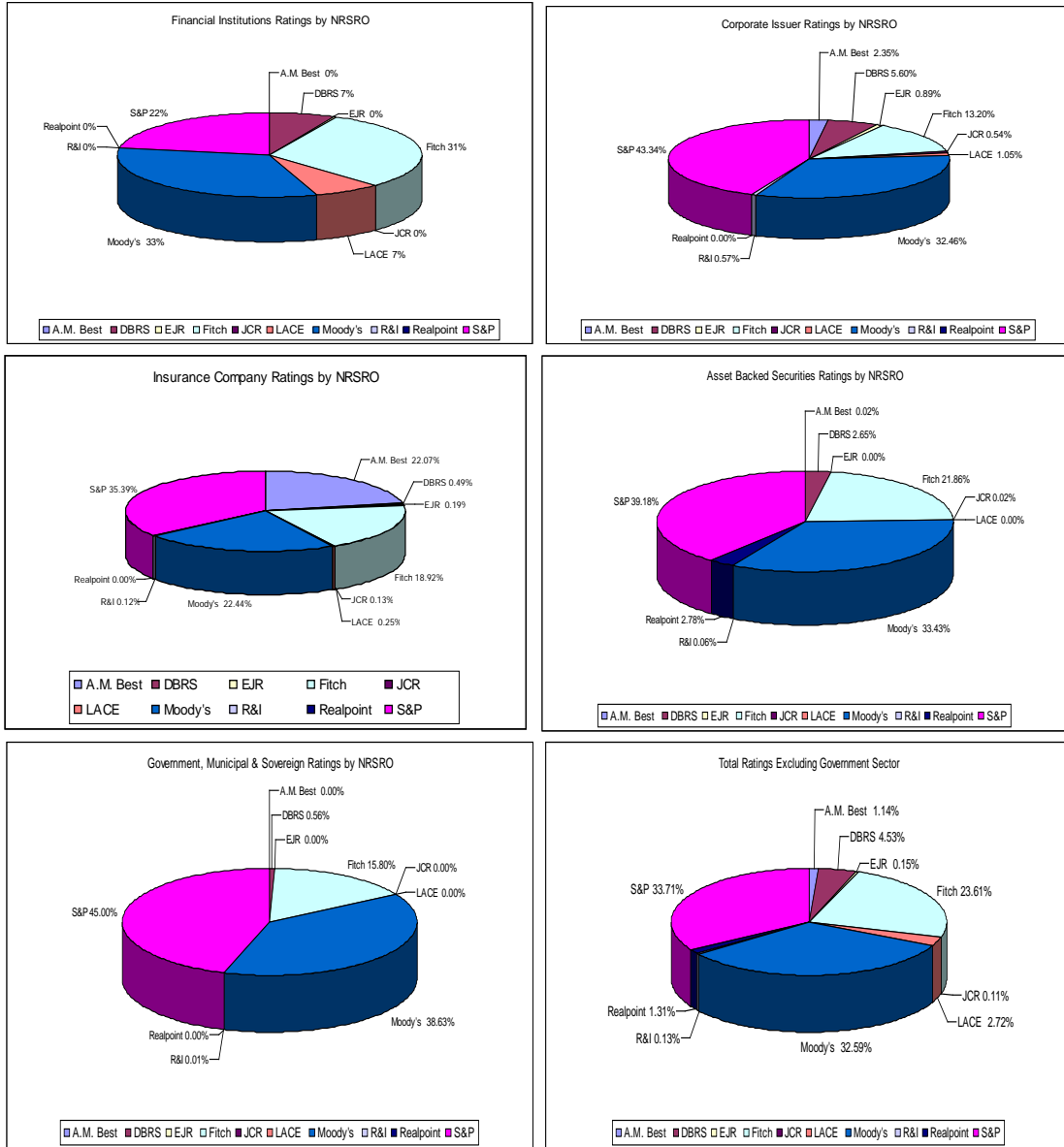
1. Ratings Outstanding by NRSRO

The table and charts below report the number of outstanding ratings reported by each NRSRO in its Form NRSRO annual certification for the year 2009. For each NRSRO, the table sets forth the number of outstanding ratings for the five classes of ratings identified in Section 3(a)(62) of the Exchange Act: (1) financial institutions, brokers, or dealers; (2) insurance companies; (3) corporate issuers; (4) issuers of asset-backed securities;⁶ and (5) issuers of government securities, municipal securities, or securities issued by a foreign government (“sovereign securities”).

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

NRSRO	Financial Institutions	Insurance Companies	Corporate Issuers	Asset-Backed Securities	Government, Municipal & Sovereign	Total Ratings
A.M. Best	3	5,364	2,246	54	0	7,667
DBRS	16,630	120	5,350	8,430	12,400	42,930
EJR	82	45	853	14	13	1,007
Fitch	72,311	4,599	12,613	69,515	352,697	511,735
JCR	156	31	518	64	53	822
LACE	17,263	60	1,000	0	61	18,384
Moody's	76,801	5,455	31,008	106,337	862,240	1,081,841
R&I	100	30	543	186	123	982
Realpoint	0	0	0	8,856	0	8,856
S&P	52,500	8,600	41,400	124,600	1,004,500	1,231,600
Total	235,846	24,304	95,531	318,056	2,232,087	2,905,824
HHI	2,599	2,601	3,145	3,145	3,767	3,495
HHI Inverse	3.85	3.84	3.18	3.18	2.65	2.86

⁶ As the term is defined in 17 CFR 229.1101(c).



Of the ten credit rating agencies registered with the Commission as NRSROs, seven operate predominantly under the issuer-pay model.⁷ The remaining three operate predominantly under the subscriber-pay model.⁸ The NRSROs operating under the issuer-pay model have determined approximately 99% of the total currently outstanding credit ratings issued by NRSROs.⁹

Market concentration is generally measured by economists using the Herfindahl-Hirschman Index (“HHI”), which is a measure of the size of firms in relationship to the industry and an indicator of the amount of competition among them. It is calculated by

⁷ A.M. Best Company, Inc., DBRS Ltd., Fitch, Inc., Japan Credit Rating Agency, Ltd., Moody's Investors Service, Rating and Investment Information, Inc., Standard and Poor's Ratings Services.

⁸ Egan-Jones Rating Company, LACE Financial Corp., Realpoint LLC.

⁹ According to Form NRSROs made public by NRSROs.

squaring the market share of each firm competing in the market and then summing the resulting number. The HHI is measured on a scale of 0 to 10,000 and approaches zero when a market consists of a large number of firms of relatively equal size. The HHI increases both as the number of firms in the market decreases and as the disparity in size between those firms increases. According to the U.S. Department of Justice, markets in which the HHI is between 1,000 and 1,800 points are considered to be moderately concentrated, and those in which the HHI is in excess of 1,800 points are considered to be concentrated.¹⁰ The inverse of the HHI (“HHI Inverse”) is a measure of the number of equally sized firms which would constitute a comparable level of concentration for a given HHI and is calculated by dividing 10,000 by the HHI.

The HHI for all NRSRO ratings outstanding is 3,495, which is the equivalent of there being approximately 2.86 equally sized firms. Three NRSROs (Fitch, Moody’s, and S&P) issued approximately 97% of all outstanding ratings across all categories reported. The concentration of outstanding ratings for these three NRSROs is high across all five categories but does vary across those categories. For instance, Fitch, Moody’s, and S&P account for over 99% of all outstanding ratings for government securities,¹¹ but less than 77% of all ratings for insurance companies. For various reasons, including those discussed below in section IV.D, concentration needs to be considered together with other factors to identify the level of competition.

Among these three largest NRSROs, concentration is not consistent across rating classes. For credit ratings related to financial institutions, Fitch and Moody’s each had issued substantially more ratings than S&P. Moody’s and S&P were the two dominant issuers of credit ratings for corporate issuers.

Among the other NRSROs, DBRS and LACE report having the two largest numbers of outstanding credit ratings for financial institutions (16,630 and 17,263 respectively or approximately 7.1% and 7.3%, respectively, of all ratings in this category), while A.M. Best reports the largest number of outstanding ratings for the insurance company category (5,364, or approximately 22.1%, of all ratings in this category). DBRS reports the largest number of outstanding ratings for the corporate sector (5,350, or 5.6%, of all ratings in this category).

Of the 318,056 outstanding credit ratings for asset-backed securities, all but 17,604 are issued by Fitch, Moody’s, and S&P. Among the other NRSROs, Realpoint reports having the largest number of outstanding credit ratings for asset-backed securities (8,856, or 2.78%, of all ratings in this category).

The table below reports the HHI Inverse statistic calculated for the ratings outstanding in each class of ratings and overall for the years 2007 through 2009.

¹⁰ <http://www.usdoj.gov/atr/public/testimony/hhi.htm>.

¹¹ Fitch, Moody’s, and S&P issued 2,348,144 of the total 2,359,184 credit ratings for government, municipal and sovereign securities and issuers.

HHI Inverse for Each Class of Ratings

Year	Financial Institutions	Insurance Companies	Corporate Issuers	Asset-Backed Securities	Government, Municipal & Sovereign	Total Ratings
2007	3.37	4.02	3.27	2.71	2.35	2.65
2008	3.72	4.05	3.79	2.82	2.83	2.99
2009	3.85	3.84	3.18	3.18	2.65	2.86

2. Number of Credit Analysts employed at each NRSRO

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

Credit Analysts and Credit Analyst Supervisors Employed at Each NRSRO

NRSRO	Credit Analysts	Credit Analyst Supervisors
A.M. Best	134	42
DBRS	67	20
EJR	5	3
Fitch	1,035	345
JCR	61	27
LACE	7	4
Moody's	1,096	143
R&I	81	6
Realpoint	15	7
S&P	1,019	223
Total	3,520	820

The three largest credit rating agencies report employing 3,150 credit analysts, or approximately 90%, of the total number of credit analysts employed by all of the NRSROs. Among the other NRSROs, A.M. Best reported employing the largest number of credit analysts (134, or approximately 4%, of the total number of credit analysts).

3. NRSRO Financial Results

Exhibit 12 to Form NRSRO requires each NRSRO to provide information as to the amount of revenue generated from various credit rating services and a separate computation of total revenue from all other services. In addition, Exchange Act Rule 17g-3 requires each NRSRO to furnish the Commission with annual financial reports. Pursuant to Section 15E(a)(3) of the Exchange Act and Rule 17g-1(i) thereunder, an NRSRO is not required to make this information publicly available.

The total aggregate revenue reported by all of the NRSROs was approximately \$3.7 billion dollars, down from the \$3.8 billion reported last year.¹² The HHI for total revenues reported by NRSROs is 3,358, which is the equivalent of 2.97 equally sized firms. The HHI for earnings reported by NRSROs is 3,926, which the equivalent of 2.55 equally sized firms. The HHI for earnings is higher than the HHI for revenue because the firms which reported the largest amounts of revenue also tended to have higher after-tax profit margins. The earnings reported by the three largest NRSROs made up over 98% of the earnings reported by all of the NRSROs.

B. NRSRO Products and Other Credit Analytic Products

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

Demand for credit ratings exists from investors, both individual and institutional, who value an independent assessment of the relative or absolute credit risk of a particular debt obligation or obligor. As such, credit ratings serve a certification function in the marketplace, providing rated issuers with less costly access to debt markets.¹³ In many cases, investment managers and financial institutions are required by regulations, including Commission rules, to use credit ratings to establish investment risk standards for their portfolio holdings.¹⁴ Parties can write contracts that create obligations based on

¹² The fiscal year end used by different NRSROs as a basis for their reporting varied from September 2009 to March 2010.

¹³ See, e.g., . Frank Partnoy, "The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Ratings Agencies," *Washington University Law Quarterly*, 77 (3), 619-714 (1999); Arnoud W.A. Boot, Todd T. Milbourn and Anjolein Schmeits, "Credit Ratings as Coordination Mechanisms," *Review of Financial Studies*, 19 (1), 81-118 (2006); Deiter Kerwer, "Ratings Agencies: Setting a Standard for Global Financial Markets," *Economic Sociology European Electronic Newsletter*, 3 (3), 40-46 (2002); Timothy J. Sinclair, "Reinventing Authority: Embedded Knowledge Networks and the New Global Finance," *Environment and Planning C: Government and Policy*, 18 (4), 487-502 (2000) (these articles, among other things, argue that credit ratings agencies create value through standardizing the credit assessment process).

¹⁴ See, Joint Forum Report *Stocktaking on the use of credit ratings* published in June 2009 (available at <http://www.bis.org/publ/joint22.pdf?noframes=1>) (discussing, among other things, the use of credit ratings in "(a) determining capital requirements; (b) identifying or classifying assets, usually in the context of eligible investments or permissible asset concentrations; (c) providing a credible

a change in credit ratings – the use of so-called “ratings triggers” (see additional discussion in the following section).

In addition to NRSROs and other credit rating agencies, the staff is aware of other relevant providers of credit research and analysis.¹⁵ Credit models and assessments by third-party providers may be used by investors as indicators of value or price for a given debt obligation. Where available, third-party providers of credit analytics and internal models are natural competitors to NRSROs for all non-regulatory uses and may serve as a check on NRSRO ratings quality or substitutes for non-regulatory uses if they provide more accurate or useful ratings.

Economists point to several factors that have increased the demand for credit ratings in recent years.¹⁶ Structural changes in financial markets have increased the number of participants, increased their anonymity, and increased the complexity of their investment strategies. At the same time, financial disintermediation has shifted credit from banks to capital markets, leading to the creation of increasingly complex financial instruments through securitization. The increasing complexity likely created additional reliance by investors on NRSRO credit ratings as they provided a single summary measure of the credit risks of difficult to evaluate financial instruments. At the same time, banking and finance regulators around the world have increased their reliance on NRSRO credit ratings.

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

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

The Findings section of the Rating Agency Act noted that “the 2 largest credit rating agencies serve the vast majority of the market.”¹⁷ Further, the Senate Report accompanying the Rating Agency Act described the largest two NRSROs (Moody’s and

evaluation of the credit risk associated with assets purchased as part of a securitization offering or a covered bond offering; (d) determining disclosure requirements; and (e) determining prospectus eligibility”).

¹⁵ See, e.g., Arturo Estrella, “Credit Ratings and Complementary Sources of Credit Quality Information,” Basel Committee on Banking Supervision Working Papers, Aug. 2000.

¹⁶ See, e.g., Fabian Dittrich, 2007, “The Credit Rating Industry: Competition and Regulation,” Doctoral Dissertation, Universitat zu Koln, Koln, Germany; Isabelle Gras, “The Power to Rate,” REGEM Analysis No. 6 (2003).

¹⁷ See Section 2 of the Rating Agency Act (Pub. L. No. 109-291 (2006)).

S&P) as a “duopoly” or “partner-monopoly.”¹⁸ Information obtained from NRSROs about the number of ratings they have outstanding, the number of credit analysts, and their financial results, as presented above, suggests that in combination with Fitch, these two entities are still the dominant market players.

Economists note that the credit rating industry has exhibited a high level of concentration throughout much of its history, dating from the early twentieth century.¹⁹ Analysts have cited the regulatory use of ratings as a factor that has created barriers to entry and led to concentration in the credit rating industry.²⁰ Financial regulators including the Federal Reserve Banks, the Office of the Comptroller of the Currency and state banking and insurance departments have used credit ratings to assist them in their oversight of financial institutions since the 1930s. Early ratings-dependent rules included requirements to mark-to-market lower rated bonds and restrictions on the purchase of speculative securities. In the 1950s, the National Association of Insurance Companies imposed higher capital requirements on the lower rated bonds of insurance companies.²¹

The Commission first used the term NRSRO in 1975 in the Net Capital Rule for broker-dealers as an objective benchmark to prescribe capital charges for different types of debt securities. Since then, the Commission has used the designation in a number of regulations. Although the use of the term NRSRO was originated for a narrow purpose in the Commission's own regulations, ratings by NRSROs today are used widely as benchmarks in federal and state legislation as well as in rules issued by other financial regulators.²²

Congress has incorporated the NRSRO concept into other pieces of financial legislation. For example, when Congress defined the term “mortgage related security” in Section 3(a)(41) of the Exchange Act as part of the Secondary Mortgage Market Enhancement Act of 1984, it required, among other things, that such securities be rated in one of the two highest rating categories by at least one NRSRO. Further, in 1989, Congress added the NRSRO concept to the Federal Deposit Insurance Act, prescribing that corporate debt securities are not “investment grade” unless they are rated in one of the four highest categories by at least one NRSRO.²³

¹⁸ See Senate Report, 109-326, p.1.

¹⁹ See, e.g., Richard Sylla, “A Historical Primer on the Business of Credit Ratings” and Lawrence J. White, “The Credit Rating Industry: an Industrial Organization Analysis” both papers in Ratings, Rating Agencies and the Global Financial System (2002).

²⁰ See, e.g., Partnoy (1999), White (2001).

²¹ See, e.g., Richard Cantor and Frank Packer, “The Credit Rating Industry,” FRBNY Quarterly Review, Summer-Fall, 1994.

²² In Section 939(e) of the Dodd-Frank Act, Congress struck language in the Section 3(a)(41) (the definition of “mortgage related security”) and Section 3(a)(53) (the definition of “small business related security”) of the Securities Exchange Act of 1934 related to ratings by NRSROs and replaced it with the language “meets standards of credit-worthiness as established by the Commission.” Additionally, Section 939A requires the Commission to replace references to credit ratings in all of its regulations with a standard of creditworthiness that it deems appropriate.

²³ See “Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets As Required by Section 702(b) of the Sarbanes-Oxley Act of 2002” (2003), <http://www.sec.gov/news/studies/credratingreport0103.pdf>.

Finally, a number of other federal and state laws and regulations today employ the NRSRO concept. For example, the U.S. Department of Education uses ratings from NRSROs to set standards of financial responsibility for institutions that wish to participate in student financial assistance programs under Title IV of the Higher Education Act of 1965, as amended (Title IV). In addition, several state insurance codes rely, directly or indirectly, on NRSRO ratings in determining appropriate investments for insurance companies. Most recently, credit ratings have been used to determine the eligibility of assets for a number of the programs established by the Federal Reserve and the Department of the Treasury in response to the credit crisis.²⁴

Credit ratings are also used widely by financial regulators outside the United States.²⁵ According to a Basel Committee on Banking Supervision (BCBS) study published in 2000, eleven out of twelve countries that are members of the BCBS used the ratings of credit rating agencies in financial regulatory supervision.²⁶ The Basel II framework, which has been implemented by members of the European Union, relies on the ratings of credit rating agencies recognized as External Credit Assessment Institutions (ECAI) in order to calculate bank capital requirements within its standardized approach for credit risk measurement.²⁷

Economies of scale and sunk costs may be economic factors which may favor the larger, more established rating agencies. Large rating agencies can allocate the costs of, among other things, analytical software, administrative, legal, compliance, marketing and support staff across a wider range of ratings providing a more efficient cost base. In addition, these rating agencies have large sunk costs in the form of developed ratings, methodologies and procedures and ratings outstanding which new entrants must create from scratch.²⁸

The importance of reputation is another economic factor that is often cited by analysts.²⁹ When the quality of a firm's product is difficult to assess at the time of purchase, consumers often use the quality of prior products produced by the firm as a benchmark for their purchasing decision.³⁰ A firm that has a long history of producing quality products develops a reputational asset which allows it to command a higher price.

²⁴ See, e.g., "Term Asset-Backed Securities Loan Facility: Terms and Conditions," (2009), http://www.newyorkfed.org/markets/talf_terms.html.

²⁵ See The Joint Forum, "Stocktaking on the Use of Credit Ratings," (June 2009), *available at* <http://www.bis.org/publ/joint22.pdf>.

²⁶ See Arturo Estrella, "Credit Ratings and Complementary Sources of Credit Quality Information," Basel Committee on Banking Supervision Working Papers No. 3 (Aug. 2000).

²⁷ See Basel Committee on Banking Supervision, "International Convergence of Capital Measurement and Capital Standards: A Revised Framework - Comprehensive Version," (June 2006).

²⁸ See, e.g., Herwig M. Langohr, "The Credit Rating Agencies and Their Credit Ratings," address given to the Bond Market Association (Feb. 2006).

²⁹ See, e.g., Dittrich (2007).

³⁰ See, e.g., Carl Shapiro, "Premiums for High Quality Products as Returns to Reputations," *Quarterly Journal of Economics* 98(4): 659-79 (Nov. 1983).

The value of this reputational asset can provide an incentive for the firm to continue to produce high quality products.³¹

Credit ratings are an example of a product whose quality, at time of purchase, is particularly difficult to evaluate. In most cases, credit ratings are estimates about the probability of default or expected loss for a given debt obligation or obligor. Defaults are expected to occur rarely and are highly sensitive to macroeconomic forces which may be difficult to forecast. The accuracy and consistency of ratings produced by a given rating agency may only be revealed over an extended period. Because it is difficult to evaluate a particular credit rating easily, establishing and maintaining a reputation for ratings accuracy, a process which can take years, is very important for any credit rating agency.

A rating agency's reputation can be damaged by a failure to continue to assign ratings accurately. The assignment of high credit ratings to many residential mortgage-backed securities ("RMBS") and collateralized debt obligations ("CDOs") in recent years followed by the scope and magnitude of subsequent downgrades during the current credit crisis appears to have resulted in a loss of confidence among at least some investors in the reliability of credit ratings issued by the largest NRSROs in this sector. There has also been a broader dislocation in the credit markets, to which any such loss of confidence could have contributed. In the wake of these events, the NRSROs that rated asset-backed securities ("ABS") have come under intense criticism and scrutiny. However, their market share does not seem to have been affected within this asset class. And while the revenue they derive from rating asset-backed securities has declined, the dollar amount of new issuance in this asset class has also declined. In short, the integrity of all ABS ratings has been questioned and the uncertainty around ABS credit quality has increased. During this time, investors' willingness to purchase ABS has declined. This is consistent with the dramatic drop-off in ABS issuances during 2009.

Network externalities may also play a role in the credit rating industry. Network externalities which are often considered in connection with such products as computer operating systems, or video recorders, exist when the value of a product increases as more people use it.³² Network externalities can create a significant obstacle to entry for a new entrant in an industry where these effects are strong. In these types of industries, a company may make a product which has superior attributes to an entrenched competitor and still fail to win market share. The procedures and methodologies of a rating agency create a standardized way of looking at credit risk, and one function of the rating is to facilitate communication about credit risk among market participants.³³ Another function of credit ratings is to facilitate comparisons between credit instruments within a sector and potentially across sectors. Market participants may consider how widely the ratings

³¹ See, e.g., Benjamin Klein and Keith Leffler, "The Role of Market Forces in Assuring Contractual Performance," *Journal of Political Economy*, Vol. 89, No. 41 (1981).

³² See, e.g., Michael L. Katz and Carl Shapiro, "Network Externalities, Competition, and Compatibility," *The American Economic Review*, Vol. 75, No. 3, pp. 424-440, (June 1985). For application to credit rating industry see Jerome S. Fons, "White Paper on Rating Competition and Structured Finance," (Jan. 2008).

³³ See, e.g., Kerwer (2002).

of a particular rating agency are used by other investors and the breadth of coverage a rating agency provides as factors in determining the usefulness of its ratings.³⁴

A wide range of private contractual agreements which reference the ratings of particular rating agencies create another barrier to entry for new entrants.³⁵ These include, for example, minimum ratings requirements that specify the ratings of specific rating agencies in the investment management contracts of institutional fund managers and the investment guidelines of fixed income mutual fund managers, pension plan sponsors, and endowment fund managers. In addition, fixed income indices used to evaluate the performance of investment managers often have inclusion characteristics which refer to the ratings of specific rating agencies. The effect of these contractual agreements can be to increase the demand and liquidity for securities bearing the ratings of specific providers.

In addition, ratings triggers are commonly found in bank loan agreements, guaranteed investment contracts, and the credit support annexes and other provisions of derivatives contracts.³⁶ When ratings triggers are present, a decline in the rating of an issuer or obligor below a certain level can alter the obligations of parties to an agreement, for example, providing a counterparty to a derivatives contract with the right to demand collateral or lenders the right to demand repayment of a loan. The ratings of specific rating agencies are often specified in such agreements. The extensive use of credit ratings in private contracts has enhanced the importance of credit ratings to the marketplace.

Barriers that prevent some NRSROs from obtaining information needed to assign ratings may also limit competition, particularly with respect to structured finance products. Generally, when the issuer-paid model is employed, much of the information relied on by the hired NRSROs to rate structured finance products is non-public. This makes it difficult for other NRSROs to rate these securities. As a result, the products frequently are issued with ratings from only one or two NRSROs and only by NRSROs that are hired by the issuer, sponsor, or underwriter. In addition, investors may also tend to place greater weight on an opinion that is based, in part, on access to privileged information.³⁷ The Commission's recently adopted amendments to Rule 17g-5 are designed to reduce these barriers.

³⁴ See, e.g., Fons (2008).

³⁵ See, e.g., Richard Cantor, Owain ap Gwilym, Stephen Thomas, "The Use of Credit Ratings in Investment Management in the U.S. and Europe," The Journal of Fixed Income, Vol. 17, No. 2 (Fall 2007); H. Kent Baker and Sattar A. Mansi, "Assessing Credit Rating Agencies by Bond Issuers and Institutional Investors," Journal of Business Finance & Accounting, Vol. 29, Numbers 9-10 (November/December 2002); G. Timothy Haight, George Engler and Kenneth J. Smith, "An Examination of the Characteristics of College Endowment Funds," Journal of Investing (Fall 2006).

³⁶ See, e.g., Moody's Special Comment, "2008 Rating Trigger Trends in the U.S. Life (Re) Insurance Industry," (Jan. 2009).

³⁷ See, e.g., Philippe Jorion, Zhu Liu, and Charles Shi, "Informational Effects of Regulation FD: Evidence from Rating Agencies," Journal of Financial Economics, (May 2005).

D. The Status of Competition among NRSROs

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

Although the credit ratings of the two largest NRSROs now represent a smaller proportion of all NRSRO ratings, the Commission is unable to discern from this data the impact of NRSRO registration on the demand for or the provision of credit ratings for several reasons. First, the registration and oversight program implemented by the Commission under the Rating Agency Act that requires disclosure of information about outstanding ratings for NRSROs is still relatively new. In addition, the credit crisis, while potentially creating additional long term demand for providers of credit assessment tools, also reduced debt issuance in a number of sectors. Issuance levels have recovered in some sectors, such as corporate debt, but remain well below levels prior to the crisis in other areas, notably ABS. Consequently, there is insufficient history to evaluate the impact that being registered as an NRSRO has had on obtaining additional business.

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

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

The subscriber-pay compensation model is a different economic model. Subscriber-pay NRSROs typically attract customers who want access to at least some of their credit ratings. Investors and other market participants purchase the right to access the pool of credit ratings issued by these NRSROs and are not necessarily users of all

credit ratings provided. Thus, a client of a subscriber-pay NRSRO may request a rating on an individual security or those securities of a specific issuer or class of issuers, but a reported increase in the number of securities rated by the NRSRO as part of its regulatory filings does not necessarily demonstrate that those additional credit ratings were specifically demanded by investors or that they are being relied upon by market participants widely. As a result, the number of ratings issued by an NRSRO using the subscriber pay model may not provide an accurate indication of how widely the ratings of that particular NRSRO are used.

E. Assessing the Impact of Additional Competition

As noted above, the Senate Report accompanying the Rating Agency Act stated that the statute's purpose was to "improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency, and competition in the credit rating industry."³⁸ The Senate Report also noted that competition would "provide investors with more choices, higher quality ratings, and lower costs."³⁹ Competition can lead to credit ratings that are of higher quality to investors along one or more dimensions (e.g., more accurate, more timely) or ratings that are of equivalent quality and reputation but at a lower price.

Increasing the number of entities that are treated as NRSROs for the purposes of laws and regulations using that term, by itself, may not have a significant effect on competition. The newer NRSROs, by showing themselves (or causing the long established NRSROs) to provide ratings that are superior in either quality or price, could create additional competition. As discussed above, because of the importance of reputation, the difficulty in establishing a reputation quickly, and other economic factors, it may take some time before the impact of increased competition can be observed. Gaining acceptance in the market for a new NRSRO may be even more difficult when investors and their agents rely upon written policies and procedures requiring the use of ratings provided by just two or three of the currently market-dominant NRSROs. Altering such policies and procedures would require proactive steps on the part of investors. In addition, while the Rating Agency Act and the Commission's registration and oversight program have made it easier for smaller entrants to become NRSROs, certain regulations, both in the United States and internationally, limit the utility of the NRSRO designation by dividing NRSROs into subclasses. For example, the Federal Reserve Board's recent Commercial Paper Funding Facility relied only on ratings issued by "major" NRSROs.⁴⁰

Section 15E(h) of the Exchange Act and Rule 17g-5 require NRSROs to establish procedures to manage conflicts of interest, to disclose applicable conflicts of interest, and prohibit them from having certain conflicts of interest.⁴¹ In the credit rating industry,

³⁸ See Senate Report, 109-326, p. 1.

³⁹ See Senate Report, 109-326, p. 7.

⁴⁰ See Commercial Paper Funding Facility: Program Terms and Conditions, available at http://www.ny.frb.org/markets/cpff_terms.html.

⁴¹ See 15 U.S.C 78o-7(h); 17 CFR 240.17g-5.

conflicts of interest may arise from a number of activities, including the manner of compensation, the provision of consulting or advisory services, and business relationships and affiliations. Reducing the barriers to entry in the market for providing NRSRO ratings and, hence, increasing competition, may, in fact, reduce conflicts of interest in substantive ways. This market disciplining mechanism will be less effective the more difficult it is for investors to determine the true credit quality of the rated debt security or obligor.

F. The Potential Impact on Competition of NRSRO Rules

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

The Commission's rules for NRSROs have provisions that were designed, among other things, to promote competition. For example, under paragraph (d) of Rule 17g-2, as amended, NRSROs are required to publicly provide the histories of 10% of their issuer-paid credit ratings, in each class of ratings for which they have issued 500 or more such ratings and with a six month grace period.⁴² The rule amendments adopted by the Commission in November 2009 further expand Rule 17g-2 to require a broader disclosure of credit rating history information by adding the requirement that NRSROs disclose rating action histories for all credit ratings initially determined on or after June 26, 2007.

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

⁴² See Amendments to Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 59342 (Feb. 2, 2009), 74 FR 6456 (Feb. 9, 2009).

NRSROs competing in the structured finance sector will potentially be affected by the recent amendments to Rule 17g-5.⁴³ These rule amendments allow non-hired NRSROs to access information relating to the issuance of structured products that was previously only readily available to hired NRSROs. An NRSRO may then be able to break into the structured finance sector by providing unsolicited ratings on these securities. This would also allow market participants to see differences between credit ratings issued by a non-hired NRSRO and those issued by a hired NRSRO and to observe, over time, the differences in the quality of the ratings.

V. COMMISSION'S VIEW ON TRANSPARENCY

One of the goals of the Rating Agency Act is to increase transparency in the credit rating industry. Section 15E of the Exchange Act and Rule 17g-1 require NRSROs to publicly disclose their Form NRSROs and Exhibits 1 through 9, which contain information about their performance statistics; their procedures and methodologies for determining credit ratings; their procedures to prevent the misuse of material, non-public information; their organizational structure; their code of ethics (or explanation of why they do not have a code of ethics); their conflicts of interest; their procedures to manage conflicts of interest; information about their credit analysts; and information about their designated compliance officers. One of the things that the Commission's examination staff focuses on during an examination of an NRSRO is the quality and accuracy of these disclosures. Prior to the implementation of the NRSRO registration and oversight program, certain credit rating agencies disclosed some of this information, particularly with respect to credit rating performance statistics and their procedures and methodologies for determining credit ratings. The NRSRO oversight program has increased the amount of information disclosed and concentrated the disclosure in a single location: Form NRSRO. The following is a list of the Internet Web site links where the Form NRSRO for each credit rating agency registered as an NRSRO currently can be obtained.⁴⁴

A.M. Best Company, Inc.

<http://www.ambest.com/nrsro/formnrsro.pdf>

DBRS Ltd.

<http://dbrs.com/about/regulatoryAffairs>

Egan-Jones Rating Company

<http://www.egan-jones.com/nrsro.aspx>

Fitch, Inc.

<http://www.fitchratings.com/jsp/corporate/PolicyRegulation.faces?context=3&detail=4>

⁴³ See Amendments to Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 61050 (Nov. 23, 2009), 74 FR 63832 (Dec. 4, 2009).

⁴⁴ These are the Internet Web site addresses as of June 2010. The addresses may change over time.

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

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

Moody's Investors Service, Inc.
<http://v3.moodys.com/Pages/reg001002.aspx>

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

Realpoint LLC
<https://www.realpoint.com/PublicDocs/NRSRO%20Application.pdf>

Standard & Poor's Ratings Services
<http://www.standardandpoors.com/regulatory-affairs/ratings/en/us>

As noted above, the November 23, 2009 Amendments to Rule 17g-2 require NRSROs to publicly provide the history of 100% of their rating action histories for all credit ratings initially determined on or after June 26, 2007, with a twelve month grace period for issuer-paid credit ratings and a twenty-four month grace period for non issuer-paid credit ratings. The goal of the rule as amended is to increase transparency by providing users of credit ratings, investors, and other market participants and observers the raw data with which to compare how the NRSROs initially rated an obligor or security and, subsequently, adjusted those ratings, including the timing of the adjustments.⁴⁵

VI. COMMISSION'S VIEW ON CONFLICTS OF INTEREST

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

⁴⁵ The Dodd-Frank Act contemplates new rules to require an NRSRO to use a form to accompany the publication of each credit rating that discloses eight qualitative types of mandated information (e.g., the main assumptions underlying the methodology used, the potential limitations of the credit rating, and the extent that third-party due diligence was used) and three quantitative types of mandated information (e.g., a measure of the volatility of the rating, the historical performance of the rating, and the sensitivity of the rating). These types of new rules should presumably increase transparency.

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

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

A number of studies have attempted to identify cases of "rating shopping" behavior, where, under the issuer pay model, issuers seek to hire rating agencies that provide more favorable ratings. For example, according to one study of RMBS transactions in the early to mid 1990s, rating agencies whose rating methodologies required lower levels of credit enhancement to reach a given rating level than competitors tended to increase their market share.⁴⁶ A more recent study of corporate ratings concluded that the presence of a new entrant could result in more "issuer-friendly" ratings.⁴⁷ Other analysts, however, have argued that the incentives for a rating agency to maintain its reputation outweigh the short term gain which can be achieved by issuing ratings of lower quality.⁴⁸

The potential for conflicts of interest may be particularly acute in the structured product area, including, among other instruments, RMBS and CDOs, where issuers are separate legal entities created and operated by a relatively concentrated group of sponsors, underwriters and managers (collectively "arrangers"). These products are highly complex and require specific and technical knowledge of financial engineering

⁴⁶ See Cantor and Packer (1994).

⁴⁷ See Bo Becker and Todd Milbourn, "Reputation and Competition, Evidence from the Credit Rating Industry," Harvard Business School Working Paper 09-051 (Oct. 2008).

⁴⁸ See, e.g., Steven L. Schwarcz, "Private Ordering of Public Markets: The Rating Agency Paradox," University of Illinois Law Review, Vol. 2002, No. 2 (Feb. 2002); Daniel M. Covitz and Paul Harrison, "Testing Conflicts of Interest at Bond Ratings Agencies with Market Anticipation: Evidence that Reputation Incentives Dominate," FEDS Working Paper No. 2003-68 (Dec. 2003).

and valuation of the underlying assets. But the complexity of the products and the issuers' ability to control the flow of information about the underlying assets may lead to an outcome where one party to the transaction, the arranger, has more or better information about the transaction than the other party (the investor).⁴⁹ This informational imbalance, combined with very high concentration in NRSRO credit raters, increases the potential for conflicts of interest to impair market integrity. As discussed above, however, reputational risk provides incentives for firms to produce high quality ratings.

The staff's examinations of select credit rating agencies regarding their role in the turmoil in the subprime mortgage-related securities markets revealed, among other things, that the rating agencies examined appear to have failed to properly manage potential conflicts of interest.⁵⁰ In the report issued in response to these examinations, the staff noted that the conflicts arising from the issuer pay model in rating structured finance products, particularly RMBS and related-CDOs, may have been exacerbated for a number of reasons, as described below.⁵¹

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

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

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

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

⁴⁹ Economists typically refer to this outcome as the existence of information asymmetries. *See, e.g.,* George A. Akerlof, "The Market for 'Lemons': Quality Uncertainty and the Market Mechanism," *Quarterly Journal of Economics* 84(3): 488-500 (1970).

⁵⁰ *See Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies By the Staff of the Securities and Exchange Commission*, (July 8, 2008), available at <http://sec.gov/news/studies/2008/craexamination070808.pdf> ("July 2008 Staff Report").

⁵¹ *See* July 2008 Staff Report, Section V.

Analysts note that fees for structured finance transactions could, in some cases, be significantly higher than fees for corporate structures of similar size.⁵² The staff examinations revealed that revenues derived from RMBS ratings increased between 2002 and 2006 by a percentage that varied among the three largest NRSROs from approximately 100% for the firm which had the lowest percentage growth in revenues to over 200% for the firm which had the highest percentage growth. For CDOs, during the same period, ratings revenue increased by a percentage that varied from approximately 200% for the firm which had the lowest percentage growth to over 800% for the firm which had the highest percentage growth.⁵³

Rule amendments adopted by the Commission on November 23, 2009 were designed, among other things, to address conflicts of interest in the credit rating process. In particular, the amendments to Rule 17g-5 are designed to address conflicts of interest and improve the quality of credit ratings for structured finance products by making it possible for more NRSROs to rate structured finance products. Currently, when an NRSRO is hired to rate a structured finance product, much of the information it relies on to determine the rating is generally not made public. As a result, structured finance products frequently are issued with ratings from only one or two NRSROs that have been hired by the arranger, with the attendant potential conflict of interest that creates. The amendments to Rule 17g-5 are designed to increase the number of credit ratings extant for a given structured finance product and, in particular, to promote the issuance of credit ratings by NRSROs that are not hired by the arranger. This will provide users of credit ratings with more views on the creditworthiness of the structured finance product. In addition, the amendments are designed to reduce the ability of arrangers to obtain better than warranted ratings by exerting influence over NRSROs hired to determine credit ratings for structured finance products. Specifically, opening up the rating process to more NRSROs will make it easier for the hired NRSRO to resist such pressure by increasing the likelihood that any steps taken to inappropriately favor the arranger could be exposed to the market through the credit ratings issued by other NRSROs.

VII. CONCLUSION

As described above, the Commission took a number of actions during the year with respect to NRSROs. In the coming year, the Commission will continue to review NRSRO issues through its oversight function, including staff examinations of the NRSROs, and engage in rulemaking efforts and other initiatives with respect to NRSROs in response to the Dodd-Frank Act.

⁵² See, e.g., Fons (2008).

⁵³ See July 2008 Staff Report.