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Office of Inspector General

Office of Audits

The SEC's Role Regarding and Oversight of Nationally Recognized Statistical Rating Organizations (NRSROs)



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UNITED STATES
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MEMORANDUM

August 27, 2009

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From: H. David Kotz, Inspector General 

Subject: *The SEC's Role Regarding and Oversight of Nationally Recognized Statistical Rating Organizations (NRSROs), Report No. 458*

This memorandum transmits the U.S. Securities and Exchange Commission (SEC) Office of Inspector General's (OIG) final report detailing the results of our review of the SEC's Role Regarding and Oversight of Nationally Recognized Statistical Rating Organizations (NRSROs). The review was conducted by the OIG as part of our continuous effort to assess the management of the Commission's programs and operations and was based on our audit plan.

We received and reviewed your comments to our draft report. Based on your input and our assessment of your comments, we revised the final report accordingly. The final report contains 24 recommendations that were developed to strengthen the SEC's oversight of NRSROs. All offices and divisions agreed to the final report's recommendations that were directed to them, except for some recommendations directed to the Division of Trading and Markets (TM).

Specifically, TM did not concur with Recommendation 24, and partially concurred with Recommendations 1, 2, 3, 4 and 7.

Within the next 45 days, please provide the OIG with a written corrective action plan that is designed to address the recommendations that were agreed upon in the report. At a minimum, the corrective action plan should include information such as the responsible official/point of contact; time frames for completing the required actions, milestone dates, and how your office/division will address the recommendations contained in the report.

Should you have any questions regarding this report, please do not hesitate to contact me. We appreciate the courtesy and cooperation that you and your staff extended to our office during this review.

Attachment

cc: Kayla J. Gillan, Deputy Chief of Staff, Office of the Chairman
Diego Ruiz, Executive Director, Office of the Executive Director
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The SEC's Role Regarding and Oversight of Nationally Recognized Statistical Rating Organizations (NRSROs)

Executive Summary

Background

A credit rating is an opinion issue by a credit rating agency (CRA), as of a specific date, of the creditworthiness, i.e., the ability to repay timely loan principal and interest, of an issuer or with respect to particular securities or money market instruments. Credit ratings are utilized in a variety of capacities in the U.S. financial system, e.g., to calculate bank capital requirements, to place limits on the types of investments that may be purchased by a particular type of investor such as a pension fund.

The Securities and Exchange Commission ("SEC" or "Commission") first incorporated reliance on credit ratings into its rules and regulations in 1975 in connection with the rule specifying how broker-dealers must compute their net capital. In that rule, the Commission specified that a broker-dealer, in computing its net capital, could take a lesser deduction from its net worth as to securities that were rated as having a comparatively low chance of default according to a credit rating of national repute, or a "nationally recognized statistical rating organization" ("NRSRO").¹ Thereafter, the Commission incorporated the NRSRO concept into many rules and regulations issued under the Federal securities laws, and the term was also used in a number of Federal, state and foreign laws and regulations.

Until the enactment of the Credit Rating Agency Reform Act of 2006 ("Rating Agency Act"), NRSROs were not required to file any formal application with the Commission. From 1975 to 2006, the Commission identified NRSROs through the staff no-action letter process.² The Commission initially identified three CRAs as NRSROs: Moody's Investor Service Inc. ("Moody's"), the Standard & Poor's Division of the McGraw Hill Companies, Inc. ("S&P") and Fitch, Inc ("Fitch").

¹ Throughout this report, the acronym "NRSRO" is used to refer both to the use of the term "nationally recognized statistical rating organization" in Commission regulations and no-action letters prior to the enactment of the Credit Rating Agency Reform Act of 2006 and to CRAs that are registered with the Commission under that Act. See the Background Section of the report at pp. 2-11 for additional information.

² See *infra* pp. 3-4 and n. 15 for a discussion of the no-action letter process.

While the Commission eventually identified a total of seven CRAs through the no-action letter process, Moody's, S&P and Fitch continued to dominate the credit rating industry.

Beginning with the issuance of a concept release in 1994, the Commission considered, but did not adopt, rules that would have, among other things, defined the term NRSRO and formalized the NRSRO no-action letter process. The CRAs became subject to harsh criticism after Enron Corporation ("Enron") filed for bankruptcy in 2001. In particular, a Senate committee staff report on Enron's bankruptcy strongly criticized the CRAs for failing to warn the public of Enron's precarious financial situation until four days before it declared bankruptcy.

After Enron's bankruptcy, the Commission's examination staff undertook examinations of the three NRSROs to aid the Commission in assessing whether it should continue to use credit ratings in its regulations and, if so, the categories of acceptable credit ratings and the appropriate level of oversight. The Commission's examinations revealed a number of significant concerns, including potential conflict of interest caused by issuers paying the NRSROs for their ratings, exacerbation of those conflicts of interest caused by the NRSROs' marketing of ancillary services to issuers, and the effectiveness of the Commission's examinations being hampered by, among other things, the lack of recordkeeping requirements tailored to NRSRO activities. The Commission also held two public hearings in 2002 on a wide variety of issues impacting CRAs.

In addition, the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley Act") was enacted in response to several major corporate and accounting scandals, including Enron's bankruptcy, that shook the public's confidence in the United States ("U.S.") financial markets. The Sarbanes-Oxley Act, among other things, required the Commission to prepare a report on the role and function of CRAs. The Commission issued the report required by the Sarbanes-Oxley Act in 2003, which identified a wide range of issues pertinent to CRAs that warranted further examination. Also in that report, the Commission stated its intent to publish another concept release and thereafter issue proposed rules. While the Commission subsequently issued a concept release in 2003 and then proposed a rule to define the term NRSRO, the Commission adopted no rules setting conditions on NRSRO designation, despite the findings surrounding Enron's bankruptcy, the problems revealed by the 2002 examinations and the results of the study required by the Sarbanes-Oxley Act.

In September 2006, the Rating Agency Act was enacted in an effort to improve the quality of credit ratings for the protection of investors and in the public interest by increasing accountability, transparency and competition in the CRA industry. The Rating Agency Act for the first time required CRAs to register formally with the Commission in order to qualify as an NRSRO. The Rating Agency Act

established an application process for approval for a CRA to issue various classes of credit ratings as an NRSRO and required numerous pertinent disclosures in a CRA's application for NRSRO designation and in subsequent updates and annual certifications. The Rating Agency Act gave the Commission examination authority to ensure an NRSRO's compliance with its requirements and, since the fall of 2008, the Office of Compliance Inspections and Examinations ("OCIE") has been responsible for conducting these examinations. The Rating Agency Act, however, prohibited the Commission from regulating the substance of credit ratings or the procedures and methodologies by which NRSROs determine credit ratings.

The Rating Agency Act mandated that the Commission issue final rules and regulations necessary to carry out the Act's requirements within nine months after the date of enactment. The Commission adopted rules to implement the requirements of the Act in June 2007. Since the Rating Agency Act became effective, the Commission has received 11 applications from a total of ten CRAs seeking NRSRO designation, all of which have been approved.

The CRAs have once again come under criticism for the role they played in connection with the recent financial crisis. Specifically, the CRAs provided ratings on structured finance products that were based on risky or "subprime" mortgages. After home values decreased beginning in 2006, the market value of the mortgage securities declined, resulting in write-downs of billions of dollars in the value of mortgage securities. Serious questions then arose as to whether the CRAs initially rated the structured products accurately and whether they should have subsequently reassessed their credit ratings.

The role played by CRAs in the recent financial crisis has led to numerous reports and proposed regulatory changes, including the SEC's adoption of NRSRO rule amendments in February 2009. Other proposed changes to the Commission's NRSRO rules, however, have not been acted upon. In addition, both President Obama's Administration and Congress have recently proposed legislative reforms that would strengthen the SEC's oversight of NRSROs. Also, the Administration's legislative proposal would make registration with the Commission mandatory for all CRAs, not just those that choose to seek NRSRO designation.

Objectives

Given the importance of NRSROs, we initiated this review in accordance with our audit plan. The objective was to identify improvements in the Commission's NRSRO oversight. The review focused on the implementation of and compliance with the Rating Agency Act and Commission rules. We also reviewed the Commission's history with NRSROs to assess the Commission's efforts to

oversee the NRSROs and to implement the Rating Agency Act's accountability, competition, and transparency objectives.

Results

Overall, our review found that, despite the importance of NRSROs to the U.S. securities markets and the Commission's reliance on NRSROs in its rules and regulations, the Commission has historically been slow to act in this area, even after Enron's bankruptcy and a Senate staff report recommendation that the Commission set specific conditions on the NRSRO designation. While, beginning in 1994, the SEC issued concept releases, conducted examinations, issued reports, held hearings and proposed regulations, it adopted no regulations regarding NRSROs until required to do so after the Rating Agency Act was enacted in 2006. Further, our review identified certain instances of non-compliance with the requirements of the Rating Agency Act or Commission rules, as well as several areas in which we believe the SEC's oversight of NRSROs can be enhanced. The current SEC Chairman has, however, identified improving the quality of credit ratings as one of her priorities, directed the Commission staff to explore possible new NRSRO regulations and allocated additional resources to establish a branch of NRSRO examiners.

Most significantly, our compliance testing identified one NRSRO application that the Commission approved based upon the Division of Trading and Markets' ("TM's") recommendation, despite the fact that TM identified numerous significant concerns with the CRA's application. These included concerns about the adequacy of the CRA's managerial resources, suspicions regarding the accuracy of the financial information provided in its application, and concerns about the authenticity of a number of certifications required by the Rating Agency Act. Under the process established by the Rating Agency Act, within 90 days upon the filing of a CRA's application for NRSRO designation, the Commission must either approve the application or institute proceedings to determine whether the application should be denied, unless the applicant consents to a longer time period. The Rating Agency Act provides that the Commission shall grant the application except under certain circumstances, including where the CRA does not comply with the statutory requirements and if the CRA lacks adequate financial and managerial resources to consistently produce credit ratings with integrity and to materially comply with their disclosed procedures and methodologies.

In its recommendation to the Commission, TM acknowledged that its concerns about the CRA's application were unresolved but recommended that they be addressed in an examination of the firm to be conducted after the application was approved. Our review found that an examination of this firm was not initiated

until ten months after the Commission approved its application and that this examination still has not been completed. [REDACTED]

Because the issues identified by TM were related to whether the firm had met the statutory eligibility requirements, our review concluded that in accordance with the provisions of the Rating Agency Act, TM should not have recommended that the Commission approve the CRA's application. Rather, TM should have recommended that the Commission institute proceedings to determine whether it should deny the application or have sought the CRA's consent to an additional period of time for the Commission to act on the application.

Our compliance testing also revealed that, while not to the same degree as with the application discussed above, TM identified numerous substantive concerns regarding the applications of several other CRAs. These included, among others, concerns about the financial condition of a CRA, the absence of required information regarding a CRA's process for rating structured products, and concerns about some CRAs' procedures for handling material non-public information. Despite these numerous issues, which we believe raised questions as to whether the approval of these applications was in the public interest, TM recommended that the Commission approve the applications and stated that it would address the issues after the applications were approved. Our review found risks in this approach and concluded that all significant issues should be resolved before TM recommends that the Commission approve a CRA's application for NRSRO registration, to the extent consistent with the Rating Agency Act.

The compliance testing we conducted further disclosed several instances where TM did not comply with, or require firms to comply with, certain procedural requirements of the Rating Agency Act and the Commission's implementing rules. For example, in two instances, TM, acting on its own, granted NRSROs extensions of time to file required annual certifications or reports when the applicable statute and regulation required such extensions to be granted by the Commission. The compliance testing also revealed instances where TM received and accepted forms or reports from NRSROs that did not include a required financial statement or certifications.

We also identified several areas in which our review found that the effectiveness of OCIE's NRSRO examination program could be improved. In particular, our review found that the Commission's ability to determine whether a CRA applying for NRSRO registration has met the requirements of the Rating Agency Act would significantly be enhanced if examinations were conducted as part of the application review process, rather than after the application has been approved.

If examinations had been conducted as part of the review process for the applications discussed above, it is likely that some of the significant issues TM identified with the applications could have been resolved before TM made a recommendation on those applications. While this proposal would require additional legislative authority, as well as greater staff resources, we note that legislation in the NRSRO area is currently being considered and Chairman Schapiro is devoting additional resources for an NRSRO examination branch.

Our review further disclosed a number of policy issues involving NRSROs that the Commission should address in order to enhance NRSRO oversight and improve the quality of credit ratings. These include: (1) requiring that a CRA seeking designation as an NRSRO submit financial statements that have been audited by an accounting firm that is regulated by the Public Company Accounting Oversight Board (“PCAOB”); (2) imposing further restrictions on the consulting and advisory services that NRSROs perform for issuers, underwriters or obligors that have paid the NRSROs for credit ratings; (3) requiring NRSROs to monitor and appropriately revise credit ratings on a periodic basis; (4) implementing a credit rating analyst rotation requirement in order to reduce the risk of undue pressure on credit rating analysts; (5) requiring enhanced disclosures by NRSROs regarding the credit ratings process, including the key assumptions used in credit ratings methodologies and procedures and any shortcoming of or limitations on credit ratings; (6) evaluating whether the quality of credit ratings is being negatively impacted by the revolving door, i.e., credit rating analysts leaving to work for an issuer as to which the analyst previously provided a credit rating; (7) conducting an assessment of the potential effects on competition in the NRSRO industry of the proposed amendments regarding the disclosure of material non-public information to other NRSROs, but not to CRAs that do have NRSRO destination; (8) recommending rules designed to address the problem of forum shopping for credit ratings, i.e., seeking a credit rating from multiple NRSROs and hiring the one that provides the highest credit rating, to reduce the potential harmful effects on the quality of credit ratings; and (9) soliciting and obtaining public comment on CRAs’ applications for NRSRO registration. In addition, our review identified several areas in which the Commission’s annual report to Congress, as required by the Rating Agency Act, could be improved.

Summary of Recommendations

Our review determined that several improvements are needed to ensure compliance with the Rating Agency Act and the Commission’s implementing regulations and to enhance NRSRO oversight.

Specifically, we made several recommendations designed to ensure compliance with the NRSRO application approval process established by the Rating Agency

Act. These included, among others, that TM (1) ensure that all significant issues identified in the application review process are resolved prior to TM recommending approval of the application by the Commission; (2) in consultation with the appropriate offices, evaluate whether action should be taken regarding the CRA that was granted NRSRO designation [REDACTED] [REDACTED], despite the numerous significant problems identified with the application [REDACTED] and (3) ensure that all pending issues previously identified during the NRSRO application process be resolved within six months of the date of the issuance of this report. We also recommended that TM, in consultation with other appropriate offices, request that the Office of General Counsel develop guidance to assist TM in deciding under what circumstances it should seek consent from an applicant to waive the 90-day statutory time period for Commission action on an NRSRO application, or recommend that the Commission institute proceedings to determine whether registration should be denied.

We also recommended, in order to ensure compliance with statutory and regulatory requirements pertaining to NRSROs, that TM (1) ensure in the future that it seeks Commission orders regarding NRSRO requests for extension of time when required by statute or the Commission's rules; and (2) ensure that CRAs applying for NRSRO registration and firms that are registered as NRSROs comply with the Commission's rules and requirements regarding the filing and certification of financial information.

In addition, our review made several recommendations designed to improve the effectiveness of OCIE's NRSRO examination program, including the seeking of legislative authority to conduct examinations of CRAs as part of the NRSRO application process, the inclusion of NRSROs in OCIE's pilot monitoring program, and obtaining an additional review of OCIE's NRSRO examination module by someone with industry expertise.

With regard to the numerous NRSRO policy issues that our review found the Commission should address to enhance its oversight of NRSROs, we made several recommendations pertaining to: (1) seeking legislative authority to require that NRSRO auditors be subject to oversight by the PCAOB; (2) performing examination work regarding and assessing the adverse effect of the provision of consulting and advisory service on the quality of credit ratings; (3) implementing a comprehensive credit rating monitoring requirement for NRSROs; (4) performing examination work regarding and assessing undue influence on credit rating analysts and the benefits of an analyst rotation requirement; (5) recommending additional disclosures about the credit ratings process; (6) examining and assessing whether the revolving door problem is negatively impacting the quality of credit ratings; (7) assessing the potential effects on competition in the credit rating industry of proposed amendments

regarding the disclosure of material non-public information to other NRSROs, but not to CRAs that do not have NRSRO designation; (8) recommending rules to reduce the potential harmful effects of forum shopping on the quality of credit ratings; and (9) incorporating the seeking and consideration of public comments into the NRSRO oversight process. Finally, we made several suggestions for including additional concepts identified by our review in the Commission's annual report to Congress regarding NRSROs.

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The SEC's Role Regarding and Oversight of Nationally Recognized Statistical Rating Organizations (NRSROs)

Background and Objectives

Background

The Role of Credit Rating Agencies

A credit rating is an opinion, as of a specific date, of the creditworthiness (i.e., the ability to timely repay loan principal and interest) of an issuer as an entity or with respect to particular securities or money market instruments, such as a corporate bond or a structured financial product.³ Credit ratings do not speak to the likely market performance of a security and, among other things, do not address whether an investor should purchase, sell, or hold a security.⁴ CRAs issue credit rating opinions using a system of letters (e.g., ranging from AAA to D) to reflect the relative creditworthiness of the issuer or the security.⁵ As discussed below, the CRAs that have been approved by the Commission are referred to as Nationally Recognized Statistical Rating Organizations ("NRSROs").⁶

A credit rating can have significance in several respects, including the following examples:

³ See Securities and Exchange Commission, 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) ("2003 Sarbanes-Oxley Act Report"), <http://www.sec.gov/news/studies/credratingreport0103.pdf>, at 5; The Role and Impact of Credit Rating Agencies on the Subprime Credit Markets: Hearing before the S. Comm. on Banking, Housing and Urban Affairs, 110th Cong. (Sept. 26, 2007) (testimony of Vickie A. Tillman, Executive Vice President, Standard & Poor's Credit Market Services) ("Tillman 9/26/07 Testimony"), at 3. See also Section 3(a)(60) of the Securities Exchange Act of 1934 (Exchange Act), 15 U.S.C. § 78c(a)(60), for a definition of the term "credit rating."

⁴ Tillman 9/26/07 Testimony at 3-4.

⁵ Id. at 3. Section 3(a)(61) of the Exchange Act, 15 U.S.C. § 78c(a), defines a CRA as "any person (A) engaged in the business of issuing credit ratings on the Internet or through another readily accessible means, for free or for a reasonable fee, but does not include a commercial credit reporting company; (B) employing either a quantitative or qualitative model, or both, to determine credit ratings; and (C) receiving fees from either issuers, investors, or other market participants, or a combination thereof." CRAs are considered important "gatekeepers" similar to securities analysts, who evaluate the quality of securities, and auditors, who review firms' financial statements. See S. 1073, 111th Cong. § 2 (2009).

⁶ See Section 3(a)(62) of the Exchange Act, 15 U.S.C. § 78c(a)(62), for a definition of the term "nationally recognized statistical rating organization" under the Rating Agency Act.

- A credit rating may affect an issuer's costs of raising capital (including the issuer's ability to access the capital markets);⁷
- Banks may use credit ratings when calculating their capital requirements under the supervisory standards of the Basel Committee on Banking Supervision ("Basel Committee");⁸
- A particular type of investor (e.g., a pension fund) may be prohibited from purchasing or holding securities that are below a certain investment grade based on the credit rating;⁹ and
- Companies incorporate credit ratings into commercial contract provisions (e.g., credit rating triggers).¹⁰

The Development of the NRSRO Concept

The Commission first used the term "NRSRO" in 1975 in connection with the adoption of its "net capital rule," Exchange Act Rule 15c3-1.¹¹ This Rule requires that a broker-dealer, when computing net capital, deduct from its net worth a certain percentage of the market value of its proprietary securities positions, known as a "haircut." In adopting Rule 15c3-1, the Commission determined that it was appropriate to apply a lower haircut to certain types of debt instruments held by a broker-dealer that were rated, depending upon the debt instrument, in one of the three or four highest categories of credit ratings by at least two of the "nationally recognized statistical rating organizations."¹²

Since 1975, the Commission has incorporated the NRSRO concept into many of the rules and regulations issued under the Securities Act of 1933, the Exchange Act and the Investment Company Act of 1940. For example, Commission Rule 2(a)-7 under the Investment Company Act of 1940 limits money market mutual fund investments to high quality short-term instruments, and uses NRSRO

⁷ 2003 Sarbanes-Oxley Act Report at 4.

⁸ "The Basel Committee consists of central bank and regulatory officials from 13 member countries and seeks to improve the quality of banking supervision worldwide, in part by developing broad supervisory standards. The Basel Committee's supervisory standards are also often adopted by nonmember countries." U.S. Gov't Accountability Office, Risk-Based Capital: Bank Regulators Need to Improve Transparency and Overcome Impediments to Finalizing the Proposed Basel II Framework, GAO-07-253 (Feb. 2007), <http://www.gao.gov/new.items/d07253.pdf>, at 1, n. 2.

⁹ See H.R. 2990, the Credit Rating Agency Duopoly Relief Act of 2005: Hearing before the H. Comm. on Financial Services, 109th Cong. (November 29, 2005) (statement of Rapid Ratings Pty Ltd), <http://financialservices.house.gov/media/pdf/112905rr.pdf>, at 3.

¹⁰ A credit rating trigger is a provision in a contract that results in adverse consequences to the borrower (e.g., the loan becomes due) if the issuer's credit rating is downgraded.

¹¹ 17 C.F.R. § 240.15c3-1.

¹² 17 C.F.R. § 240.15c3-1(c)(2)(vi)(E)(F), and (H).

ratings as benchmarks for establishing minimum quality investment standards.¹³ Additionally, Congress incorporated the term “NRSRO” into a wide range of legislation, and a number of other Federal, state and foreign laws and regulations used the term “NRSRO.”¹⁴

The Commission’s Use of the No-Action Letter Process to Identify NRSROs

Prior to the enactment of the Rating Agency Act in 2006, the Commission used the no-action letter process to identify CRAs as NRSROs for purposes of the Commission’s rules.¹⁵ Initially, when NRSRO ratings were first incorporated into the net capital rule, the Commission staff determined, in a no-action letter, that because the ratings of Moody’s, S&P and Fitch were used nationally, the staff would raise no questions if these firms were used as NRSROs for the purposes of the net capital rule.¹⁶ The Commission staff subsequently issued no-action letters identifying several other CRAs as NRSROs.¹⁷ To determine whether to issue an NRSRO no-action letter to a CRA, the staff considered a number of criteria, the most important being that the CRA was nationally recognized, i.e., it was widely accepted in the U.S. as an issuer of credible and reliable ratings by the predominant users of securities ratings. The staff also reviewed the operational capability and reliability of the CRA.¹⁸

At the time the Rating Agency Act was enacted, a total of seven CRAs had been identified as NRSROs through the no-action letter process, although Moody’s, S&P and Fitch dominated the credit rating industry.¹⁹ According to Congressional testimony, Commission staff did not act on some no-action letter requests from CRAs in a timely manner. For example, in 2004, the President

¹³ 17 C.F.R. § 270.2(a)-7.

¹⁴ Proposed Rule: Definition of Nationally Recognized Statistical Rating Organization, Securities Act Release No. 33-8570 (Apr. 19, 2005), <http://www.sec.gov/rules/proposed/33-8570.pdf>, at 8.

¹⁵ Through the SEC’s no-action letter process, “[a]n individual or entity who is not certain whether a particular product, service, or action would constitute a violation of the [F]ederal securities law may request a ‘no-action’ letter from the SEC staff. Most no-action letters describe the request, analyze the particular facts and circumstances involved, discuss applicable laws and rules, and, if the staff grants the request for no action, concludes that the SEC staff would not recommend that the Commission take enforcement action against the requester based on the facts and representations described in the individual’s or entity’s original letter.” <http://www.sec.gov/answers/noaction.htm>.

¹⁶ Securities Act Release No. 33-8570 at 9.

¹⁷ *Id.* at 9-10.

¹⁸ *Id.* at 10.

¹⁹ See Rating the Raters: Enron and the Credit Rating Agencies: Hearing before the S. Comm. on Governmental Affairs, 107th Cong. (Mar. 20, 2002) (statement of Sen. Joseph Lieberman, Chairman, S. Comm. on Governmental Affairs), <http://hsgac.senate.gov/032002lieberman.htm>.

and Chief Economist of LACE Financial Corporation (“LACE”) testified that it took the Division of Market Regulation (now TM) eight years to review its request for no-action relief (which was denied) and that LACE’s appeal was pending for over two years.²⁰ Similarly, the Managing Director of Egan-Jones Ratings Company (“EJR”) testified that EJR’s no-action letter request was still pending after approximately four and a half years.²¹

The Commission’s Reviews of CRAs Prior to the Enactment of the Rating Agency Act

In addition to the SEC staff’s issuance of no-action letters, the Commission reviewed a number of issues pertaining to CRAs and how they should be regulated between 1994 and 2006, which are discussed below. However, none of these reviews led to the adoption of final regulations.

1994 Concept Release. In 1994, the Commission issued a concept release seeking public comment on a number of issues related to the Commission’s use of NRSRO ratings, including:

- Whether the Commission should continue to employ the NRSRO concept to distinguish various types of debt and other securities for purposes of its rules;
- Whether the Commission should define the term “NRSRO” for the purposes of all its rules and what, if any, objective criteria should be used in determining whether a CRA was an NRSRO for purposes of the Commission’s rules;
- Whether the current no-action letter process with respect to NRSROs was satisfactory or, if not, whether the Commission should establish alternative procedures for designating NRSROs;
- The practice of NRSROs charging issuers for credit ratings, and specifically whether it appropriate for an NRSRO to charge an issuer based on the size of the transaction being rated; and

²⁰ The Ratings Game: Improving Transparency and Competition Among the Credit Rating Agencies: Hearing before the H. Comm. on Financial Services, 108th Cong. (Sept. 14, 2004) (statement of Barron Putnam, Ph.D., President and Chief Economist, LACE Financial Corporation), at 2.

²¹ Rating the Rating Agencies: The State of Transparency and Competition: Hearing before the Subcomm. on Capital Markets, Insurance and Gov’t Sponsored Entities of the H. Comm. on Financial Services, 108th Cong. (April 2, 2003) (testimony of Sean J. Egan, Managing Director, Egan-Jones Ratings Company), <http://financialservices.house.gov/media/pdf/040203se.pdf>, at 5.

- The use of limited scope credit ratings that may not denote an assessment solely of the credit risk of an instrument.²²

According to the Commission, it received 25 comment letters in response to the concept release, and most commenters supported continuing the NRSRO concept but desired a formalized process for approving NRSROs.²³ These commenters generally were of the view that the no-action procedures in place at the time did not provide sufficient guidance on how to submit an application for NRSRO recognition and the types of information that should be included in the application.²⁴ Commenters specifically recommended, therefore, that the Commission formalize the no-action criteria for recognizing NRSROs in a Commission rule.²⁵

1997 Proposed Rules. As a result of the 1994 Concept Release, in 1997, the Commission proposed rules that would have defined the term “NRSRO,” established a list of attributes to be used by the Commission in identifying CRAs as NRSROs, and formalized the application process for NRSRO recognition.²⁶ The Commission did not act upon the 1997 rule proposal due to, among other things, the initiation of broad-based Commission and Congressional reviews of CRAs following Enron’s filing for bankruptcy in December 2001.²⁷

Enron Bankruptcy and Subsequent Congressional Investigation. On December 2, 2001, Enron, along with its subsidiaries, filed for bankruptcy protection. At that time, Enron was the largest company to file bankruptcy in the nation’s history, and the company’s failure triggered a crisis in investor confidence in the U.S. capital markets.²⁸ In January 2002, the Senate Committee on Governmental Affairs launched a broad investigation into Enron’s collapse, “focusing on the role of government and the private sector watchdogs and the steps, if any, that could have been taken to detect Enron’s problems or prevent its failure.”²⁹ The Committee held a hearing to elicit information on why the CRAs “continued to rate Enron a good credit risk until four days before the

²² Concept Release: Nationally Recognized Statistical Rating Organizations, Securities Act Release No. 33-7085 (Aug. 31, 1994), <http://www.sec.gov/rules/concept/34-34616.pdf>.

²³ 2003 Sarbanes-Oxley Act Report at 11.

²⁴ *Id.*

²⁵ *Id.*

²⁶ Proposed Rule: Capital Requirements for Brokers or Dealers under the Securities Exchange Act of 1934, Exchange Act Release No. 34-39457 (Dec. 17, 1997).

²⁷ 2003 Sarbanes-Oxley Report at 15.

²⁸ Staff of S. Comm. on Governmental Affairs, 107th Cong., Report on the Financial Oversight of Enron: The SEC and Private-Sector Watchdogs (Oct. 8, 2002)(“Senate Staff Report”), at 1.

²⁹ 2003 Sarbanes-Oxley Act Report at 16.

firm declared bankruptcy, and to determine how future Enron-type calamities could be avoided.”³⁰ Specifically, “[c]oncerns had been expressed regarding the significant market power of the three NRSROs, their privileged access to non-[public issuer information, their apparent lack of care and diligence in the Enron situation, and their very limited regulatory oversight.”³¹

On October 8, 2002, the staff of the Senate Committee on Governmental Affairs issued a report that, among other things, criticized the CRAs for failing “to warn the public of Enron’s precarious situation until a mere four days before Enron declared bankruptcy.”³² The Senate staff’s report also noted that the CRAs were subject to little, if any, formal regulation or oversight and that little existed to hold them accountable for future poor performance.³³ As a result, the staff report recommended, among other things, that the Commission, in consultation with certain other agencies, “set specific conditions on the NRSRO designation through additional regulation, to ensure that the reliance of the public on credit rating agencies is not misplaced.”³⁴

2002 NRSRO Examinations and Public Hearings on CRAs. Beginning in March 2002, pursuant to a Commission formal order of investigation issued under Section 21(a) of the Exchange Act, Commission examination staff conducted examinations of each of the three NRSROs, all of which were registered with the Commission as investment advisers. The purpose of the order was to ascertain facts, conditions, practices, and other matters relating to the role of CRAs in the U.S. securities markets, and to aid the Commission in assessing whether to continue to use credit ratings in its regulations “and, if so, the categories of acceptable credit ratings and the appropriate level of regulatory oversight.”³⁵

The Commission’s 2002 examinations of the NRSROs identified several concerns, including those relating to:

- (a) potential conflicts of interest caused by the fact that issuers pay the NRSROs for their ratings;
- (b) exacerbation of those conflicts of interest due to the marketing by the NRSROs of ancillary services to issuers, such as pre-rating assessments and corporate consulting, thereby heightening the NRSROs’ dependence on issuer revenue;
- (c) the potential for the NRSROs, given their

³⁰ Id.

³¹ Id. (footnote omitted).

³² Senate Staff Report at 6. See also 2003 Sarbanes-Oxley Act Report at 17-18.

³³ 2003 Sarbanes-Oxley Act Report at 18.

³⁴ Id.

³⁵ Id. at 19.

substantial power in the marketplace, to improperly pressure issuers to purchase ancillary services; (e) the effectiveness of the NRSROs' existing policies and procedures designed to protect confidential information; and (f) the effectiveness of the Commission's examination being hampered by, among other things, the lack of recordkeeping requirements tailored to NRSRO activities, the NRSROs' assertions that the document retention and production requirements of the Investment Advisers Act of 1940 are inapplicable to the credit rating business, and their claims that the First Amendment shields the NRSROs from producing certain documents to the Commission.³⁶ [Footnote omitted.]

In November 2002, the Commission held two public hearings (i.e., roundtables) on a wide variety of issues affecting CRAs, including the current role and function of CRAs; information flow in the credit rating process; concerns regarding CRAs, such as potential conflicts of interest or abusive practices; and regulatory treatment of CRAs, including concerns about potential barriers to entry.³⁷

2003 Sarbanes-Oxley Act Report and Concept Release. Subsequently, in January 2003, the Commission issued a report on the role and function of CRAs in accordance with Section 702(b) of the Sarbanes-Oxley Act.³⁸ As a result of its study, the Commission identified a wide range of issues that merited further examination and stated its intent to publish a concept release to address concerns related to CRAs and thereafter issue proposed rules.³⁹

Accordingly, in July 2003, the Commission issued a concept release seeking public comment on 56 questions designed to evaluate further the issues identified in the January 2003 Sarbanes-Oxley Act report.⁴⁰ These questions

³⁶ Id. at 19-20.

³⁷ See the transcripts of the November 15, 2002 and November 21, 2002 Commission hearings at <http://www.sec.gov/news/extra/credrate/credrate111502.txt>, and <http://www.sec.gov/news/extra/credrate/credrate112102.txt>, respectively.

³⁸ Pub. L. 107-204, § 702(b), 116 Stat. 745 (2002). Section 702 of the Sarbanes-Oxley Act required the Commission to submit a study to the President, the Committee on Financial Services of the House of Representatives and the Committee on Banking, Housing, and Urban Affairs of the Senate within 180 days following enactment of that statute examining the following topics: "(A) the role of credit rating agencies in the evaluation of issuers of securities; (B) the importance of that role to investors and the functioning of the securities markets; (C) any impediments to the accurate appraisal by credit rating agencies of the financial resources and risks of issuers of securities; (D) any barriers to entry into the business of acting as a credit rating agency, and any measures needed to remove such barriers; (E) any measures which may be required to improve the dissemination of information concerning such resources and risks when credit rating agencies announce credit ratings; and (F) any conflicts of interest in the operation of credit rating agencies and measures to prevent such conflicts or ameliorate the consequences of such conflicts." 2003 Sarbanes-Oxley Act Report at 3.

³⁹ 2003 Sarbanes-Oxley Act Report at 43-44.

⁴⁰ Concept Release: Rating Agencies and the Use of Credit Ratings under the Federal Securities Laws, Securities Act Release No. 33-8236 (June 4, 2003), <http://www.sec.gov/rules/concept/33-8236.htm>.

focused on “whether credit ratings should continue to be used for regulatory purposes under the [F]ederal securities laws and, if so, the process for determining whose credit ratings should be used, and the level of oversight to apply to” such CRAs.⁴¹ A total of 46 commenters responded to the 2003 Concept Release, the majority of whom supported retention of the NRSRO concept but also supported improvements in the clarity of the process for identifying NRSROs.⁴²

2005 Proposed Rule. In 2005, the Commission again proposed a rule to define the term “NRSRO.” The proposed definition contained three components that must be met in order for a CRA to qualify as an NRSRO.⁴³ However, according to the Commission, the proposal did not attempt to address many of the broader issuers raised in response to the 2003 Concept Release.⁴⁴ The proposal was not adopted. As a consequence, even after the focus on the NRSROs after Enron’s bankruptcy and the Senate Staff’s report’s specific recommendation that the Commission set specific conditions on the NRSRO designation, the Commission failed to adopt any rules to set conditions on the NRSRO designation until after the enactment of the Rating Agency Act in 2006. Moreover, while the Commission recognized that more explicit regulatory authority from Congress was necessary to conduct a rigorous program of NRSRO oversight,⁴⁵ the Commission took no “formal position on whether additional legislation should be forthcoming”⁴⁶

⁴¹ Id. at 1.

⁴² Proposed Rule: Definition of Nationally Recognized Statistical Rating Organization, Securities Act Release No. 33-8570 (April 19, 2005), <http://www.sec.gov/rules/proposed/33-8570.pdf>, at 17-18.

⁴³ The three components included: (1) limiting “the definition to entities that issue publicly available credit ratings that are current assessments of the creditworthiness of obligors with respect to specific securities or money market instruments;” (2) requiring a CRA to be generally accepted in the financial markets; and (3) requiring that “a credit rating agency uses systematic procedures designed to ensure credible and reliable ratings, manage conflicts of interest, and prevent the misuse of non[-]public information” and has “sufficient financial resources to ensure compliance with such procedures, if they are to meet the definition.” Id. at 21-22, 28 and 31.

⁴⁴ Id. at 4.

⁴⁵ The State of the Securities Industry: Hearing before the S. Comm. on Banking, Housing and Urban Affairs, 109th Cong. (Mar. 9, 2005) (testimony of William Donaldson, Chairman, U.S. Securities and Exchange Commission), www.sec.gov/news/testimony/ts030905whd.htm, at 5.

⁴⁶ Reforming Credit Rating Agencies: The SEC’s Need for Statutory Authority: Hearing before the Subcomm. on Capital Markets, Insurance, and Gov’t Sponsored Enterprises of the H. Comm. on Financial Services, 109th Cong. (April 12, 2005) (testimony of Annette Nazareth, Director, Division of Market Regulation, U.S. Securities and Exchange Commission), www.sec.gov/news/testimony/ts041205aln.htm, at 6. Ms. Nazareth did state that the Commission welcomed Congressional attention and “would stand ready to work with Congress on crafting appropriate legislation if Congress determine[d] such legislation [were] necessary.” Id.

The Credit Rating Agency Reform Act of 2006 and the Commission's Implementing Rules

On September 29, 2006, former President Bush signed the Rating Agency Act into law. The legislative history accompanying the Rating Agency Act stated as follows:

Over the years, the SEC has been criticized at times for not awarding more NRSRO designations and thereby perpetuating an anticompetitive industry, and for failing to supervise and inspect NRSROs to ensure compliance with the [F]ederal securities laws and NRSRO requirements. NRSROs have been criticized by a broad array of interested parties with respect to conflicts of interest, ratings that significantly lag the markets, and anticompetitive and abusive business practices.⁴⁷

The stated purpose of the Rating Agency Act 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 agency industry.”⁴⁸

The Rating Agency Act required CRAs to register formally with the Commission in order to qualify as an NRSRO.⁴⁹ The Rating Agency Act established an application process and required an applicant to disclose, among other things, its procedures and methodologies for developing credit ratings and for managing conflicts of interest.⁵⁰ A CRA may register to issue credit ratings as an NRSRO in the following five classes, or a combination of one or more of these classes:

- Financial institutions, brokers, or dealers;
- Insurance companies;
- Corporate issuers;
- Issuers of asset-backed securities; and
- Issuers of government securities, municipal securities, or securities issued by a foreign government.⁵¹

⁴⁷ S. Rep. No. 109-326, at 2 (2006).

⁴⁸ Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291, 120 Stat. 1327 (2006).

⁴⁹ Section 15E(a) of the Exchange Act, 15 U.S.C. § 78o-7(a).

⁵⁰ A CRA seeking the NRSRO designation must file Form NRSRO with the Commission. A CRA can currently issue credit ratings without seeking the NRSRO designation. However, under certain circumstances, e.g., as required by investment guidelines, an issuer may be required to have a credit rating from an NRSRO.

⁵¹ Section 3(a)(62) of the Exchange Act, 15 U.S.C. § 78c(a)(62).

The Commission must approve the CRA's application for NRSRO registration before it issues the credit ratings as an NRSRO for each class of credit rating.⁵²

In addition to the initial application requirement, the Rating Agency Act also requires that each NRSRO promptly amend its application for registration if any information or document provided therein becomes materially inaccurate (with certain exceptions).⁵³ Further, each NRSRO must furnish to the Commission on an annual basis an amendment to its registration in such form as the Commission may prescribe by rule, certifying that the information and documents in the application for registration (with one exception) continues to be accurate, and listing any material change.⁵⁴ The Rating Agency Act also gave the Commission examination authority to ensure an NRSRO's compliance with the requirements of the Rating Agency Act.⁵⁵

The Rating Agency Act required the Commission to issue in final form rules and regulations necessary to carry out the requirements of the Act, including the required application form, no later than 270 days after the date of enactment.⁵⁶ It also provided that "[t]he Commission shall issue final rules . . . to prohibit any act or practice relating to the issuance of credit ratings by a nationally recognized statistical rating organization that the Commission determines to be unfair, coercive or abusive"⁵⁷ However, under the Rating Agency Act, the Commission (or any State or political subdivision thereof) may not "regulate the substance of credit ratings or the procedures and methodologies by which any nationally recognized statistical rating organization determines credit ratings."⁵⁸

The Commission's initial rules to implement the Rating Agency Act were adopted on June 5, 2007, and became effective on June 26, 2007 (except for the rule and form prescribing the NRSRO application process, which became effective immediately).⁵⁹ On June 28, 2007, the Commission announced that the seven CRAs that had previously been identified as NRSROs had all applied to be

⁵² Section 15E(a)(2) of the Exchange Act, 15 U.S.C. § 78o-7(a)(2).

⁵³ Section 15E(b) of the Exchange Act, 15 U.S.C. § 78o-7(b).

⁵⁴ *Id.*

⁵⁵ Section 17(a)(1) of the Exchange Act, 15 U.S.C. § 78q(a)(1).

⁵⁶ Section 15E(n) of the Exchange Act, 15 U.S.C. § 78o-7(n).

⁵⁷ Section 15E(i) of the Exchange Act, 15 U.S.C. § 78o-7(i).

⁵⁸ Section 15E(c)(2) of the Exchange Act, 15 U.S.C. § 78o-7(c)(2).

⁵⁹ Final Rule: Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 34-55857 (June 5, 2007), <http://www.sec.gov/rules/final/2007/34-55857.pdf>. See 17 C.F.R. §§ 240.17g-1 through 240.17g-6 for the Commission's rules regarding NRSROs.

registered with the Commission as NRSROs and could continue to represent themselves and act as NRSROs during the pendency of their applications.⁶⁰

On September 24, 2007, the Commission issued its first orders approving seven CRAs' applications for NRSRO registration under the Rating Agency Act.⁶¹ The Office of Financial Responsibility within TM is responsible for rulemaking pertinent to NRSROs and evaluating NRSRO activities to assess competition in the industry. OCIE is currently responsible for conducting NRSRO examinations.⁶² Other SEC offices, such as the Office of Economic Analysis, provide input to TM and OCIE with respect to the NRSROs.

The CRAs' Involvement in the Recent Credit Crisis

In the early 2000s, lenders began to offer mortgages to individuals who did not meet the typical qualifications (e.g., income level or credit history).⁶³ Many of these mortgage loans had teaser rates⁶⁴ and/or were interest-only mortgages (i.e., the entire monthly payment is for interest and does not reduce the loan principal). These riskier mortgage loans are generally referred to as "subprime" mortgages or loans. The theory behind lenders offering these riskier mortgage loans was that the homeowner would be able to refinance the mortgage loan in a few years because of the increased growth in home values and the individual's improved credit rating. Lenders converted these mortgage loans into securities and sold the securities to other firms (known as the "securitization process").

⁶⁰ Press Release, Securities and Exchange Commission, Credit Rating Agencies Apply for Registration as Nationally Recognized Statistical Rating Organizations (June 28, 2007), www.sec.gov/news/press/2007/2007-124.htm.

⁶¹ Press Release, Securities and Exchange Commission, Seven Credit Rating Agencies Register with SEC as Nationally Recognized Statistical Rating Organizations (Sept. 24, 2007), www.sec.gov/news/press/2007/2007-199.htm. The Commission subsequently approved NRSRO applications of three other CRAs and, as a consequence, there are currently ten NRSROs.

⁶² After the Rating Agency Act became effective, former SEC Chairman Christopher Cox assigned TM the examination responsibility for the NRSROs. However, TM had not yet established a fully functional NRSRO examination program when the recent credit crisis surfaced. As a result, staff from TM, OCIE, and OEA performed a joint examination of Moody's, S&P and Fitch (see discussion below). Thereafter, in the fall of 2008, former Chairman Cox transferred primary examination responsibility for the NRSROs to OCIE. According to OCIE, on October 22, 2008, OCIE received an e-mail from former Chairman Cox's office giving it permission to begin additional NRSRO examinations, and OCIE sent document requests to four NRSROs on the following day, October 23, 2008. We previously found that TM had similar delays in establishing an examination program for Consolidated Supervised Entities (i.e., investment banks), see OIG Audit Report 446-A, dated September 25, 2008.

⁶³ Proposed Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 34-57967 (June 16, 2008), <http://www.404.gov/rules/proposed/2008/34-57967.pdf>, at 3 and n. 1.

⁶⁴ A teaser rate is a low introductory interest rate that is used to attract a borrower. See http://www.fdic.gov/regulations/examinations/credit_card/pdf_version/ch21.pdf.

Beginning in mid-2006, home values decreased and mortgage loan defaults started to increase, causing the market value of the mortgage securities to decline.⁶⁵ In the ensuing months, the financial services industry wrote down billions of dollars in the value of mortgage securities, which, in accordance with Generally Accepted Accounting Principles (“GAAP”), must be valued at market value. The CRAs played a critical role in these events because there are serious questions as to whether the CRAs initially rated the mortgage securities (i.e., structured products) accurately and whether they should have subsequently reassessed their credit ratings.⁶⁶

The Commission’s Response to the CRAs’ Involvement in the Recent Credit Crisis

As a result of the CRAs’ involvement in the recent credit crisis, the Commission undertook several measures to improve NRSRO oversight.⁶⁷ For example, beginning in August 2007, Commission staff conducted examinations of S&P’s, Moody’s, and Fitch’s processes for rating subprime Residential Mortgage Backed Securities (RMBS) and Collateralized Debt Obligations (CDO). In July 2008, the Commission’s staff issued a public summary report of issues identified in the staff’s examinations that found as follows:

- there was a substantial increase in the number and in the complexity of RMBS and CDO deals since 2002, and some of the rating agencies appear to have struggled with the growth;
- significant aspects of the ratings process were not always disclosed;
- policies and procedures for rating RMBS and CDOs can be better documented;

⁶⁵ Exchange Act Release No. 34-57967 at 3.

⁶⁶ Technical Committee of the International Organization of Securities Commissions (“IOSCO”), *The Role of Credit Rating Agencies in Structured Financial Markets*, Final Report (“IOSCO Report”) (May 2008), <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD270.pdf>, at 2; Financial Stability Forum, *Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience* (Apr. 7, 2008), http://www.fsforum.org/publications/r_0804.pdf, at 32; Press Release, New York Attorney General, Attorney General Cuomo Announces Landmark Reform Agreements with the Nation’s Three Principal Credit Rating Agencies (June 5, 2008) (“NYAG Press Release”), http://www.oag.state.ny.us/media_center/2008/jun/june5a_08.html.

⁶⁷ Other regulators also took actions because of CRAs’ involvement in the recent credit crisis. For example, in June 2008, the New York Attorney General reached an agreement with S&P, Moody’s, and Fitch on a series of reforms for rating RMBSs, see NYAG Press Release. In addition, an IOSCO Task Force analyzed the role that CRAs played in the structured finance market and made recommendations for improvement, see IOSCO Report. Further, the European Union (EU) has approved a regulation on CRAs, see Council of the European Union, *Proposal for a Regulation of the European Parliament and of the Council on Credit Rating Agencies* (Apr. 28, 2009) (“EU Regulation”). The European Council approved the proposed regulation on July 27, 2009.

- the rating agencies are implementing new practices with respect to the information provided to them;
- the rating agencies did not always document significant steps in the ratings process -- including the rationale for deviations from their models and for rating committee actions and decisions -- and they did not always document significant participants in the ratings process;
- the surveillance processes used by the rating agencies appear to have been less robust than the processes used for initial ratings;
- issues were identified in the management of conflicts of interest and improvements can be made; and
- the rating agencies' internal audit processes varied significantly.⁶⁸

The staff's report also summarized generally the remedial actions that the examined NRSROs indicated they would take as a result of the examinations that were conducted, and described the Commission's proposed rules, which, if adopted, would require the NRSROs to take further actions.⁶⁹

On February 2, 2009, the Commission issued a release adopting rule amendments that were designed to address practices identified, in part, by Commission staff during the examinations discussed above.⁷⁰ In summary, these rule amendments required an NRSRO (1) to provide enhanced disclosure on Form NRSRO of performance measurements statistics and the procedures and methodologies used to determine credit ratings for structured finance products and other debt securities; (2) to make, keep and preserve additional records under Rule 17g-2; (3) to make publicly available a random sample of 10 percent of the ratings histories of issuer-paid credit ratings in each class of credit ratings for which it is registered, with specified updates; and (4) to furnish the Commission with an additional annual report.⁷¹

⁶⁸ Staff of the Office of Compliance Inspections and Examinations, Division of Trading and Markets and Office of Economic Analysis, Securities and Exchange Commission, Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies (July 2008)(2008 Summary Report), <http://www.sec.gov/news/studies/2008/craexamination070808.pdf>, at 1-2. [REDACTED]

⁶⁹ 2008 Summary Report at 2.

⁷⁰ Rule: Amendments to Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 34-59342 (Feb. 2, 2009), <http://www.sec.gov/rules/final/2009/34-59342.pdf>,

⁷¹ Id. at 5.

The Commission issued another release on February 2, 2009, either re-proposing or proposing rule amendments that would:

- require the public disclosure of credit rating histories for all outstanding credit ratings issued by an NRSRO on or after June 26, 2007, that were “paid for by the obligor being rated or by the issuer, underwriter, or sponsor of the security being rated;” and
- amend “its conflict of interest rule to prohibit an NRSRO from issuing a rating for a structured finance product paid for by the product’s issuer, sponsor, or underwriter unless the information about the product provided to the NRSRO to determine the rating and, thereafter, to monitor the rating is made available to other persons.”⁷²

These re-proposed or proposed rule amendments are still pending. Several other significant NRSRO rulemaking proposals have also not been adopted, including proposals to:

- Amend rules under the various security law provisions that rely on NRSRO credit ratings in an effort “to address concerns that the reference to NRSRO ratings in Commission rules may have contributed to an undue reliance on NRSRO ratings by market participants.”⁷³
- Require an NRSRO that is rating a structured finance product to publish a report “describing how the credit ratings procedures and methodologies and credit risk characteristics for structured finance products differ from

⁷² Proposed Rules: Re-proposed Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 34-59343 (Feb. 2, 2009), <http://www.sec.gov/rules/proposed/2009/34-59343.pdf>, at 1.

⁷³ Proposed Rule: Reference to Ratings of Nationally Recognized Statistical Rating Organizations, Investment Company Release No. IC-28327 (July 1, 2008). See also Proposed Rule: References to Ratings of Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 34-58070 (July 1, 2008), <http://www.sec.gov/rules/proposed/2008/34-58070.pdf>; Proposed Rule: Security Ratings, Securities Act Release No. 33-8940 (July 1, 2008), <http://162.138.185.34/rules/proposed/2008/33-8940.pdf>. A recent report by the Department of Treasury on financial regulatory reform stated that “[r]egulators should reduce their use of credit ratings in regulations and supervisory practices, wherever possible.” Dep’t of the Treasury, Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation (June 2009) (“Treasury Report”), http://www.financialstability.gov/docs/regs/FinalReport_web.pdf, at 46. The Department of the Treasury “will work with the SEC and the President’s Working Group on Financial Markets to determine where references to ratings can be removed from regulations.” Press Release, Dep’t of the Treasury, Fact Sheet: Administration’s Regulatory Reform Agenda Moves Forward Credit Rating Agency Reform Legislation Sent to Capitol Hill (July 21, 2009) (“Treasury Fact Sheet”), <http://www.treas.gov/press/releases/tg223.htm>, at 2. Also, both a recently-introduced Senate bill and a recent legislative proposal by the Obama Administration would require the Government Accountability Office to study the appropriateness of relying on ratings for use in Federal, State, and local securities and banking regulations. S. 1073, 111th Cong. (2009), § 6; Treasury Fact Sheet at 2; Subtitle C-Improvements to the Regulation of Credit Rating Agencies of Title IX-Additional Improvements to Financial Markets Regulation (“Administration Legislative Proposal”), § 933. http://www.financialstability.gov/docs/regulatoryreform/titleIX_subtC.pdf.

those of other types of rated instruments such as corporate and municipal debt securities,” or alternatively “to use ratings symbols for structured finance products that differentiated them from the credit ratings for other types of debt securities.”⁷⁴

■ Prohibit unfair, coercive, or abusive conduct involving on the part of NRSROs involving unsolicited credit ratings (i.e., ratings that a CRA “decides to issue without being requested to do so by an issuer, obligor, underwriter, or other interested party”).⁷⁵ Commenters on this proposal expressed concerns that it was overbroad and feared that it would prohibit legitimate business activities that are not coercive, and the Commission did not adopt the proposed rule. The former Director of TM stated that TM “would like to gain a better understanding through [the] examination function of how credit rating agencies define ‘unsolicited credit ratings’ and the practices they employ with respect to these ratings.”⁷⁶

In February 2009, newly-appointed SEC Chairman Mary Schapiro stated that one of her priorities was “[i]mproving the quality of credit ratings by addressing the inherent conflicts of interest credit rating agencies face as a result of their compensation models and limiting the impact of credit ratings on capital requirements of regulated financial institutions.”⁷⁷ On April 15, 2009, the Commission held a hearing regarding its recent NRSRO rulemaking initiatives pertaining to conflicts of interest, competition, and transparency.⁷⁸

⁷⁴ Proposed Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 34-5967 (June 16, 2008), <http://www.404.gov/rules/proposed/2008/34-57967.pdf>, at 97. The recent Department of Treasury Report stated that “[c]redit rating agencies should differentiate the credit ratings that they assign to structured credit products from those they assign to unstructured debt.” Treasury Report at 46. A recent legislative proposal by the Obama Administration would require CRAs to use different symbols for structured finance products to indicate the disparate risks associated with these products. Treasury Fact Sheet at 2; Administration Legislative Proposal, § 932.

⁷⁵ Proposed Rule, Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 34-55231 (Feb. 23, 2007), <http://www.sec.gov/rules/proposed/2007/34-55231.pdf>, at 43, 135.

⁷⁶ Erik Sirri, former Director, Division of Market Regulation, Remarks before the SEC Open Meeting: Final Rules Implementing the Credit Rating Agency Reform Act of 2006 (May 23 2007), <http://www.sec.gov/news/speech/2007/spch052307ers.htm>, at 3.

⁷⁷ Mary L. Schapiro, Chairman, Securities and Exchange Commission, Address to Practicing Law Institute’s “SEC Speaks in 2009” Program (February 6, 2009), <http://www.sec.gov/news/speech/2009/spch020609mls.htm>, at 3.

⁷⁸ Press Release, Securities and Exchange Commission, SEC Roundtable to Examine Oversight of Credit Rating Agencies (Mar. 6, 2009), <http://www.sec.gov/news/press/2009/2009-46.htm>.

Recent White House and Legislative Proposals for Increased Regulation of CRAs

In addition to the Commission's recent focus on NRSROs, both the Obama Administration and Congress have begun efforts to tighten government oversight of CRAs. For example, in June 2009, the Department of Treasury released its proposal for reform of the U.S. financial regulatory system that includes a recommendation that the SEC continue its efforts to strengthen the regulation of credit rating agencies in several respects.⁷⁹

On May 19, 2009, Senator Jack Reed (D-R.I.) introduced a bill to provide for credit rating reforms entitled the Rating Accountability and Transparency Enhancement Act of 2009 (the "RATE Act").⁸⁰ This bill would provide for increased Commission oversight of NRSROs, particularly in the areas of internal controls over the procedures and methodologies for determining credit ratings, the management of conflicts of interest, the designation of a compliance officer and transparency of credit rating methodologies and information reviewed.⁸¹ It would also require the Commission to establish an office that administers the Commission's rules with respect to the practices of NRSROs for determining credit ratings.⁸²

More recently, on July 21, 2009, the Obama Administration sent Congress a legislative proposal designed to tighten government oversight of CRAs and to stem potential conflicts of interest in their business practices. According to the Department of Treasury's press release:

The legislation would . . . work to reduce conflicts of interest at credit rating agencies while strengthening the [SEC's] authority over and supervision of rating agencies. In recent years, investors were overly reliant on credit rating agencies that often failed to accurately describe the risk of rated products. This lack of transparency prevented investors from understanding the full nature of the risks they were taking. The Administration's legislation would tighten oversight of credit rating agencies, protect investors from inappropriate rating agency practices, and being increased transparency to the credit rating process.⁸³

⁷⁹ Treasury Report at 46.

⁸⁰ S. 1073, 111th Cong. (2009). A companion measure was introduced in the House of Representatives by Representative Tom Rooney (R-Fla.) on July 14, 2009, H.R. 321, 111th Cong. (2009).

⁸¹ *Id.*, § 3.

⁸² *Id.*

⁸³ Treasury Fact Sheet at 1.

Significantly, among numerous other reforms (some of which are already contained in the RATE Act), the Administration's legislative proposal would make registration with the Commission mandatory for all CRAs, not just those that choose to apply for NRSRO designation.⁸⁴ The Administration's proposal would also require the SEC to conduct reviews of the internal controls, due diligence, and implementation of all ratings methodologies for all NRSROs at least annually, although the Commission may delegate these reviews as necessary to the PCAOB.⁸⁵

Objectives

Given the importance of NRSROs, we initiated this review in accordance with our audit plan. The objective was to identify improvements in the Commission's NRSRO oversight. The review focused on the Commission's implementation of and compliance with the Rating Agency Act and Commission rules. We also reviewed the Commission's history with NRSROs to assess the Commission's efforts to oversee NRSROs and to implement the Rating Agency Act's accountability, competition, and transparency objectives.

⁸⁴ Id at. 2. Chairman Schapiro testified that her "personal belief is that legislation to require mandatory registration by credit rating agencies would be a significant step forward in making sure that this sector of the market is brought under regulatory oversight without the danger that some credit rating agencies may fail to register in order to avoid regulation." Regulatory Perspectives on the Obama Administration's Financial Regulatory Reform Proposals: Hearing before the Comm. on Financial Services, 111th Cong. (July 22, 2009)(testimony of Mary L. Schapiro, Chairman, Securities and Exchange Commission)("7/22/09 Schapiro Testimony"), <http://www.sec.gov/news/testimony/2009/ts072209mls.htm>, at 8.

⁸⁵ Treasury Fact Sheet at 2; Administration Legislative Proposal, § 932. While the RATE Act requires similar internal control reviews by the Commission, it allows the Commission to determine the frequency of those reviews. S. 1073, 111th Cong. (2009), § 3.

Findings and Recommendations

Finding 1: All Significant Issues Identified with NRSRO Applications Should be Resolved During the Application Process

TM identified significant issues during the process of reviewing CRA applications for registration as NRSROs. Before these issues were resolved, TM recommended that the Commission issue orders approving the CRAs' applications to become NRSROs, and the Commission approved the orders. Based on the significant issues that TM identified (many of which were related to the eligibility requirements specified in the Rating Agency Act), our review found that there are serious questions as to whether the approval of at least one CRA's application was in the public interest.

Section 15E(a)(2)(A) of the Exchange Act requires that the Commission take action on an application (i.e., either approve the application or institute proceedings to determine whether the application should be denied) within 90 days of the filing of the application, unless the applicant consents to a longer time period.⁸⁶ Under the statute, the Commission shall grant the application unless the CRA does not comply with the statutory requirements, the CRA "does not have adequate financial and managerial resources to consistently produce credit ratings with integrity and to materially comply" with their disclosed procedures and methodologies and certain statutory provisions, or the CRA, if registered, would be subject to suspension or revocation.⁸⁷

We performed testing for compliance with the Rating Agency Act and implementing rules by obtaining and reviewing 11 application submissions from ten CRAs and TM's action memoranda recommending that the Commission

⁸⁶ 15 U.S.C. § 78o-7(a)(2)(A).

⁸⁷ 15 U.S.C. § 78o-7(a)(2)(C). The Commission is authorized by statute to, by order, "censure, place limitations on the activities, functions, or operations of, suspend for a period not exceeding 12 months, or revoke the registration of any" NRSRO if the Commission finds, on the record after notice and opportunity for hearing, that such action "is necessary for the protection of investors and in the public interest and that the NRSRO, or any person associated therewith, has engaged in certain specified conduct." 15 U.S.C. § 78o-7(d).

designate these CRAs as NRSROs. We also reviewed other pertinent materials, such as each NRSRO's required annual financial reports.⁸⁸

Based on our review of that documentation, our review found that there are serious questions as to whether the approval of the application of one CRA [REDACTED], was in the public interest, given the significant issues that TM identified with the application [REDACTED]. The issues involving this CRA's [REDACTED] application, as described in TM's action memorandum to the Commission, included the following:

- Concerns about the adequacy of the CRA's managerial resources, including the experience of its compliance officer. Neither the Act nor the Commission's rules prescribe minimum qualifications for NRSRO compliance officers.⁸⁹
- Suspicions about the accuracy of the financial information provided in the CRA's application. The firm's auditor was not subject to oversight by the PCAOB, as is discussed below.
- Questions as to the authenticity of a number of the initial ten Qualified Institutional Buyer (QIB) certifications submitted by the CRA. Ultimately, the CRA submitted ten certifications that complied with the Rating Agency Act and the instructions to Form NRSRO.⁹⁰
- Questions about whether the subscriber fees charged by the CRA were reasonable, based upon the information provided by the CRA. TM noted that neither the Rating Agency Act nor its legislative history provided specific guidance on how the Commission should determine whether a fee was reasonable. TM concluded that "given the scant guidance in the statute as to how to evaluate the reasonableness of an applicant's fees and the staff's limited information on subscriber fees in general," it did not recommend at this time that the Commission find the CRA's fees to be unreasonable.⁹¹ TM also stated, "We believe there are compelling reasons to find that certain levels of fees are unreasonable; however, the emphasis in the legislative history that the statute was designed to

⁸⁸ Our compliance testing is described in more detail in Appendix II, "Scope and Methodology."

⁸⁹ Both the RATE Act and the Administration's legislative proposal would require each NRSRO to designate a compliance officer and specify the duties of, and limitations on, that compliance officer. S. 1073, 111th Cong. (2009), § 3; Administration Legislative Proposal, § 932.

⁹⁰ These certifications are required by Section 15E(a)(1)(B)(ix) of the Exchange Act, 15 U.S.C. § 78o-7(a)(1)(B)(ix), unless the CRA had received NRSRO status through a no-action letter prior to August 2, 2006, see Section 15E(a)(1)(D) of the Exchange Act, 15 U.S.C. § 78o-7(a)(1)(D). The term "Qualified Institutional Buyer" is defined in 17 C.F.R. § 230.144A(a)(1).

⁹¹ Action Memorandum to the Commission from TM, subject: Application of [REDACTED] to register with the Commission as an NRSRO ([REDACTED]) (" [REDACTED] Action Memorandum), at 2

accommodate subscriber-based credit rating agencies cannot be ignored.”⁹²

- Concerns about the high volatility of the credit ratings issued by the CRA. While TM noted that there could be appropriate explanations for the ratings volatility, it indicated that it would be difficult to determine the causes of the volatility until an examination of the CRA was conducted.
- Concerns that the CRA “provided a much less detailed description” of its credit rating process than did the other NRSROs. This lack of detailed disclosure could impair an investor’s ability to understand the CRA’s credit rating process. TM stated that if the CRA’s application were approved, the staff would discuss with the CRA “how it could improve its discourse by providing a more detailed explanation of its credit ratings procedures.”⁹³ TM concluded, however, that the CRA substantially provided the information required.
- A concern that the CRA did not list specific policies and procedures for managing conflicts of interest. However, TM noted that the CRA did require that all ratings be reviewed by a rating committee, thus providing some level of assurance that no one analyst could unduly influence a rating. TM believed that the CRA’s policy and procedure to manage the conflict of interest that could arise when a subscriber requests a credit rating could be enhanced.

Although none of these significant issues were resolved, TM recommended that the Commission approve this CRA’s application. In its recommendation, TM informed the Commission as follows:

Given the 90-day application timeframe, staff resources, and the design of the Rating Agency Act that the application process be based primarily on information submitted by the applicant, we have not attempted to verify the accuracy of the financial information [provided by the CRA] or determine whether the applicable policies and procedures have been implemented. We believe the best approach to resolve these concerns would be to include these issues in an examination of the firm.⁹⁴

⁹² Id. at 7. The staff identified the issue of unreasonable subscriber fees with two other CRA applications for NRSRO designation. However, based on TM’s action memoranda, it appears that the evidence was not as compelling with the other CRAs as it was with the CRA discussed above. [REDACTED]

⁹³ Id. at 11.

⁹⁴ Id. at 2-3.

During the review, TM staff informed us that, at the time it recommended approval of the CRA's application, they only had suspicions and concerns but lacked evidence. TM staff also stated that they did not believe that the CRA would consent to a further extension of the 90-day requirement.⁹⁵ Moreover, TM staff did not believe that a proceeding to determine whether registration should be denied could be resolved within the specified statutory-time frame.⁹⁶ Finally, TM staff explained that they were reluctant to recommend instituting proceedings to determine whether registration should be denied because the Rating Agency Act was relatively new, and the staff were unable to obtain clarity regarding certain of the terms used in the applicable provisions of the statute. Consequently, TM staff believed that there was a significant chance the Commission would not prevail in a proceeding to deny the CRA's application.

We also learned during our review that although TM had recommended that the concerns it identified with the CRA's application be resolved through an examination of the firm, an examination of this CRA was not initiated until ten months after the Commission issued the order approving its application [REDACTED], and this examination is still ongoing. [REDACTED]

[REDACTED] Accordingly, our review found that instead of issuing an order designating this CRA as an NRSRO, TM should have either recommended that the Commission institute proceedings to determine whether it should deny the application [REDACTED] or sought consent from the CRA to waive the 90-day statutory requirement to allow TM additional time to address the issues identified with the application [REDACTED]

In addition to the significant problems identified with the application discussed above, TM identified significant issues with the applications of other CRAs that TM recommended for Commission approval. These issues included the following, as described in TM's action memoranda to the Commission:

- There was concern about the financial condition of a CRA [REDACTED]. Specifically, the auditor of the CRA's [REDACTED]

⁹⁵ According to TM staff, the CRA reluctantly consented to a two-day extension to enable the staff to have the Commission approve the order granting the CRA's application.

⁹⁶ Under the Rating Agency Act, a proceeding to determine whether registration should be denied must "be concluded not later than 120 days on which the application for registration is furnished to the Commission . . ." 15 U.S.C. § 78o-7(a)(2)(B)(i)(II). However, "[t]he Commission may extend the time for conclusion of such proceeding for not longer than 90 days, if it finds good cause for such extension and publishes its reasons for so finding, or for such longer period as to which the applicant consents." 15 U.S.C. § 78o-7(a)(2)(B)(iii).

European affiliate issued a going concern audit opinion⁹⁷ on the affiliates. Further, TM stated that it did “not have information concerning the financial resources of the owners of [the CRA] and its affiliates or whether the owners have any legal obligation to support the affiliates.”⁹⁸ TM concluded: “Should [the CRA’s] revenues decrease, it is not clear that it could continue to operate at the same level without support from its owners. However, the staff believes that [the CRA] will have sufficient financial resources if its revenue continues as it has in the past.”⁹⁹

- One CRA [REDACTED] did not submit the required information regarding its credit rating process for structured products, and this information was not on the CRA’s website. TM concluded that the CRA substantially provided the information required and indicated it would discuss the issue with the CRA, if its application were approved.
- Three CRAs [REDACTED] provided information on the largest users of their credit rating services, as required by Exhibit 10 of Form NRSRO. However, TM was concerned that some of the users may actually be affiliated with one another. TM, therefore, wanted the CRAs to provide an aggregate revenue amount at the conglomerate level. TM staff stated that they would discuss the issue with the CRAs if the applications were approved.
- TM was concerned about the procedures of two CRAs [REDACTED] for handling material non-public information. TM concluded that the CRAs substantially provided the information required and would discuss the issue with the CRAs if their application were approved.
- TM could not determine, because of the table headings used, whether the amounts contained on a chart submitted by one CRA [REDACTED] conformed to the required financial disclosures. TM stated that it would discuss the issue with the CRA if the application were approved.

⁹⁷ The American Institute of Certified Public Accountant’s Statement on Auditing Standards No. 59, The Auditor’s Consideration of an Entity’s Ability to Continue as a Going Concern, requires an auditor to evaluate whether substantial doubt exists about an audit client’s ability to continue as a going concern. When the auditor concludes that such substantial doubt exists, the audit report should include an explanatory paragraph to reflect this uncertainty or, alternatively, the auditor may choose to issue a disclaimer of opinion upon the financial statements.

⁹⁸ Action Memorandum to the Commission from TM, subject: Application of [REDACTED] to register with the Commission as an NRSRO ([REDACTED]), at 4.

⁹⁹ Id.

- One CRA [REDACTED] did not categorize its revenue or provide a list of the line items in each category, as required on Exhibit 12 of Form NRSRO, among other disclosure issues.¹⁰⁰ TM concluded that the CRA substantially provided the information required and would discuss the issue with the CRA if the application were approved.
- Based upon the information provided in the application of one CRA [REDACTED], TM was unable to determine if the CRA adequately documented its conflicts of interest procedures for ensuring that a single issuer does not provide ten percent or more of an NRSRO's total net revenue during a fiscal year. Nevertheless, TM concluded that the CRA had substantially provided the required information, but stated that it would recommend that the CRA document these procedures if the Commission approved the CRA's application.

Although TM identified these numerous substantive concerns regarding the applications of several CRAs that were related to the Rating Agency Act's eligibility requirements, TM nonetheless recommended that the Commission designate all of these CRAs as NRSROs. Several of these issues raise questions as to whether it was in the public interest for the Commission to approve these CRAs' applications. In all of these instances as with the CRA application discussed in detail above, TM stated that it would address the issues after the Commission issued the order approving the CRAs' applications.

We believe that there is risk in the approach adopted by TM and the Commission of resolving problems identified with a CRA's application subsequent to the application's approval. Under this approach, there is no specified time frame within which these issues must be addressed. TM stated that some of the issues it identified during the application process have not yet been resolved partially because OCIE has not yet examined every NRSRO.¹⁰¹ Further, there is no guarantee that the CRA will adequately implement any recommended corrective actions. Therefore, with respect to the other CRA applications where TM identified significant problems, our review found that TM should have resolved these issues before recommending that the Commission grant a CRA's application for NRSRO registration to the extent consistent with the Rating Agency Act.

¹⁰⁰ TM also identified issues with the disclosure of revenues by four other CRAs [REDACTED].

¹⁰¹ [REDACTED]

Recommendation 1:

The Division of Trading and Markets (TM) should ensure that all significant issues identified in the application review process are resolved before it recommends that a credit rating agency (CRA) be registered as a Nationally Recognized Statistical Rating Organization. One way to resolve issues would be to require that the Office of Compliance Inspections and Examinations complete an examination of a CRA before TM makes a recommendation on the application to the Securities and Exchange Commission (which would require additional legislative authority, see Recommendation 9).

Recommendation 2:

The Division of Trading and Markets, in consultation with the Office of Compliance Inspections and Examinations (OCIE) and the Office of Economic Analysis, should evaluate whether action should be taken regarding the credit rating agency (CRA) that was granted registration as a Nationally Recognized Statistical Rating Organization (NRSRO), despite the numerous significant problems identified with its application. These actions could include, as deemed appropriate, making a referral to the Division of Enforcement for consideration of censure, suspension, or other remedies specified in Section 15E(d) of the Securities Exchange Act of 1934. The evaluation should consider any new information obtained (e.g., from the OCIE examination of the CRA) since the CRA's application approved.

Recommendation 3:

The Division of Trading and Markets should ensure that all pending issues identified during the application process involving the credit rating agencies that the Securities and Exchange Commission approved as Nationally Recognized Statistical Rating Organizations are resolved within six months of the date of issuance of the Office of Inspector General's report.

Recommendation 4:

The Division of Trading and Markets, in consultation with the Office of Economic Analysis and the Office of Compliance Inspections and Examinations, should develop measures for determining whether subscriber fees charged by the credit rating agencies are reasonable.

Recommendation 5:

The Division of Trading in Markets (TM), in consultation with the Office of Compliance Inspections and Examinations, the Office of Economic Analysis, and

the Office of Risk Assessment, should request that the Office of General Counsel develop guidance regarding the types of deficiencies, (e.g., overly broad disclosures) that should prompt TM either to (1) seek consent from the applicant to waive the 90-day statutory time period for granting an application for registration as a Nationally Recognized Statistical Rating Organization (NRSRO), or (2) recommend instituting proceedings to determine whether registration should be denied.

Recommendation 6:

The Division of Trading and Markets and the Office of Compliance Inspections and Examinations should take appropriate actions to inform Nationally Recognized Statistical Rating Organizations about the Commission's expectations regarding the experience of their compliance officers.

Finding 2: TM Granted Extensions of Time without Requesting Commission Orders as Required by Statute or Regulation, and Received and Accepted Forms or Reports that Did Not Comply with Commission Rules

During our compliance testing (as described in Appendix II), we found two examples where TM granted NRSROs an extension of time to file required documents on its own, without recommending that the Commission provide the relief by order, as required by statute or regulation. Our review also revealed instances where TM received and accepted forms or reports from firms that did not include a financial statement or certifications required by Commission rule.

Failure to Seek Commission Orders for an Extension of Time as Required by Statute or Regulation

As noted above, Section 15E(b) of the Exchange Act requires each NRSRO to furnish to the Commission an amendment to Form NRSRO on an annual basis, not later than 90 days after the end of each calendar year, certifying that the information and documents and documents in the application for NRSRO registration continue to be accurate, and listing any material change to such information or documents that occurred during the previous calendar year.¹⁰²

¹⁰² 15 U.S.C. § 78o-7(b). See also 17 C.F.R. § 240.17g-1(f).

The Commission has authority under Section 36 of the Exchange Act to, “by rule, regulation, or order, . . . conditionally or unconditionally exempt any person security, or transaction, or any class or classes of persons, securities, or transactions from any provision or provision of this title or of any rule or regulation hereunder, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.”¹⁰³

In addition, Commission Rule 17g-3(a) requires an NRSRO to furnish the Commission with several financial reports on an annual basis, not more than 90 calendar days after the end of its fiscal year.¹⁰⁴ As this rule was initially adopted, the required financial reports included:

- (1) Audited financial statements of the NRSRO or audited consolidated financial statements of its parent if the NRSRO is a separately identifiable division or department of the parent;
- (2) if applicable, unaudited consolidating financial statements of the parent of the NRSRO that include the NRSRO;
- (3) an unaudited financial report providing information concerning the NRSRO’s revenue in four different categories for the fiscal year;
- (4) an unaudited financial report providing the total aggregate and median annual compensation of the NRSRO’s credit rating analysts for the fiscal year; and
- (5) an unaudited financial report listing the 20 largest issuers and subscribers, based on net revenue, that used credit rating services provided by the NRSRO during the last fiscal year.¹⁰⁵

Under Rule 17g-3(c), “[t]he Commission may grant an extension of time or an exemption with respect to any requirements in this section either unconditionally or on specified terms and conditions on the written request of [an NRSRO] if the

¹⁰³ 15 U.S.C. § 78mm(a)(1).

¹⁰⁴ 17 C.F.R. § 240.17g-3(a).

¹⁰⁵ 17 C.F.R. § 240.17g-3(a)(1)-(5). The Commission amended its rules on February 2, 2009, to require the filing of an additional report, i.e., an “unaudited report of the number of credit ratings actions (upgrades, downgrades, placements on credit watch, and withdrawals) taken during the fiscal year in each class or credit ratings” for which the NRSRO is registered with the Commission. 17 C.F.R. §240.17g-3(a)(6). See Exchange Act Release No. 34-59342 at 35.

Commission finds that such extension or exemption is necessary or appropriate in the public interest and consistent with the protection of investors.¹⁰⁶

Our review found two examples, as described below, where TM granted NRSROs an extension of time to file the annual Form NRSRO certification and/or the required annual reports on its own, without seeking an order from the Commission.

First, one NRSRO [REDACTED] did not file its annual Form NRSRO certification and financial reports for 2008 within 90 days, as required by Section 15E(b) of the Exchange Act and Commission Rule 17g-3(a). Specifically, these documents were due on March 31, 2009. However, this NRSRO requested an extension of the March 31, 2009 deadline for filing the Form NRSRO annual certification to no later than April 10, 2009.¹⁰⁷ The NRSRO informed TM that the requested extension was made in order to allow the NRSRO to complete the additional work required as a result of the recently adopted amendments to the NRSRO rules, which would become effective on April 10, 2009.¹⁰⁸ The NRSRO explained that the granting of the requested extension would “relieve [it] from the burden of filing two separate documents within the span of a few days and the burden on Commission staff of reviewing each separate filing.”¹⁰⁹ According to the [REDACTED] letter from the NRSRO, TM verbally granted the requested extension. TM staff stated that they believed that, given the short length of the extension, the most efficient way to provide the requested relief was through the no-action letter process. The NRSRO’s annual Form NRSRO certification was dated April 8, 2009, and the Commission received the firm’s annual financial reports on April 10, 2009.

Second, another NRSRO [REDACTED] requested an extension of 30 days to file its required annual financial reports for the fiscal year ended December 31, 2008, which were due on March 31, 2009.¹¹⁰ This NRSRO’s stated reasons for requesting the extension were that its previous auditor resigned on February 5, 2009, that it had recently engaged a new auditor, and that the 30-day extension should provide enough time for completion of the audit.¹¹¹ TM consulted with the

¹⁰⁶ 17 C.F.R. § 240.17g-3(c)(emphasis added).

¹⁰⁷ Letter from [REDACTED] to Thomas McGowan, Assistant Director of TM ([REDACTED] (“[REDACTED] Letter”).

¹⁰⁸ Id. See Exchange Act Release No. 34-59342. With one exception, all of the amendments adopted by the Commission on February 2, 2009, were effective as of April 10, 2009.

¹⁰⁹ [REDACTED] Letter.

¹¹⁰ Letter from Michael A. Macchiaroli, Associate Director, TM, to [REDACTED], at 1.

¹¹¹ Id.

Office of the Chairman and was informed that the Chairman had no objection to giving the NRSRO the requested 30-day extension.¹¹² However, we found no record that the other Commissioners were informed of this issue.

TM then issued a no-action letter to the NRSRO, stating that based on the information provided by the NRSRO, TM would not recommend enforcement action to the Commission if the NRSRO furnished the required financial reports for fiscal year 2008 “not more than 30 calendar days after March 31, 2009.” The NRSRO submitted its annual financial reports on April 29, 2009.

In both of the examples described above, TM granted extensions to NRSROs to the 90-day filing requirements of the Exchange Act and the Commission’s rules on its own, without seeking orders from the Commission. While the Commission has general exemptive authority under the Exchange Act and the Commission may grant extensions of time under Rule 17g-3(c), TM had no authority to grant these extensions without seeking orders from the Commission. As a result of TM’s actions, the Commission was denied the ability to determine whether the requested extensions were necessary or appropriate in the public interest and consistent with the protection of investors.

Recommendation 7:

The Division of Trading and Markets should ensure that it seeks Commission orders in response to requests by Nationally Recognized Statistical Rating Organizations for extensions of time when required by statute or the Commission’s rules.

TM Failed to Require Compliance with Certain Commission Requirements and Rules Regarding Financial Reports and Certifications

As is discussed below, our compliance testing revealed that, TM did not direct a firm to submit a required financial statement and, in several instances, ignored the Commission’s requirement that the firms’ required annual financial reports be appropriately certified.

First, the Commission requires a firm to file a statement of cash flows both in connection with its initial application for NRSRO designation and as part of its annual audited financial statements.¹¹³ Our review found that one NRSRO [REDACTED]

¹¹² Id. at 1-2.

¹¹³ See Instructions to Exhibit 11 of Form NRSRO and 17 C.F.R. § 240.17g-3(a)(1)(i). Under Section 15E(a)(1)(B)(x) of the Exchange Act, 15 U.S.C. § 78o-7(a)(1)(B)(x), the Commission may require the submission of “any other information and documents concerning the applicant and any person associated with such applicant as the Commission, by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors.” The Commission approved the instruction to Exhibit 11 of Form NRSRO on June 5, 2007, see Exchange Act Release No. 34-55957.

did not file a statement of cash flows either during the application process, or as part of the required annual financial reports [REDACTED]. TM staff informed us that they were not aware that the NRSRO had not filed the required statements of cash flows until this matter was brought to their attention during the review.

Second, Commission Rule 17g-3(b) requires an NRSRO to attach to each financial report furnished pursuant to Rule 17g-3(a) "a signed statement by a duly authorized person associated with the [NRSRO] that the person has responsibility for the report and, to the best knowledge of the person, the financial report fairly presents, in all material respects, the financial condition, results of operations, cash flows, revenues, [and] analyst compensation . . . of the [NRSRO] for the period presented." We found during our review that two NRSROs [REDACTED] did not provide certifications for their annual financial reports as required by Rule 17g-3(b). TM pointed out that these NRSROs attached the annual financial reports required by Rule 17g-3(b) to their annual Form NRSRO filing, which included a certification that the information and statements contained in the Form, including Exhibits and Attachments, were accurate in all significant respects. Further, several NRSROs [REDACTED] submitted only one certification to cover all of the annual financial reports, instead of submitting a separate certification for each financial report, as Rule 17g-3(b) requires.

TM staff stated that they did not believe the NRSROs' failures to provide the certifications specified in Rule 17g-3(b) constituted a material failure to comply with the rule because the ability to hold the NRSROs accountable for furnishing false information in their annual financial reports to the Commission was not impaired. Nonetheless, TM agrees that NRSROs should use the proper certification method for the annual reports as required under Rule 17g-3. TM stated that it is, therefore, recommending that the Commission amend the instructions to Form NRSRO to clarify that the Rule 17g-3 reports are to be certified as required by the rule and not using the certification specified for the Form NRSRO submission. TM also agrees to monitor the Form NRSRO and Rule 17g-3 annual report submissions more closely to verify that they are appropriately certified and contain the required information.

Recommendation 8:

The Division of Trading and Markets should ensure that credit rating agencies applying for designation as Nationally Recognized Statistical Rating Organizations (NRSROs) and firms that have registered as NRSROs comply with

the Commission's rules and requirements regarding the filing and certification of financial information.

Finding 3: The Effectiveness Of The NRSRO Examination Program Should Be Improved

Our review identified several recommendations that would improve the effectiveness of the NRSRO examination program, including conducting examinations before the Commission issues an order approving a CRA's application for NRSRO registration.

Conducting Examinations Before Issuing Orders Approving Applications

Under the Rating Agency Act, the Commission shall grant a CRA's application for NRSRO designation under the following circumstances:

- if the Commission finds that the requirements of Section 15E of the Exchange Act are met; and
- unless the Commission finds that the CRA "does not have adequate financial and managerial resources to consistently produce credit ratings with integrity and to materially comply with the procedures and methodologies disclosed" in its application, as well as the statutory provisions concerning prevention of misuse of non-public information, management of conflicts of interest, prohibited conduct, and designation of compliance officers; or if the applicant were registered, its registration would be subject to suspension or revocation under the Act.¹¹⁴

The Commission must either issue an order approving the application or institute proceedings to deny the application within 90 days, unless the CRA consents to a longer period of time.¹¹⁵

The Rating Agency Act does not provide the Commission with any express authority to conduct examinations of CRAs prior to approval of their applications for NRSRO registration.¹¹⁶ As noted above, prior to the enactment of the Rating Agency Act, OCIE encountered difficulties in obtaining documents from the

¹¹⁴ 15 U.S.C. § 78o-7(a)(2)(C).

¹¹⁵ 15 U.S.C. § 78o-(a)(2)(A).

¹¹⁶ TM believes, however, that the Commission has authority to examine issues pertinent to an application of an existing NRSRO to issue additional classes of credit ratings.

NRSROs to conduct examinations.¹¹⁷ OCIE currently does not conduct examinations until sometime after a CRA's application for NRSRO registration has been approved.¹¹⁸ As a consequence, TM does not have the benefits of examination results when deciding what recommendation to make to the Commission regarding a pending NRSRO application.

Our review found that the Commission could significantly enhance its ability to determine whether a CRA meets the requirements of the Rating Agency Act, if an examination were conducted as part of the application review process. For example, during the application process for one CRA [REDACTED], as previously discussed, TM was concerned about several significant issues, including the following:

- TM had suspicions regarding the accuracy of the financial information submitted in the CRA's application, and the adequacy of its managerial resources (e.g., the compliance officer's experience).
- TM found that the CRA's credit ratings were volatile. The staff noted that there could be appropriate explanations for the volatility, but that these explanations would be difficult to ascertain until an examination of the CRA was conducted.

TM concluded that the best way to address its concerns about this CRA's application was through the examination process after the Commission issued an order approving the CRA's application. However, an examination of this NRSRO was not begun until ten months after the Commission approved its [REDACTED] application, and the examination of this NRSRO is still pending. Finally, as of the date of this report, OCIE has not yet examined three other NRSROs [REDACTED] at all, despite the fact that TM identified substantive concerns with their applications.

If OCIE conducted examinations of CRAs while their applications for NRSRO registration were pending, the examinations could focus on and address the types of issues described above. Further, OCIE would be able to determine whether a CRA has adequate books and records prior to its obtaining NRSRO registration.¹¹⁹ OCIE has identified at least one CRA [REDACTED] that does not have adequate books and records; however, this determination was made after the Commission approved the CRA's application for NRSRO registration. Retention and production of adequate documents and e-mail are essential in order for the

¹¹⁷ 2008 Summary Report at 7-9.

¹¹⁸ Moreover, these examinations have not necessarily been conducted immediately after approval of an NRSRO's application.

¹¹⁹ 17 C.F.R. §240.17g-2 specifies the records that are required to be made and retained by NRSROs.

staff to conduct examinations.¹²⁰ Finally, by conducting an examination of a CRA during the application process, OCIE could evaluate the adequacy of the disclosures made in the CRA's application (e.g., it could determine whether the disclosures are too broad and more specification is required). As previously discussed, TM identified several instances during the application process where CRAs' disclosures were questionable.

For all of these reasons, therefore, we believe that conducting examinations prior to the approval of NRSRO applications would greatly enhance the Commission's NRSRO application approval process. While this proposal would likely require additional staff resources, Chairman Schapiro has recently testified that she has "allocated additional resources to establish a branch of examiners dedicated specifically to conducting examination oversight of the NRSROs."¹²¹

Recommendation 9:

The Chairman, in concert with the other Commissioners, shall review the Office of Inspector General's findings on conducting examinations before issuing orders approving applications and, as appropriate and as part of their broader analysis of issues pertaining to Nationally Recognized Statistical Rating Organizations (NRSROs), direct the Office of Compliance Inspections and Examinations and the Division of Trading and Markets, in consultation with the Office of the General Counsel, to seek legislative authority to conduct examinations as part of the NRSRO application process. As part of this review, the Chairman and Commissioner should consider:

- Whether the current 90-day statutory time period should be extended to allow for examinations to be conducted; and
- What additional staffing resources would be required to implement this additional responsibility.

Including NRSROs in the Pilot Monitoring Program

As part of a pilot program, OCIE has assigned staff to monitor the largest broker-dealers, investment advisers and investment companies. The purpose of this pilot program is to improve the examination process by enabling staff to identify

¹²⁰ 2008 Summary Report at 9.

¹²¹ SEC Oversight: Current State and Agenda: Hearing before the H. Comm. on Financial Services, Subcomm. On Capital Markets, Insurance and Government-Sponsored Enterprises, 111th Cong. (July 14, 2009) (Testimony of Mary L. Schapiro, Chairman, U.S. Securities and Exchange Commission) ("7/14/09 Schapiro Testimony"), <http://www.sec.gov/news/testimony/2009/ts071409mls.htm>, at 10. See also 7/22/09 Schapiro Testimony at 9.

issues in real time through enhanced communication with the firm and to explore these issues more thoroughly and timely. Real-time identification of issues assists OCIE to identify risks and instances of non-compliance with rules before they materialize or become significant. However, OCIE has not included the NRSROs in the pilot program.¹²²

Our review found that given the NRSROs' important role in the financial markets and the criticisms surrounding the quality of their credit ratings, a monitoring program for the NRSROs would enhance the Commission's oversight of the NRSROs. Among other things, this type of program would enable OCIE staff to review complaints received by the NRSROs in real time¹²³ and to monitor the quality of credit ratings, e.g., by looking into the reasons for credit rating upgrades and downgrades.

Given the importance of the NRSROs, it is questionable whether this examination cycle is sufficient.¹²⁴ Therefore, we believe that a monitoring program would be a very effective complement to the examination cycle.

Recommendation 10:

The Office of Compliance Inspections and Examinations (OCIE) should include the Nationally Recognized Statistical Rating Organizations (NRSROs) in its pilot monitoring program. Given the different sizes (i.e., market dominance) of the various NRSROs and the current examination cycle, OCIE should specifically tailor its monitoring program for each particular NRSRO.

Additional Review of OCIE's NRSRO Examination Module

OCIE is in the process of developing an examination module that contains specific steps to be performed when conducting NRSRO examinations. This module is currently in draft form. According to OCIE, while the module serves as a guide for the NRSRO examination staff, the staff are not supposed to use the module as a checklist.

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¹²³ 17 C.F.R. § 240.17g-2(b)(8) requires NRSROs to maintain copies of complaints "about the performance of a credit analyst in intimating, determining, maintaining, monitoring, changing, or withdrawing a credit rating."

¹²⁴ Because OCIE has not yet examined every NRSRO at least once, it is premature to reach any definitive conclusions about the adequacy of the current examination cycle. As noted above, however, the Administration's legislative proposal would require the Commission to perform reviews of NRSROs' internal controls at least annually, or delegate such reviews to the PCAOB.

OCIE has advised us that it consulted with TM on the adequacy of the draft module, but did not seek any outside expertise. Our review found that having an expert in credit rating and NRSRO matters review the adequacy of the draft module would be another useful quality control to bring a fresh and different perspective to the process and possibly identify missing examination steps or steps that should be enhanced. OCIE stated that an outside review of the draft module conceptually could be useful, but raised concerns about potential conflicts of interest. OCIE also stated that it is interested in hiring staff with recent NRSRO experience with the additional five staff positions it recently received and, as noted above, Chairman Schapiro has recently allocated additional resources to establish a branch of NRSRO examiners. To the extent they have industry experience, these newly-hired staff could review the draft module to suggest possible improvements, consistent with any applicable ethics limitations.

Accordingly, our review found that OCIE could obtain an additional review of its draft examination module either by contracting with an expert or relying on the expertise of newly-hired staff.

Recommendation 11:

The Office of Compliance Inspections and Examinations (OCIE), in consultation with the Ethics Office and the Office of Administrative Services, should obtain an additional review of the draft OCIE Nationally Recognized Statistical Rating Organization (NRSRO) examination module by an expert in credit rating and NRSRO matters.

Finding 4: The Commission Should Address Several Policy Issues in Order to Improve NRSRO Oversight

Several policy issues involving NRSROs should be addressed by the Commission. The Commission previously considered some of these issues but took no action.

PCAOB Oversight of NRSRO Auditors

Section 15E(a)(2)(C) of the Exchange Act provides that if a CRA complies with the statutory application requirements, the Commission must approve the application unless:

the applicant does not have adequate financial and managerial resources to consistently produce credit ratings with integrity and to materially comply with the procedures and methodologies disclosed¹²⁵ [Emphasis added.]

The Commission requires a CRA seeking designation as an NRSRO to provide, (in Exhibit 11 of Form NRSRO, audited financial statements in order enable the Commission to assess the CRA's financial resources.¹²⁶ In addition, CRAs are required to provide this information annually after becoming NRSROs.¹²⁷

Despite the importance of the financial statement information being provided, the Commission does not require that the financial statements be audited by a firm that is subject to oversight by the PCAOB.¹²⁸ Instead, the auditor is required to comply with various Commission accountant qualification requirements specified in Rule 2-01 of Regulation S-X.¹²⁹ TM stated that the Sarbanes-Oxley Act would need to be amended in order for the Commission to require that a firm's auditor be subject to PCAOB oversight.

The Sarbanes-Oxley Act established a comprehensive program for the oversight of the auditors of public companies through the establishment of the PCAOB. This oversight program includes a registration requirement, a continuing program of inspections, and the establishment of auditing and related attestation, quality control, ethics and independence standards to be used by registered firms.¹³⁰ In

¹²⁵ 15 U.S.C. § 78o-7(a)(2)(C)(ii)(I).

¹²⁶ The instructions to Form NRSRO allow an applicant that does not have audited financial statements for one or more of the three fiscal or calendar years immediately preceding the date of the initial application to the Commission to provide unaudited financial statements for the applicable year or years. However, the applicant must provide audited financial statements for the fiscal or calendar year ending immediately before the date of the initial application, and the unaudited financial statements must be accompanied by a certification by an authorized person that the financial statements fairly present, in all material respects, the applicant's financial condition, results of operations, and cash flows for the period presented.

¹²⁷ 17 C.F.R. § 240.17g-3(a).

¹²⁸ The Sarbanes-Oxley Act, which was enacted in July 2002 in response to numerous financial-related scandals involving public companies (e.g., Enron and WorldCom) and their auditors (e.g., Arthur Andersen), established the PCAOB as a nonprofit corporation. The PCAOB's statutory mission is to "protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports for companies the securities of which are sold to, and held by and for, public investors." Section 101(a) of the Sarbanes-Oxley Act, 15 U.S.C. § 7211. Section 102(a) of the Sarbanes-Oxley Act requires that accounting firms be registered with the PCAOB, if they "prepare or issue, or . . . participate in the preparation or issuance of, any audit report with respect to any issuer [as defined in Section 3 of the Exchange Act]." 15 U.S.C. § 7212(a).

¹²⁹ 17 C.F.R. § 240.17g-3(a)(1)(iii).

¹³⁰ See <http://www.pcaobus.org> for additional information on the PCAOB's oversight of public accounting firms.

contrast, Rule 2-01 of Regulation S-X is limited in scope and “is designed to ensure that auditors are qualified and independent of their audit clients both in fact and in appearance.”¹³¹ The Rule lists a number of factors as “generally guidance only” and provides that the Commission will consider all relevant facts and circumstances in determining whether an accountant is independent.¹³²

During our review, we learned of the following examples of significant problems identified by Commission staff with the audited financial statement information provided by NRSROs, which are particularly noteworthy because none of the NRSROs in these examples used auditing firms that were subject to PCAOB oversight:



- TM had suspicions regarding the accuracy of the financial information a CRA [redacted] provided in its application for registration as an NRSRO, as noted above.

In light of these examples and TM’s reliance on a CRA’s financial statements to assess its financial resources in connection with its application for NRSRO registration and thereafter, our review found that requiring the CRA’s auditor to

¹³¹ 17 C.F.R. § 210.2-01.

¹³² Id.

¹³³ [redacted] Commission Rule 17g-5(c)(1) prohibits an NRSRO from issuing or maintaining a credit rating solicited by a person that, in the most recent fiscal year, provided the NRSRO with net revenue equal to or exceeding ten percent of the NRSRO’s total net review for the fiscal year. 17 C.F.R. § 240.17g-5(c)(1).

¹³⁴ [redacted]

¹³⁵ [redacted]

¹³⁶ [redacted]

register with the PCAOB and be subject to its comprehensive program of oversight would be in the public interest.

Recommendation 12:

The Chairman, in concert with the other Commissioners, shall review the Office of Inspector General's findings concerning PCAOB oversight of NRSRO auditors, and as appropriate and as part of their broader analysis of issues pertaining to Nationally Recognized Statistical Rating Organizations (NRSROs), direct the Division of Trading and Markets (TM), in consultation with the Office of the Chief Accountant, the Office of Risk Assessment and the Office of the General Counsel, to seek legislative authority to provide the Public Company Accounting Oversight Board (PCAOB) with oversight over audits of NRSROs. If that authority is obtained, TM should recommend rules that require NRSROs and credit rating agencies seeking to become NRSROs to use auditors that are overseen by the PCAOB.

Consulting and Advisory Services

Most NRSROs perform consulting and advisory services in addition to issuing credit ratings. Providing such services to an entity as to which the NRSRO has issued a credit rating may create a conflict of interest.¹³⁷

Section 15E(h)(2) of the Exchange Act provides that the Commission should prohibit or require NRSROs to disclose and manage conflicts of interest relating to an NRSRO's provision of consulting, advisory, or other services to the obligor or any affiliate of the obligor.¹³⁸ Under Commission Rule 17g-5(b)(3), which was adopted in June 2007, a person within an NRSRO is prohibited from having a conflict of interest as a result of "being paid for services in addition to determining credit ratings by issuers, underwriters, or obligors that have paid the [NRSRO] to determine a credit rating," unless the NRSRO has disclosed the conflict and has established and is managing and enforcing written policies and procedures to address and manage the conflict.¹³⁹ The Commission stated that it did not receive any comments on the proposal for this provision and adopted the requirement as substantially proposed.¹⁴⁰

¹³⁷ Similar conflicts of interest existed in accounting profession until Section 201 of the Sarbanes-Oxley Act, 15 U.S.C. § 78j-1(a)(g), was enacted in 2002.

¹³⁸ 15 U.S.C. § 78o-7(h)(2),

¹³⁹ 17 C.F.R. § 240.17g-5(b)(3).

¹⁴⁰ Exchange Act Release No. 34-55857 at 138.

On February 2, 2009, the Commission issued a release that added a new paragraph to Rule 17g-5 that prohibited an NRSRO from performing a narrow category of consulting services, as follows:

Under this paragraph, an NRSRO is prohibited from issuing or maintaining a credit rating with respect to an obligor or security where the NRSRO or a person associated with the NRSRO made recommendations to the obligor or the issuer, underwriter, or sponsor of the security about the corporate or legal structure, assets, liabilities, or activities of the obligor or issuer of the security. The purpose of this rule is to address the potential lack of impartiality that could arise when an NRSRO determines a credit rating based on a corporate structure that was developed after consultations with the NRSRO or its affiliate on how to achieve a desired credit rating. In simple terms, the rule prohibits an NRSRO from rating its own work or the work of an affiliate.¹⁴¹ [Emphasis added.]

This rule amendment, however, does not prohibit an NRSRO from providing other types of consulting and advisory work for the issuer being rated. We noted that IOSCO's Code of Conduct addresses the possible conflicts of interest created by CRA consulting businesses as follows:

A CRA should separate, operationally and legally, its credit rating business and CRA analysts from any other businesses of the CRA, including consulting businesses, that may present a conflict of interest. A CRA should ensure that ancillary business operations which do not necessarily present conflicts of interest with the CRA's rating business have in place procedures and mechanisms designed to minimize the likelihood that conflicts of interest would arise. A CRA should also define what it considers, and does not consider, to be an ancillary business and why.¹⁴² [Red-line markings omitted.]

¹⁴¹ Exchange Act Release No. 34-59342 at 38-39. See 17 C.F.R. § 17g-5(c)(5).

¹⁴² The Technical Committee of the International Organization of Securities Commissions, Code of Conduct Fundamentals for Credit Rating Agencies, (Revised May 2008), <http://www.fsa.go.jp/inter/ios/20080609-1/04.pdf>, at 7-8, Code of Conduct Section 2.5. According to an IOSCO report, all but two of the NRSROs (EJR and Lace) have partially, substantially or fully adopted IOSCO's CRA Code. Technical Committee of the International Organization of Securities Commissions, A Review of Implementation of the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies (Mar. 2009). The EU's regulation does not prohibit CRAs from performing ancillary activities for the issuers for which they perform credit rating services, but recognizes that "[t]he performance of ancillary activities should not compromise the independence or integrity of their credit rating activities." EU Regulation at 5, Preamble, Point (2d).

In addition, some of the larger NRSROs have recognized the need to segregate non-rating consulting services from their ratings business.¹⁴³ The Obama Administration's recent legislative proposal would strengthen credit rating independence by barring CRAs from consulting with any company they also rate, although the Commission would have authority to grant exemptions from this prohibition on a case-by-case basis.¹⁴⁴

Our review found that the potential conflicts of interest created by NRSROs performing other types of consulting and advisory work for issuers could have a significant negative effect on the quality of credit ratings. For example, during its 2002 NRSRO examinations, OCIE found the following issues:

- "Individuals at [REDACTED] with responsibility for Enron's rating may have been influenced by [REDACTED] business relationship with Enron. The Staff reviewed emails from [REDACTED] in which [REDACTED] ratings employee discussed proposals for generating additional revenue from Enron through potential business alliances and in which an [REDACTED] ratings employee commented that if Enron filed for bankruptcy, [REDACTED] would lose \$1 million dollars in revenue."¹⁴⁵ [Emphasis added.]
- "At this time, the rating services divisions of each of the NRSROs account for a large majority of NRSRO revenue. However, each NRSRO is diversifying its activities and expanding its services. Such new services include the rating assessment services addressed above as well as other informational services paid through subscriptions [REDACTED]

¹⁴³ A Moody's official has represented that Moody's "recently reorganized its operating businesses to formalize the separation of [its] ratings-related and non-rating activities into two different business units." Turmoil in U.S. Credit Markets: The Role of the Credit Rating Agencies: Hearing before the S. Comm. on Banking, Housing and Urban Affairs, 110th Cong. (April 22, 2008) (Testimony of Claire Robinson, Senior Managing Director, Moody's Investor Service) at 10. Similarly, S&P has stated, ". . . S&P's credit ratings business does not provide consulting services to the issuers [S&P] rates. We do not advise issuers about how to conduct their business, whether to seek financing, or how and when to approach the capital markets. Additionally, our ratings analysts are strictly segregated from other S&P activities and those of our parent company, The McGraw-Hill Companies, Inc." Credit Rating Agencies and the Financial Crisis: Hearing before the H. Comm. on Oversight and Governmental Reform, 110th Cong. (October 22, 2008) (Testimony of Deven Sharma, President, Standard & Poor's), <http://oversight.house.gov/documents/20081022125052.pdf>, at 13.

¹⁴⁴ Treasury Fact Sheet at 1; Administration Legislative Proposal, § 933. http://www.financialstability.gov/docs/regulatoryreform/titleX_subtC.pdf

¹⁴⁵ [REDACTED]

To the extent that these other services begin to generate substantial revenue from issuers, the potential conflict increases between the need to please the issuers paying for those services and the need to provide independent, objective ratings of those same issuers. If a large portion of that revenue comes from a small number of few issuers, the concern about that potential conflict will heighten even further. The potential for this conflict is akin to the auditor independence issue relating to auditors offering corporate consulting services to their auditing clients.”¹⁴⁶ [Emphasis added.] [Footnote omitted.]

In addition, the Commission’s 2003 Concept Release raised concerns about NRSROs performing consulting and advisory work for the entities they rate.¹⁴⁷ Specifically, the 2003 Concept Release stated as follows:

Some also believe that conflicts of interest can arise when credit rating agencies offer consulting or other advisory services to the entities they rate. The NRSROs generally represent that they have established extensive guidelines to manage conflicts in this area, including firewalls to separate their ratings services from other ancillary businesses. They also indicate that advisory services presently represent a very small portion of their total revenues. Commenters have also expressed concern that conflicts in this area could become much greater if these ancillary services were to become a substantial portion of an NRSRO’s business, and suggestions were made that their percentage contribution to the total revenues of an NRSRO be capped. Others were concerned that issuers could be unduly pressured to purchase advisory services, particularly in cases where they were solicited by a rating analyst at an NRSRO.¹⁴⁸ [Emphasis added.]

Based on our review of each NRSRO’s most recent financial report on sources of revenue, we found that, contrary to the statement in the 2003 Concept Release, services other than credit ratings, including consulting and advisory services, are a significant revenue source for some NRSROs, either in terms of the total

¹⁴⁶ ██████████. OCIE recognized that “[t]his conflict may be mitigated by the fact that some of the users of non-rating services may not issue debt instruments and therefore, may not need be rated by the NRSROs.” ██████████.

¹⁴⁷ Securities Act Release No. 33-8236 at 10-11.

¹⁴⁸ Id.

revenue generated and/or as a percentage of total revenues.¹⁴⁹ Table 1 below contains an analysis of revenues reported by the ten existing NRSROs.¹⁵⁰

Table 1: Comparison of NRSRO Revenue from Other Services and Products vs. Total Revenue

NRSRO	REVENUE FROM OTHER SERVICES AND PRODUCTS	TOTAL REVENUE	PERCENTAGE OF TOTAL REVENUE
██████████	\$32.9 million	\$96.3 million	34.16%
██████████	\$7.2 million	\$55 million	13.09%
██████████	\$.5 million	\$2.6 million	19.23%
██████████	\$31 million	\$702 million	4.42%
██████████	\$0	\$18.2 million	0.00%
██████████	\$5,000	\$1.038 million	.48%
██████████	\$0	\$1,269 million	0.00%
██████████	\$4.1 million	\$10.4 million	39.42%
██████████	\$5.8 million	\$46.3 million	12.53%
██████████	\$119 million	\$1,640 million	7.26%

Source: Data provided by TM based on the most recent NRSRO Annual Financial Reports.

Moreover, several CRAs (e.g., ██████████) disclosed in their NRSRO applications (Exhibit 6 to Form NRSRO) that they were paid for services in addition to determining credit ratings by issues, underwriters, or obligors that had paid the CRA for a credit rating.

Accordingly, our review found that further restrictions on these other types of services may be in the public interest. Specifically, our review found that revenue from services other than credit ratings, including consulting and advisory

¹⁴⁹ It should be noted at the time the 2003 Concept Release was published, there were only four NRSROs (Moody's, S&P, Fitch and DBRS.)

¹⁵⁰ The amounts in this table were obtained from TM based upon the NRSROs' most recent annual financial reports, which are furnished to the Commission on a confidential basis under Section 15E(k) of the Exchange Act. The Commission's rules require that the NRSROs furnish this information within 90 calendar days after the end of the firm's fiscal year, see 17 C.F.R. § 240.17g-3(a)(3). The revenue from other services and products amount for one NRSRO ██████████ was based upon a percentage estimate provided by the firm as it did not give dollar amounts for revenue detail. In addition, the revenue amounts for three NRSROs (██████████) were converted from foreign currency.

services, can be significant for some NRSROs. To the extent these services are performed for issuers, underwriters or obligors that pay the NRSROs for credit ratings, the quality of credit ratings could be adversely affected. We are recommending, therefore, that OCIE perform examination work to determine whether the quality of credit ratings is being adversely affected by NRSROs performing consulting and advisory services for issuers, underwriters or obligors that have paid the NRSROs for credit ratings, and that TM analyze this issue. If warranted by the results of OCIE's examination work and TM's analysis, TM should recommend that the Commission propose appropriate rules designed to prevent an NRSRO's consulting and advisory services from potentially adversely affecting the quality of credit ratings. As necessary, the Commission could exempt smaller NRSROs from any restrictions on providing such services in order to promote competition in among NRSROs.

Recommendation 13:

The Office of Compliance Inspections and Examinations should perform examination work to determine whether the quality of credit ratings is being adversely affected by Nationally Recognized Statistical Rating Organizations (NRSROs) performing consulting and advisory services for issuers, underwriters or obligors that have paid the NRSROs for credit ratings.

Recommendation 14:

The Division of Trading and Markets (TM), in consultation with the Office of Compliance Inspections and Examinations (OCIE), the Office of Economic Analysis, the Office of International Affairs, and the Office of Risk Assessment, should assess the impact of the provision of consulting and advisory services on the quality of credit ratings and how best to minimize the potential harmful effects, without unduly limiting competition among the Nationally Recognized Statistical Rating Organizations (NRSROs). If warranted by the results of OCIE's examination work and TM's analysis, TM should recommend that the Commission propose appropriate rules designed to prevent an NRSRO's consulting and advisory services from potentially adversely affecting the quality of credit ratings.

Monitoring of Credit Ratings

After an NRSRO issues a credit rating, it typically monitors (i.e., conducts surveillance of) the credit rating, although it is not required to do so. The purpose of this monitoring is to determine whether the credit rating needs to be changed based on new information. The monitoring process, including the amount of resources devoted to it, varies among the NRSROs.

In 2002, the Senate staff's report on Enron's bankruptcy raised questions about the NRSROs' credit rating monitoring process because the three major NRSROs did not lower their credit ratings of Enron to below investment grade until four days prior to its bankruptcy filing.¹⁵¹ In 2005, when the Commission proposed a rule to define the term NRSRO, the former Director of TM stated at the open Commission meeting on the proposed rule as follows:

The proposed definition also requires that credit ratings are kept current – meaning that such ratings are actively monitored on a continuous basis. Some credit rating agencies that review and update their credit ratings only on a periodic basis have sought NRSRO no-action relief. The staff believes that credit ratings used for regulatory purposes should be actively monitored on a continuous basis and confirmed, upgraded, or downgraded, if and when necessary.¹⁵² [Emphasis added.]

The Commission's proposed rule defining the term "NRSRO" included a requirement that, in order to qualify as an NRSRO, the CRA's credit ratings must be "current," i.e., that they "are actively monitored and updated appropriately on a continuous basis"¹⁵³ Notwithstanding the recognized importance of monitoring credit ratings, the Commission did not propose mandating how frequently NRSROs needed to monitor their credit ratings, e.g., monthly, quarterly, or annually.¹⁵⁴ In the proposed rule release, the Commission concluded as follows:

Specifying a time period within which a credit rating agency must update or affirm a rating might be problematic because the appropriate time period for responding to a material event may vary considerably based on, for example, the complexity of an issuer or the specific security being rated. Accordingly, it may be appropriate

¹⁵¹ Senate Staff Report at 97. Office of International Affairs (OIA) staff pointed out that the existence of rating triggers in many of Enron's debt agreements contributed to the timing of Enron's decision to declare bankruptcy shortly after the major NRSROs downgraded its debt below investment grade. Accordingly, the degree of the downgrade, rather than its timing, may be of more importance.

¹⁵² Annette Nazareth, Director, Division of Market Regulation, Securities and Exchange Comm'n, NRSRO Proposal Opening Statement at March 3, 2005 Commission Meeting (Mar. 4, 2005), <http://www.sec.gov/news/speech/spch030305aln.htm>, at 2.

¹⁵³ Proposed Rule: Definition of Nationally Recognized Statistical Rating Organization, Securities Act Release No. 33-9570 (Apr. 19, 2005), <http://www.sec.gov/rules/proposed/33-8570.pdf>, at 26.

¹⁵⁴ The EU's regulation provides that a "credit rating agency shall monitor credit ratings and review its credit ratings and methodologies on an ongoing basis and at least annually, in particular where material changes occur that could have an impact on a credit rating. A credit rating agency shall establish internal arrangements to monitor the impact of changes in macroeconomic or financial market conditions on credit ratings." EU Regulation at 24, Article 7, Point 4 (emphasis omitted).

for a credit rating agency to have the flexibility to respond to material events relating to its ratings on a case-by-case basis. This approach responds to comments that the Commission should not set detailed standards as to when a rating agency should update its ratings.¹⁵⁵

Moreover, the Commission never acted on the 2005 proposed rule that would have required active monitoring of credit ratings on a continuous basis.¹⁵⁶

Further, the SEC's 2008 NRSRO examinations found that the surveillance processes used by S&P, Moody's, and Fitch appear to have been less robust than the processes used for their initial ratings.¹⁵⁷ Specifically, SEC staff identified several problems with these NRSROs' surveillance efforts, as follows:

- The adverse impact of the amount of resources devoted to surveillance of credit ratings on the timeliness of surveillance efforts;
- Poor documentation of the surveillance performed; and
- The lack of written surveillance procedures.¹⁵⁸

Accordingly, our review found that a specific credit rating monitoring requirement, including the upgrading or downgrading of ratings as appropriate, could improve the quality of credit ratings and, therefore, would be in the public interest.

Recommendation 15:

The Chairman, in concert with the other Commissioners, shall review the Office of Inspector General's findings on monitoring of credit ratings and, as appropriate and as part of their broader analysis of issues pertaining to Nationally Recognized Statistical Rating Organizations (NRSROs), direct the Division of Trading and Markets (TM), in consultation with the Office of Compliance

¹⁵⁵ *Id.* at 27.

¹⁵⁶ On February 2, 2009, the Commission adopted rule amendments that required NRSROs to disclose the frequency of their surveillance efforts and how changes to their quantitative and qualitative ratings models are incorporated into the surveillance process. Amendments to Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 34-59342 (Feb. 2, 2009) at 15. Proposed legislation would require NRSROs to "notify users of credit ratings when a change is made to a procedure or methodology, including to a qualitative or quantitative model, or an error is identified in a procedure or methodology that may result in credit rating actions, and the likelihood of the change resulting in current credit ratings being subject to rating actions." S. 1073, 111th Cong. § 3 (2009). See also Administration Legislative Proposal § 932.

¹⁵⁷ 2008 Summary Report at 21.

¹⁵⁸ *Id.* at 21-22.

Inspections and Examinations, the Office of Economic Analysis, the Office of International Affairs (OIA), the Office of Risk Assessment, and the Office of the General Counsel, to recommend appropriate rules to implement a comprehensive credit rating monitoring requirement for Nationally Recognized Statistical Rating Organizations (NRSROs). TM should also meet with OIA periodically (e.g., quarterly) to discuss the effects that any foreign laws or rules regarding credit rating monitoring are having, or may have, on the NRSROs.

Credit Rating Analyst Rotation

The larger NRSROs use a rating committee process under certain circumstances, including to rate a new issuer or instrument, assess a major transaction or event that might impact a current rating, or to consider reviewing a rating for change.¹⁵⁹ The lead credit rating analyst frames the issues and presents most of the data under consideration, although the opinions of all members are considered and vetted resulting in a non-public memorandum discussing the committee's decision, rationale, assumptions and underlying data.¹⁶⁰

Our review found that concerns exist as to whether credit rating analysts are or could be subject to undue influence (i.e., pressure to rate a security higher than it should be rated). As part of reforms designed to enhance the integrity of the ratings process and to safeguard against factors that could challenge that process, S&P agreed to implement periodic rotations for lead analysts to "help prevent long-standing professional or personnel relationships from affecting ratings."¹⁶¹ These changes are consistent with the EU's regulation on CRAs, which states as follows:

Long lasting relationships with the same rated entities or its related third parties could compromise the independence of analysts and persons approving credit ratings. Therefore those analysts and persons should be subject to an appropriate rotation mechanism which should provide for a gradual change in analytical teams and credit rating committees.¹⁶² [Emphasis omitted.]

¹⁵⁹ 2003 Sarbanes-Oxley Act Report at 26. Our review of the NRSROs' filings with the Commission indicated that all but one (LACE) employ a rating committee process.

¹⁶⁰ Id.

¹⁶¹ Turmoil in U.S. Credit Markets: The Role of the Credit Rating Agencies: Hearing before the S. Comm. on Banking, Housing and Urban Affairs, 110th Cong. (April 22, 2008) (testimony of Vickie A. Tillman, Executive Vice President, Standard & Poor's Credit Rating Services), at 3.

¹⁶² EU Regulation at 9, Preamble, Point (13). The EU's regulation does provide that competent authorities should be able to exempt CRAs employing fewer than 50 employees from certain of the rules' requirements, including the rotation mechanism. Id. at 9, Preamble, Point (12a).

The EU's regulation also requires an annual transparency report that includes "a description of the management and analyst rotation policy."¹⁶³

During our review, we also examined concerns that had arisen with respect to other gatekeepers in the securities industry and how those concerns had been addressed. We discovered that when faced with a concern about undue influence in the accounting profession, legislation was enacted in Section 203 of the Sarbanes-Oxley Act, as follows:

It shall be unlawful for a registered public accounting firm to provide audit services to an issuer if the lead (or coordinating) audit partner (having primary responsibility for the audit), or the audit partner responsible for reviewing the audit, has performed audit services for that issuer in each of the 5 previous fiscal years of that issuer.¹⁶⁴

In its rule implementing Section 203 of the Sarbanes-Oxley Act, the Commission required that the lead partner and concurring partner "rotate after five years and, upon rotation, be subject to a five-year 'time out' period."¹⁶⁵ The Commission explained in its rule release that "[b]ecause of the importance of achieving a fresh look to the independence of the audit function," it believed "that a five-year time-out period is appropriate for these two partners."¹⁶⁶

Our review found, therefore, that given the similar potential for undue influence in the CRA industry, a credit rating analyst rotation requirement could likewise bring a "fresh look" to the independence of the credit rating process and reduce the likelihood of undue pressure on credit rating analysts and, at the same time, improve the quality of credit ratings.

¹⁶³ Id. at 51. OIA pointed out several reasons why the EU's regulation may not be an appropriate model to follow with respect to analyst rotation. For example, it has been suggested that analyst rotation could undermine the independence of lead analysts, who otherwise may have developed a level of industry expertise that would make them less reliant on information provided by issuers. Likewise, legislative proposals mandating analyst rotation may conflate the roles of CRAs, which might be described as "forward-focused," using their own methodologies to predict future probabilities, and independent auditors, which might be described as "backwards-focused," using formalized auditing standards to confirm the accuracy of statements regarding historic facts.

¹⁶⁴ 15 U.S.C. § 78j-1(j).

¹⁶⁵ Final Rule: Strengthening the Commission's Requirements Regarding Auditor Independence, Securities Act Release No. 33-9193 (Jan. 28, 2003), <http://www.sec.gov/rules/final/33-8183.htm>, at 24.

¹⁶⁶ Id. It should be noted that the Sarbanes-Oxley Act and related SEC rules require rotation of audit partners, but not rotation of audit teams. It has been suggested that lead analysts at NRSROs are more like members of an audit team than they are like lead auditors.

Recommendation 16:

The Office of Compliance Inspections and Examinations should perform examination work into whether, and under what circumstances, credit rating analysts face undue influence and the effects of such undue influence on the credit ratings issued by Nationally Recognized Statistical Rating Organizations.

Recommendation 17:

The Division of Trading and Markets (TM), in consultation with the Office of Compliance Inspections and Examinations (OCIE), the Office of International Affairs (OIA), and the Office of Risk Assessment, should assess the effects of undue influence on the quality of credit ratings and the potential benefits of a credit analyst rotation requirement. Depending on the results of OCIE's examination work and TM's analysis, TM should recommend rules to address the risk of undue influence. TM should also meet with OIA periodically (e.g., quarterly) to discuss the effects that any foreign laws or rules on credit rating analyst rotation are having, or may have, on the Nationally Recognized Statistical Rating Organizations. If necessary, the Commission should seek legislative authority to implement the proposed rules designed to address the risk of undue influence.

Credit Ratings Disclosures

Concerns have previously been identified with NRSROs generally not sufficiently probing information provided by issuers. For example, the Senate staff's report on Enron's bankruptcy criticized the NRSROs for relying too extensively on information provided by Enron.¹⁶⁷ According to the report, it appeared "that the credit raters took Enron at their word and failed to probe more deeply."¹⁶⁸ Moreover, if the issuer is paying for the credit rating, an NRSRO might have an incentive to take the issuer's statements at face value in order to obtain further business from the issuer.

On February 2, 2009, the Commission issued a release adopting amendments (to the instructions of Exhibit 2 of Form NRSRO) to require disclosure regarding the amount of due diligence performed in determining credit ratings. Specifically, the release stated as follows:

The Commission also is amending the instructions to Exhibit 2 to Form NRSRO to require enhanced disclosures about the procedures and methodologies an NRSRO uses to determine credit

¹⁶⁷ Senate Staff Report at 115-122.

¹⁶⁸ *Id.* at 115-16.

ratings, including whether and, if so, how information about verification performed on assets underlying a structured finance transaction is relied on in determining credit ratings; whether and, if so, how assessment of the quality of originators of assets underlying a structured finance transaction factor into the determination of credit ratings; and how frequently credit ratings are reviewed, whether different models are used for ratings surveillance than for determining credit ratings, and whether changes made to models and criteria for determining initial ratings are applied retroactively to existing ratings.¹⁶⁹

However, only one of the three additional disclosure requirements (pertaining to the disclosures regarding surveillance efforts) applies to securities other than structured products despite the events surrounding Enron's bankruptcy (which affected the timely repayment of principal and interest on Enron's corporate bonds). Further, the rule does not require that NRSROs disclose any significant limitations and assumptions surrounding the credit rating or the data used in developing the credit rating. The Commission previously considered requiring such disclosures, as the Commission's 2003 Concept Release asked about these types of issues as follows:

Question 50: Specifically, should NRSRO recognition be conditioned on a rating agency disclosing the key bases of, and assumptions underlying its rating decisions? If so, should these disclosures be made pursuant to standards developed by the industry, or otherwise?

* * *

Question 52: Should NRSRO recognition be conditioned on a rating agency's disclosing whether or not an issuer participated in the rating process? Or, could issuers be required to make such disclosures?¹⁷⁰

Some of the public comment letters supported enhanced credit rating disclosures, while other comment letters did not.¹⁷¹

¹⁶⁹ Exchange Act Release 34-59342 at 77-78. In addition, as part of the settlement with the NYAG, S&P, Moody's and Fitch agreed to the following reform: "Credit rating agencies will develop criteria for the due diligence information that is collected by investment banks on the mortgages comprising an RMBS. The credit rating agencies will receive loan level results of due diligence and review those results prior to issuing ratings. The credit rating agencies will also disclose their due diligence criteria on their websites." NYAG Press Release at 1.

¹⁷⁰ Securities Act Release No. 33-8236 at 15.

¹⁷¹ See comments posted at <http://www.sec.gov/rules/concept/s71203.shtml>.

The RATE Act would, among other things, require the Commission to establish a form for NRSROs to make numerous disclosures including the main assumptions used in credit rating procedures and methodologies, the potential shortcomings of the credit ratings, the use of third party due diligence services, an explanation or measure of the potential volatility for the rating, etc.¹⁷² Further, Chairman Schapiro described the following area as one in which positional reform is needed:

Requiring more disclosure from credit rating agencies, including potentially the assumptions underlying their methodologies, fees received from issuers, and factors that could change ratings.¹⁷³

Lastly, a recent report issued by the Department of the Treasury on financial regulatory reform stated as follows:

Credit rating agencies should also publicly disclose, in a manner comprehensible to the investing public, precisely what risks their credit ratings are designed to assess (for example, likelihood of default and/or loss severity in event of default), as well as material risks not reflected in the ratings. Such disclosure should highlight how the risks of structured products, which rely on diversification across a large number of individual loans to protect the more senior investors, differ fundamentally from the risks of unstructured corporate debt.

Credit rating agencies should disclose sufficient information about their methodologies for rating structured finance products, including qualitative reviews of originators, to allow users of credit ratings and market observers to reach their own conclusions about the efficacy of the methodologies. Credit rating agencies should also disclose to the SEC any unpublished rating agency data and methodologies.¹⁷⁴

Accordingly, our review found that enhanced credit rating disclosures would better enable investors to make well-informed investment decisions and would be in the public interest.

¹⁷² S. 1073, 111th Cong. § 3 (2009).

¹⁷³ Mary Schapiro, Chairman, Securities Exchange Commission, Address to the Council of Institutional Investors (Apr. 6, 2009), <http://www.sec.gov/news/speech/2009/spch040609mls.htm>, at 5.

¹⁷⁴ Treasury Report at 46. Under the Administration's recent legislative proposal, CRAs would "be required to provide a much fuller picture of the risks in any rated security through the addition of qualitative and quantities disclosure of the risks and performance variance inherent in any given security." Treasury Fact Sheet at 2; see also Administration Legislative Proposal, § 932.

Recommendation 18:

The Chairman, in concert with the other Commissioners, shall review the Office of Inspector General's findings on credit ratings disclosures and, as appropriate and as part of their broader analysis of issues pertaining to Nationally Recognized Statistical Rating Organizations (NRSROs), direct the Division of Trading and Markets, in consultation with the Office of Compliance Inspections and Examination, the Office of Economic Analysis, and the Office of Risk Assessment, to recommend additional rule amendments to enhance the disclosures surrounding the credit ratings process, including, for example, the key assumptions used in credit ratings methodologies and procedures, and any shortcomings of or limitations on credit ratings.

Revolving Door

Concerns have been expressed about a "revolving door" problem created by credit rating analysts leaving to work for issuers as to which the credit rating analyst has provided credit ratings. Such a revolving door could adversely affect the quality of credit ratings because the objectivity of the credit rating analyst could be impaired. One commentator explained the cause of the revolving door problem, as follows:

Given the lower compensation levels of NRSRO analysts relative to their counterparts at investment banks and other issuers, there is a real risk that analysts, seeking to elicit future offers or employment, would compromise their objectivity or ratings quality in an effort to curry favor from those firms whose products they have been called to rate. The numerous examples of NRSRO analysts leaving an NRSRO firm whose securities the analyst had been engaged to rate begs attention and reflection.¹⁷⁵

The Sarbanes-Oxley Act previously addressed a similar revolving door problem in the accounting profession. Specifically, Section 206 of the Sarbanes-Oxley Act prohibits a registered public accounting firm from performing any required audit service for an issuer "if a chief executive officer, controller, chief financial officer, chief accounting officer, or any person serving in an equivalent position for the issuer, was employed by that registered independent public accounting firm and participated in any capacity in the audit of that issuer during the 1-year period preceding the date of the initiation of the audit."¹⁷⁶

¹⁷⁵ Joshua Rosner, Toward an Understanding: NRSRO Failings in Structured Ratings and Discreet Recommendations to Address Agency Conflicts, The Journal of Structured Science (Winter 2009).

¹⁷⁶ 15 U.S.C. § 78j-1(l).

The Commission's rules concerning NRSROs do not address the revolving door issue in any manner. In contrast, IOSCO has recommended that "[a] CRA should establish policies and procedures for reviewing the past work of analysts that leave the employ of the CRA and join an issuer that the analyst has rated, or a financial firm with which an analyst has had significant dealings as an employee of the CRA."¹⁷⁷ Further, the EU's regulation states as follows:

Where a rating analyst terminates his or her employment and joins a rated entity, in the credit rating of which the analyst has been involved, or a financial firm, with which the rating analyst has had dealings as part of his or her duties at the credit rating agency, a credit rating agency shall review the relevant work of [the] analyst over 2 years preceding his departure.¹⁷⁸ [Emphasis omitted.]

In addition, at a hearing held on the recent financial crisis, an S&P official testified that S&P was "[i]mplementing 'look back' reviews when analysts leave to work for an issuer" in order to "safeguard against undue influence by issuers in the ratings process."¹⁷⁹ Similarly, a Moody's official testified that it had adopted a new policy requiring a six-month "look-back" review of the work of a lead credit analyst who leaves Moody's to work for an issuer or a financial intermediary representing the issuer "to confirm the integrity and rigor of that analyst's work."¹⁸⁰ Lastly, both the RATE Act and the Administration's legislative proposal would require look-back reviews when an employee of an obligor, or an issuer or underwriter of a security or money market instrument was employed by a credit rating agency and participated in any capacity in determining credit ratings for the obligor or the securities or money market instruments of the issuer during the one-year period preceding the date of the issuance of the credit rating.¹⁸¹



¹⁷⁷ IOSCO Report at 15, Recommendation 9.

¹⁷⁸ EU Regulation at 47, Annex I, Section C.6. The EU's regulation also states that rating analysts and other persons directly involved in credit rating activities "shall not take up a key management position with the rated entity or its related third party before 6 months have lapsed since the credit rating." *Id.*, Section C.7.

¹⁷⁹ Turmoil in U.S. Credit Markets: The Role of the Credit Rating Agencies: Hearing Before the S. Comm. on Banking, Housing and Urban Affairs, 110th Cong. (April 22, 2008) (testimony of Vickie A. Tillman, Executive Vice President, Standard & Poor's Credit Ratings Services), at 3.

¹⁸⁰ Turmoil in U.S. Credit Markets: The Role of the Credit Rating Agencies: Hearing Before the S. Comm. on Banking, Housing and Urban Affairs, 110th Cong. (April 22, 2008) (testimony of Claire Robinson, Senior Managing Director, Moody's Investor Service), at 10.

¹⁸¹ S. 1073, 111th Cong. § 3 (2009); Administration Legislative Proposal, § 932. These proposals would also require the Commission to conduct periodic reviews of the NRSROs' look-back policies. *Id.*

Based upon the information discussed above, our review concluded that OCIE should further examine whether revolving door is, in fact, harming the quality of credit ratings, and that TM should analyze this issue.

Recommendation 19:

The Office of Compliance Inspections and Examinations should conduct examinations to evaluate whether the revolving door problem is negatively impacting the quality of credit ratings.

Recommendation 20:

The Division of Trading and Markets (TM), in consultation with the Office of Compliance Inspections and Examinations (OCIE), the Office of International Affairs (OIA), and the Office of Risk Assessment should assess the problems presented by the revolving door. Depending on the results of OCIE's examination work and TM's analysis, TM should (1) recommend rules to establish requirements to address the revolving door issue as it relates to Nationally Recognized Statistical Rating Organizations (NRSROs); and (2) meet with OIA periodically (e.g., quarterly) to discuss the effects that any foreign laws or rules designed to address the credit rating agency revolving door problem are having, or may have, on NRSROs. If necessary, the Commission should seek legislative authority to implement the proposed rules designed to address the revolving door issue.

Rule 17g-5 Information Disclosure Program and Proposed Amendment to Regulation Fair Disclosure (FD) Exclusion for NRSROs

In August 2000, the Commission adopted Regulation FD to address selective disclosure of material non-public information in the securities industry. In adopting Regulation FD, the Commission stated as follows:

The regulation provides that when an issuer, or person acting on its behalf, discloses material non[-]public information to certain enumerated persons (in general, securities market professionals and holders of the issuer's securities who may well trade on the basis of the information), it must make public disclosure of that information.¹⁸²

At the time it adopted Regulation FD, the Commission provided an exclusion (Rule 200(b)(2)(iii) of Regulation FD) from the regulation's requirements for

¹⁸² Final Rule: Selective Disclosure and Insider Trading, Securities Act Release No. 33-7881 (Aug. 15, 2000), <http://www.sec.gov/rules/final/33-7881.htm>, at 1.

“disclosures to an entity whose primary business is the issuance of credit ratings, provided the information is disclosed solely for the purpose of developing a credit rating and the entity’s ratings are publicly available.”¹⁸³ In adopting this exclusion, the Commission stated that it was not aware “of any incidents of selective disclosure [of non-public information] involving ratings organizations.”¹⁸⁴

On February 2, 2009, the Commission re-proposed, with substantial modifications, amendments to Rule 17g-5 that were originally proposed on June 16, 2008.¹⁸⁵ The Commission’s re-proposed amendments to Rule 17g-5 would prohibit an NRSRO from issuing a credit rating for a structured finance product paid for by the product’s issuer, sponsor, or underwriter unless the information about the product provided to the NRSRO to determine the credit rating and, thereafter, to monitor the rating is made available to other NRSROs.¹⁸⁶ The goal of this proposal “is to increase the number of ratings extant for a given structured finance security or money market instrument and, in particular, promote the issuance of ratings by NRSROs that are not hired by the arranger.”¹⁸⁷ Simultaneously, the Commission proposed to “amend Rule 100(b)(2)(iii) of Regulation FD to permit the disclosure of material non-public information to NRSROs irrespective of whether they make their ratings publicly available.”¹⁸⁸ According to the Commission, “[t]his would accommodate subscriber-based NRSROs that do not make their ratings publicly available for free and it would accommodate NRSROs that access the information under the proposed Rule 17g-5 disclosure program but ultimately do not issue a credit rating using the information.”¹⁸⁹

¹⁸³ Id. at 7. See 17 C.F.R. § 243.100(b)(2)(iii).

¹⁸⁴ Securities Act Release No. 33-7881 at 7.

¹⁸⁵ Exchange Act Release No. 34-59343. Rule 17g-5, 17 C.F.R. § 17g-5, pertains to NRSRO conflicts of interest.

¹⁸⁶ Specifically, “under the re-proposed amendments: (1) NRSROs that are hired by arrangers to perform credit ratings for structured finance products would need to disclose to other NRSROs (and only other NRSROs) the deals for which they were in the process of determining such credit ratings; (2) the arrangers would need to provide the NRSROs they hire to rate structured finance products with a representation that they will provide information given to the hired NRSRO to other NRSROs (and only other NRSROs); and (3) NRSROs seeking to access information maintained by the NRSROs and the arrangers would need to furnish the Commission an annual certification that they are accessing the information solely to determine credit ratings and will determine a minimum number of credit ratings using the information.” Exchange Act Release No. 34-59343 at 31-32.

¹⁸⁷ Id. at 33.

¹⁸⁸ Id. at 51.

¹⁸⁹ Id.

While the proposed amendments to Rule 17g-5 and Regulation FD may enhance competition among the existing NRSROs by improving the quality of unsolicited credit ratings, they might also adversely impact a CRA that is seeking to become an NRSRO. Under the proposal, only existing NRSROs will have access to the material non-public information. Thus, a CRA that is not an NRSRO (of which there are approximately 57¹⁹⁰) would not have access to potentially valuable information, thereby possibly reducing the quality of its credit ratings.¹⁹¹ As a result, it might be difficult for a CRA that is attempting to become an NRSRO to meet the statutory QIB requirement since QIBs may be reluctant to hire a CRA that has issued credit ratings of questionable quality.¹⁹²

In conclusion, the purpose of the proposed amendments to Rule 17g-5 and Regulation FD is to promote the issuance of unsolicited credit ratings as a means to improve the quality of credit ratings, which is in the public interest. However, we have concerns about the potential adverse effects that the proposed rule amendments could have on CRAs that are seeking to become NRSROs. Accordingly, our review found that an assessment of the potential effects of the proposed amendments on competition in the NRSRO industry would be beneficial.¹⁹³

Recommendation 21:

The Chairman, in concert with the other Commissioners, shall review the Office of Inspector General's findings on the Rule 17g-5 information disclosure program and Regulation Full Disclosure (FD) and, as appropriate and as part of their broader analysis of issues pertaining to Nationally Recognized Statistical Rating Organizations (NRSROs), direct the Division of Trading and Markets, in consultation with the Division of Corporation Finance, the Office of Compliance Inspections and Examinations, the Office of Economic Analysis, and the Office of

¹⁹⁰ This number was obtained from www.defaultrisk.com/rating_agencies.htm, although this does not purport to be a complete list of all of the world's CRAs.

¹⁹¹ Former Director of the Division of Market Regulation Annette Nazareth previously stated that according to a number of market participants, "a rating agency's access to non[-]public information improves the rating process and results in a more informed and complete credit rating." Memorandum from Annette L. Nazareth, former Director, Division of Market Regulation to former Chairman Donaldson, subject: Letter from Chairman Baker on Issues Relating to Rating Agencies (June 4, 2003), <http://www.sec.gov/spotlight/ratingagency/baker060403.pdf>, at 9.

¹⁹² This problem would be eliminated under the Administration's legislative proposal, which would require all CRAs to register as NRSROs.

¹⁹³ While increasing competition among CRAs was one of the stated goals of the Rating Agency Act, some recent academic literature suggests that increased competition may actually lead to lower quality ratings because the incumbent agencies produce more issuer-friendly and less informative ratings when competition is stronger. See Bo Becker and Todd Milbourn, Reputation and competitions; evidence from the credit rating industry, Working Paper 09-051 (2009).

Risk Assessment, to assess the potential effects on competition in the credit rating industry of the re-proposed amendments to Rule 17g-5 and the proposed amendment to Regulation FD and, if appropriate, recommend changes to the rule proposals.

Forum Shopping for Credit Ratings

Forum shopping occurs when an issuer seeks a credit rating from multiple NRSROs, but hires the NRSRO that provides the highest credit rating. This practice results in NRSROs competing with one another as to which NRSRO will give the highest credit rating, and not necessarily which NRSRO will provide the best analysis. Some individuals believe that forum shopping is a fundamental problem among NRSROs.¹⁹⁴

As previously explained, the Rating Agency Act attempted to improve the quality of credit ratings, in part by increasing competition. However, increased competition could actually reduce the quality of credit ratings because increased competition creates a greater potential for forum shopping since there would be more NRSROs competing for a particular line of business (e.g., credit ratings on structured finance products such as RMBS).¹⁹⁵ In fact, [REDACTED] stated as follows:

[REDACTED] stated to the Staff generally that, while increased competition could potentially pose some benefits, it also might result in a marketplace in which issuers shop for the highest rating, regardless of the quality and accuracy of that rating.¹⁹⁶

The June 2008 agreement between the NYAG and S&P, Moody's, and Fitch should reduce the potential for forum shopping for RMBS because these NRSROs are required to disclose whether they performed an initial review of a

¹⁹⁴ See, e.g., Credit Rating Agencies and the Financial Crisis: Hearing Before the H. Comm. On Gov't Oversight and Governmental Reform, 110th Cong. (Oct. 22, 2008) (testimony of Jerome S. Fons, Managing Director, Credit Policy of Moody's Investors Service), <http://oversight.house.gov/documents/20081022102726.pdf>, at 6; Credit Rating Agencies and the Financial Crisis: Hearing Before the H. Comm. On Gov't Oversight and Governmental Reform, 110th Cong. (October 22, 2008) (testimony of Sean J. Egan, Managing Director of Egan-Jones Rating Co.), <http://oversight.house.gov/documents/20081022102906.pdf>, at 9. See also NYAG Press Release, at 1 (stating that investment banks were "able to get free previews of RMBS assessments from multiple credit rating agencies, enabling the investment banks to hire the agency that provided the best rating").

¹⁹⁵ Structured finance products are inherently more susceptible to forum shopping than other types of securities (e.g., corporate bonds) because there is less transparency regarding the underlying assets and the structure of the transaction. Fons, Jerome, White Paper on Rating Competition and Structured Finance (Jan. 10, 2008), <http://www.fonsrisksolutions.com/Documents/Ratings%20White%20Paper.pdf>, at 6-8. (The author is an independent consultant and former Managing Director, Credit Policy, Moody's Investors Service.)

¹⁹⁶ [REDACTED]

securitization but were not hired by the investment bank that requested the credit rating.¹⁹⁷ Further, according to this agreement with the NYAG, issuers must compensate these NRSROs under a fee-for-service structure, under which they will be compensated regardless of whether the NRSRO is ultimately selected to rate a RMBS.¹⁹⁸ This requirement is intended to eliminate the ability of investment banks to obtain a free preview of the credit rating.

The EU's regulation also addresses the problem of forum shopping and state as follows:

Credit rating agencies should take measures to avoid situations where issuers request the preliminary rating assessment of the structured finance instrument concerned from a number of credit rating agencies in order to identify the one offering the best credit rating for the proposed structure. Issuers should also avoid applying such practices.¹⁹⁹

The Commission has not adopted any rules specifically designed to address the problem of forum shopping. However, Chairman Schapiro recently testified that she has "directed the Commission staff to explore possible new regulations in [the NRSRO area], including limiting the potential for rating shopping." Also, we were informed during the review that the Division of Corporation Finance is developing rule recommendations designed to address ratings shopping.²⁰⁰ The increased issuance of unsolicited credit ratings could diminish the adverse consequences of forum shopping because more credit ratings would be available to the public, rather than just the highest credit rating. The Commission's re-proposed information disclosure program discussed above is intended to increase the number and quality of unsolicited credit ratings for structured products, which are more susceptible to forum shopping given their lack of transparency.

In summary, our review found that forum shopping could reduce the quality of credit ratings because issuers would hire an NRSRO based on which NRSRO offered the highest credit rating, as opposed to the quality of the credit rating

¹⁹⁷ NYAG Press Release, at 1.

¹⁹⁸ *Id.*

¹⁹⁹ EU Regulation at 10, Point 19.

²⁰⁰ 7/14/09 Schapiro Testimony at 10; 7/22/09 Schapiro Testimony at 9. According to Chairman Schapiro, "[o]ne possible approach would be to require disclosure by issuers of all pre-ratings obtained from NRSROs prior to selecting a firm to conduct a rating, as well as requiring NRSROs to provide additional disclosures." 7/14/09 Schapiro Testimony at 10. The Administration's legislative proposal would require an issuer to disclose all of the preliminary ratings it received from different CRAs so investors will see how much forum shopping occurred and whether there were discrepancies with the final rating. Treasury Press Release at 2; Administration Legislative Proposal, § 934.

analysis. As a result, we believe that Commission action to limit the potential harmful effects of forum shopping would be in the public interest.

Recommendation 22:

The Chairman, in concert with the Commissioners, shall review the Office of Inspector General's findings on forum shopping for credit ratings and, as appropriate and as part of their broader analysis of issues pertaining to Nationally Recognized Statistical Rating Organizations, direct the Division of Trading and Markets, in consultation with the Office of Compliance Inspections and Examinations, the Office of Economic Analysis, the Office of International Affairs, and the Office of Risk Assessment, to recommend rules designed to reduce the potential harmful effects on the quality of credit ratings caused by forum shopping.

Public Comment on a Firm's Application and the Status of Competition

The Commission currently has no process in place for soliciting and obtaining public comment on a CRA's application for NRSRO registration. The SEC employs a public comment process in other areas, such as applications for registration as a self-regulatory organization, see Section 19(a)(1) of the Exchange Act.²⁰¹ Also, the Federal Communications Commission uses a public comment process to obtain pertinent information to evaluate radio broadcasters' license renewal applications and to assess the state of competition in the wireless telecommunications industry.²⁰² The Commission's 2003 Concept Release inquired as to whether public comments should be sought initially on a CRA's application for NRSRO designation, and periodically after the Commission designates a CRA as an NRSRO (in order to assess the credibility and reliability of an NRSRO's credit ratings).²⁰³ The Commission received many comments supporting one or both of these concepts, but never acted on the concept release.²⁰⁴

²⁰¹ 15 U.S.C. § 78s(a).(1).

²⁰² See 47 C.F.R. § 73.3580(d)(4)(i)(requiring those filing renewal applications and amendments thereto to include in their pre-filing announcement a statement that "[i]ndividuals who wish to advise the FCC of facts relating to [the] renewal application and to whether [the] station has operated in the public interest should file comments and petitions with the FCC" by a certain date); Public Notice, Federal Communications Commission, Wireless Telecommunications Bureau Seeks Comment on Commercial Mobile Radio Services Market Competition (Feb. 25, 2008), http://fjallfoss.fcc.gov/edocs_public/attachmatch/DA-08-453A1.pdf.

²⁰³ Securities Act Release No. 33-8236 at 9-10, Questions 26 and 31.

²⁰⁴ See <http://www.sec.gov/rules/concept/s71203.shtml> for a listing of the comments submitted in response to the 2003 Concept Release.

Accordingly, our review found that soliciting public comments could enhance the Commission's oversight of NRSROs because securities industry professionals could offer unique insights regarding, in particular, the current state of competition among NRSROs that could augment TM's analysis of market competition (which currently is significantly based on numerical data).²⁰⁵ Further, public comments could, for example, assist TM in identifying NRSROs that are not following their stated procedures and methodologies or firms that do not have sufficient financial and managerial resources to warrant NRSRO registration.

Recommendation 23:

The Chairman, in concert with the other Commissioners, shall review the OIG's findings on public comment on a firm's application and the status of competition and, as appropriate and as part of their broader analysis of issues pertaining to Nationally Recognized Statistical Ratings Organizations (NRSROs), direct the Division of Trading and Markets, in consultation with the Office of Compliance Inspections and Examinations, the Office of Economic Analysis, and the Office of Risk Assessment, to incorporate the seeking and consideration of public comments into the Securities and Exchange Commission's NRSRO oversight process.

Finding 5: The SEC's Annual Report to Congress on NRSROs Should be Improved

The Rating Agency Act requires the Commission to prepare an annual report to Congress. Our review has identified several improvements to assist Congress in its oversight.

Section 6 of the Rating Agency Act requires the Commission to prepare an annual report to Congress regarding NRSROs. Specifically, the Rating Agency Act requires that the Commission's report, for the year to which the report relates:

- (1) identifies applicants for registration under section 15E of the Securities Exchange Act of 1934, as added by this Act;
 - (2) Specifies the number of and actions taken on such applications;
- and

²⁰⁵ Such information would also be of assistance to the Commission in connection with its annual report to Congress on the state of competition, transparency, and conflicts of interest among NRSROs that is required by Section 6 of the Rating Agency Act. Pub. L. 109-291, § 6. See Finding 5 below.

(3) specifies the views of the Commission on the state of competition, transparency, and conflicts of interest among nationally recognized statistical rating organizations.²⁰⁶

Our review identified several issues that we believe should be included in future annual reports, including:

- An assessment of whether the quality of credit ratings has improved since the Rating Agency Act was enacted.
- Whether the cost of credit ratings has been reduced as a result of increased competition since the enactment of the Rating Agency Act.²⁰⁷
- The views of the Federal Trade Commission²⁰⁸ and/or the Antitrust Division of the Department of Justice²⁰⁹ on how to assess competition in the NRSRO industry, unless the Commission acquires this type of experience and expertise.
- A summary of the public's comments on the status of competition in the NRSRO (if this information is obtained, see Recommendation 23).
- An assessment on the adequacy of the Commission's resources (e.g., the number of staff and their technical expertise) devoted to NRSRO oversight.
- The effects, if any, of foreign laws and rules regarding CRAs on accountability, competition and transparency with respect to NRSROs.
- Suggested legislative changes designed to improve NRSRO oversight.
- The status of the implementation of the recommendations contained throughout this report and any future recommendations pertinent to NRSRO oversight (e.g., from the Government Accountability Office).²¹⁰

²⁰⁶ Pub L. 109-291 § 6.

²⁰⁷ The Senate Committee on Banking, Housing, and Urban Affairs' Report on the Rating Agency Act (S. 3850) stated as follows: "The Committee believes that eliminating the artificial barrier to entry will enhance competition and provide investors with more choices, higher quality ratings, and lower costs." S. Rep. No. 109-326, at 8 (2006)(emphasis added).

²⁰⁸ "The [Federal Trade Commission's] competition mission is to enforce the rules of the competitive marketplace — the antitrust laws. These laws promote vigorous competition and protect consumers from anticompetitive mergers and business practices." FTC Guide to the Antitrust Laws, <http://www.ftc.gov/bc/antitrust/index.shtm>.

²⁰⁹ "For over six decades, the mission of the Antitrust Division [of the Department of Justice] has been to promote and protect the competitive process — and the American economy — through the enforcement of the antitrust laws." Overview, Antitrust Division, <http://www.usdoj.gov/atr/overview.html>.

²¹⁰ Section 7 of the Rating Agency Act requires the Government Accountability Office ("GAO") to perform a study of the implementation and impact of the Act, as described in Appendix II, "Scope and Methodology." The Rating Agency Act requires GAO to report the results of its study not earlier than three years nor later than four years after the date of enactment of the Rating Agency Act, i.e., between September 29, 2009 and

Based upon the work performed during our review, we determined that incorporating the concepts listed above into the SEC's annual report could aid Congress by providing it with additional information on the effectiveness of the Rating Agency Act and the Commission's implementing rules in improving oversight of NRSROs.

Recommendation 24:

The Division of Trading and Markets, in consultation with Office of Compliance Inspections and Examinations, the Office of Economic Analysis, the Office of International Affairs, the Office of Risk Assessment and the Office of the General Counsel, should incorporate the additional concepts identified by the Office of Inspector General's review into the Commission's annual report to Congress on Nationally Recognized Statistical Rating Organizations.

September 29, 2010. P. Law 109-291, § 7. GAO announced in early July 2009 that it was initiating a review of the implementation of the Rating Agency Act. The planned scope of that review includes an assessment of (1) the SEC's implementation and enforcement of the Rating Agency Act, including SEC oversight of NRSROs; (2) the SEC's and market participants' views on the implementation, impact, and effectiveness of the Rating Agency Act and related SEC rules, including their impact on rating quality, financial markets, and competition among CRAs; and (3) the influence of NRSRO ratings or references to them in Federal regulations on investment guidelines and decisions, competition among CRAs, rating quality and regulatory oversight. Letter from Richard J. Hillman, Managing Director, Financial Markets and Community Investment, GAO, to Diego Tomas Ruiz, Executive Director, SEC (July 7, 2009). Further, both the RATE Act and the Administration's legislative proposal would require another GAO study within 30 months of the bill becoming law. S. 1073, 111th Cong. § 6 (2009); Administration Legislative Proposal, §936.

Acronyms

A.M. Best	A.M. Best Company, Inc.
Basel Committee	Basel Committee on Banking Supervision
CDO	Collateralized Debt Obligations
Commission	The Securities and Exchange Commission
CRA	Credit Rating Agency
DBRS	Dominion Bond Rating Service Limited
EJR	Egan-Jones Ratings Company
EU	The European Union
Enron	Enron Corp.
Exchange Act	The Securities Exchange Act of 1934
Fitch	Fitch Inc.
GAAP	General Accepted Accounting Principles
GAO	Government Accountability Office
IOSCO	International Organization of Securities Commissions
JCR	Japan Credit Rating Agency, Ltd
LACE	LACE Financial Corp
Moody's	Moody's Investor Services, Inc.
NRSROs	Nationally Recognized Statistical Rating Organizations
NYAG	New York Attorney General
OCIE	The Office of Compliance Inspections and Examinations
OEA	The Office of Economic Analysis
OGC	The Office of the General Counsel
OIA	The Office of International Affairs
OIG	The Office of Inspector General
PCAOB	Public Company Accounting Oversight Board
QIB	Qualified Institutional Buyer
RATE Act	The Rating Accountability and Transparency Enhancement Act of 2009
Rating Agency Act	The Credit Rating Agency Reform Act of 2006
R&I	Rating and Investment Information Inc.
Realpoint	Realpoint LLC
Regulation FD	Regulation Fair Disclosure
RMBS	Residential Mortgage Backed Securities
S&P	Standard and Poor's Division of the McGraw-Hill Companies Inc.
SEC	The Securities and Exchange Commission

Appendix I

Sarbanes-Oxley Act
TM
U.S.

The Sarbanes Oxley Act of 2002
The Division of Trading and Markets
United States of America

Scope and Methodology

Scope. We reviewed the history of the Commission's involvement with NRSROs beginning in 1994 and focusing on the period after Enron's bankruptcy in 2001. As part of that review, we obtained an extensive amount of information, including Commission concept releases, proposed rule releases, final rule releases, examination reports, staff studies, public hearing transcripts, as well as a Congressional staff investigative report and hearing records. The review also focused on the implementation of and compliance with the Rating Agency Act, which became law on September 29, 2006, and the Commission's rules promulgated thereunder. In order to assess the Commission's efforts to implement the Rating Agency Act's objectives of accountability, competition, and transparency, we obtained from TM all 11 NRSRO applications that had been submitted by ten CRAs, as well as TM's action memoranda to the Commission recommending approval of the applications.²¹¹ We also obtained from TM the NRSROs' subsequent annual amendments to their NRSRO registration and annual financial reports, as well as the Commission's June 2008 annual report as required by Section 6 of the Rating Agency Act. Finally, we obtained information pertinent to the CRAs' involvement in the recent credit crisis and the Commission's response, including Commission proposed rule releases, final rule releases, examination reports, reports prepared by outside organizations and Congressional hearing materials, as well as recently-proposed legislation.

We conducted our review from October 2008 to July 2009.

Methodology. In order to meet the objectives of identifying improvements in the Commission's NRSRO oversight and reviewing the Commission's history with the NRSROs, we obtained and analyzed numerous Commission materials, including NRSRO examination reports and module, concept releases, proposed rule releases, final rule releases, transcripts of hearings (i.e., roundtables), staff studies, and the annual report to Congress on NRSROs. We also reviewed an extensive amount of information from sources outside the Commission, including Congressional investigative reports and hearing materials, proposed legislation, a recent study by the Department of the Treasury, academic papers, and international standards (e.g., the EU's regulation and an IOSCO report and code of conduct). We conducted interviews of several staff from TM, OCIE OIA, OEA and the Office of Risk Assessment in order to obtain an understanding of the

²¹¹ The Commission has designated a total of ten CRAs as NRSROs. One NRSRO submitted two applications – an initial one to issue certain classes of ratings and a second one to issue additional classes of ratings. The Commission has not denied any NRSRO applications.

Commission's role regarding and oversight of NRSROs, to identify areas for improvement and to confirm our findings.

To meet our objective of focusing on the implementation of and compliance with the Rating Agency Act and Commission rules, we conducted detailed testing to determine compliance with the requirements of the Act and the implementing rules. In order to perform our testing, we reviewed all 11 NRSRO applications that were submitted to the Commission since the enactment of the Rating Agency Act in September 2006, and TM's action memoranda to the Commission recommending approval of these applications. We also reviewed the subsequently-filed annual amendments to the firms' NRSRO registration and the annual financial reports required by the Commission's rules. We evaluated these documents to determine compliance with the various requirements of the Rating Agency Act and the Commission's implementing regulations. We also assessed whether, based upon the available information, TM's recommendations that the Commission approve the CRAs' applications for NRSRO designation were appropriate and in the public interest.

In addition, consistent with our objective of identifying improvements in the Commission's NRSRO oversight, we analyzed the CRAs' role regarding Enron's bankruptcy and the recent credit crisis in order to identify policy issues that the Commission should address in order to strengthen the Commission's oversight of NRSROs. We also evaluated recent efforts to strengthen controls over the accounting profession and equity research analysts because accountants and equity research analysts act as critical gatekeepers in the securities industry, as do the NRSROs. We analyzed whether developments and changes made in these other areas could be applied to NRSROs in order to strengthen the Commission's oversight of NRSROs and improve the quality of credit ratings. Finally, we obtained information concerning the public comment process used by the Federal Communications Commission in considering whether the SEC should adopt such a process for evaluating NRSRO applications and assessing the state of competition in the credit rating industry.

Internal/Management Controls. We reviewed internal controls that were considered significant within the context of our objectives. We interviewed staff and management from TM and other organizations and reviewed the processes surrounding the receipt and review of, and recommendations on, applications by CRAs for NRSRO registration, as well as the receipt and review of NRSRO annual filings and certifications.

Criteria

The Credit Rating Agency Reform Act of 2006, Public Law 109-291.

Legislation enacted to improve the quality of credit ratings for the protection of investors and in the public interest by fostering accountability, transparency, and competition in the credit rating industry. Established for the first time a formal application process for CRAs to qualify as NRSROs. Enacted on September 29, 2006.

The Sarbanes-Oxley Act of 2002, Public Law 107-204. Legislation that set new or enhanced standards for all U.S. public companies and public accounting firms. Created the PCAOB to oversee, regulate, inspect and discipline accounting firms in their roles as auditors of public companies. Enacted on July 30, 2002.

Commission Rules Regarding NRSROs, 17 C.F.R. §§ 240.17g-1 to 240.17g-6. Implemented the requirements of the Rating Agency Act. Initially adopted on June 5, 2007, in Exchange Act Release No. 34-55857, and amended on February 2, 2009 in Exchange Act Release No. 34-59342.

Commission Form NRSRO and Accompanying Instructions. Form on which CRAs initially apply for NRSRO designation, apply to rate additional classes of credit ratings, supplement an application, provide the require annual certification and update their registration. Initially adopted by the Commission in Exchange Act Release No. 34-55857, dated June 5, 2007.

Report of the Staff to the Senate Committee on Governmental Affairs on Financial Oversight of Enron: The SEC and Private-Sector Watchdogs. Documented the results of the Committee's review of the financial oversight of Enron and the roles of private sector watchdogs, including the CRAs. Issued on October 8, 2002.

Commission Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets. Addressed topics identified for study by Section 702(b) of the Sarbanes-Oxley Act of 2002. Issued in January 2003.

Commission Concept Release on Rating Agencies and the Use of Credit Ratings under the Federal Securities Laws. Sought comments on various issues relating to CRAs as part of the Commission's review of the role of CRAs in the operation of the securities markets. Issued as Securities Act Release No. 33-8236 on June 4, 2003.

Summary Report of Issues Identified in the Commissions Staff's Examinations of Select Credit Rating Agencies. Summarized issues identified in Commission examinations of three CRAs to review their role in the recent turmoil in the subprime mortgage securities markets. Issued on July 8, 2008.

IOSCO Final Report on the Role of Credit Rating Agencies in Structured Finance Markets and Revised Code of Conduct Fundamentals for Credit Rating Agencies. Contains an analysis of the role CRAs play in the structured finance market and makes recommendations for revisions to IOSCO's CRA Code of Conduct. Issued by IOSCO's Technical Committee in May 2008.

EU's Proposal for a Regulation of the European Parliament and of the council on Credit Rating Agencies. Contains the EU's proposed regulation for CRAs, which play an important role in global securities and banking markets. The European Parliament approved the proposed regulation as amended on April 23, 2009, and the European Council approved the regulation on July 27, 2009.

Department of Treasury Report on Financial Regulatory Reform. Proposed several reforms to restore confidence in the integrity of the U.S. financial system in light of the recent financial crisis. Recommended reforms include the strengthening of SEC regulation of CRAs. Issued in June 2009.

List of Recommendations

Recommendation 1:

The Division of Trading and Markets (TM) should ensure that all significant issues identified in the application review process are resolved before it recommends that a credit rating agency (CRA) be registered as a Nationally Recognized Statistical Rating Organization. One way to resolve issues would be to require that the Office of Compliance Inspections and Examinations complete an examination of a CRA before TM makes a recommendation on the application to the Securities and Exchange Commission (which would require additional legislative authority, see Recommendation 9).

Recommendation 2:

The Division of Trading and Markets, in consultation with the Office of Compliance Inspections and Examinations (OCIE) and the Office of Economic Analysis, should evaluate whether action should be taken regarding the credit rating agency (CRA) that was granted registration as a Nationally Recognized Statistical Rating Organization (NRSRO), despite the numerous significant problems identified with its application. These actions could include, as deemed appropriate, making a referral to the Division of Enforcement for consideration of censure, suspension, or other remedies specified in Section 15E(d) of the Securities Exchange Act of 1934. The evaluation should consider any new information obtained (e.g., from the OCIE examination of the CRA) since the CRA's application approved.

Recommendation 3:

The Division of Trading and Markets should ensure that all pending issues identified during the application process involving the credit rating agencies that the Securities and Exchange Commission approved as Nationally Recognized Statistical Rating Organizations are resolved within six months of the date of issuance of the Office of Inspector General's report.

Recommendation 4:

The Division of Trading and Markets, in consultation with the Office of Economic Analysis and the Office of Compliance Inspections and Examinations, should

develop measures for determining whether subscriber fees charged by the credit rating agencies are reasonable.

Recommendation 5:

The Division of Trading in Markets (TM), in consultation with the Office of Compliance Inspections and Examinations, the Office of Economic Analysis, and the Office of Risk Assessment, should request that the Office of General Counsel develop guidance regarding the types of deficiencies, (e.g., overly broad disclosures) that should prompt TM either to (1) seek consent from the applicant to waive the 90-day statutory time period for granting an application for registration as a Nationally Recognized Statistical Rating Organization (NRSRO), or (2) recommend instituting proceedings to determine whether registration should be denied.

Recommendation 6:

The Division of Trading and Markets and the Office of Compliance Inspections and Examinations should take appropriate actions to inform Nationally Recognized Statistical Rating Organizations about the Commission's expectations regarding the experience of their compliance officers.

Recommendation 7:

The Division of Trading and Markets should ensure that it seeks Commission orders in response to requests by Nationally Recognized Statistical Rating Organizations for extensions of time when required by statute or the Commission's rules.

Recommendation 8:

The Division of Trading and Markets should ensure that credit rating agencies applying for designation as Nationally Recognized Statistical Rating Organizations (NRSROs) and firms that have registered as NRSROs comply with the Commission's rules and requirements regarding the filing and certification of financial information.

Recommendation 9:

The Chairman, in concert with the other Commissioners, shall review the Office of Inspector General's findings on conducting examinations before issuing orders

approving applications and, as appropriate and as part of their broader analysis of issues pertaining to Nationally Recognized Statistical Rating Organizations (NRSROs), direct the Office of Compliance Inspections and Examinations and the Division of Trading and Markets, in consultation with the Office of the General Counsel, to seek legislative authority to conduct examinations as part of the NRSRO application process. As part of this review, the Chairman and Commissioner should consider:

- Whether the current 90-day statutory time period should be extended to allow for examinations to be conducted; and
- What additional staffing resources would be required to implement this additional responsibility.

Recommendation 10:

The Office of Compliance Inspections and Examinations (OCIE) should include the Nationally Recognized Statistical Rating Organizations (NRSROs) in its pilot monitoring program. Given the different sizes (i.e., market dominance) of the various NRSROs and the current examination cycle, OCIE should specifically tailor its monitoring program for each particular NRSRO.

Recommendation 11:

The Office of Compliance Inspections and Examinations (OCIE), in consultation with the Ethics Office and the Office of Administrative Services, should obtain an additional review of the draft OCIE Nationally Recognized Statistical Rating Organization (NRSRO) examination module by an expert in credit rating and NRSRO matters.

Recommendation 12:

The Chairman, in concert with the other Commissioners, shall review the Office of Inspector General's findings concerning PCAOB oversight of NRSRO auditors, and as appropriate and as part of their broader analysis of issues pertaining to Nationally Recognized Statistical Rating Organizations (NRSROs), direct the Division of Trading and Markets (TM), in consultation with the Office of the Chief Accountant, the Office of Risk Assessment and the Office of the General Counsel, to seek legislative authority to provide the Public Company Accounting Oversight Board (PCAOB) with oversight over audits of NRSROs. If that authority is obtained, TM should recommend rules that require NRSROs and credit rating agencies seeking to become NRSROs to use auditors that are overseen by the PCAOB.

Recommendation 13:

The Office of Compliance Inspections and Examinations should perform examination work to determine whether the quality of credit ratings is being adversely affected by Nationally Recognized Statistical Rating Organizations (NRSROs) performing consulting and advisory services for issuers, underwriters or obligors that have paid the NRSROs for credit ratings.

Recommendation 14:

The Division of Trading and Markets (TM), in consultation with the Office of Compliance Inspections and Examinations (OCIE), the Office of Economic Analysis, the Office of International Affairs, and the Office of Risk Assessment, should assess the impact of the provision of consulting and advisory services on the quality of credit ratings and how best to minimize the potential harmful effects, without unduly limiting competition among the Nationally Recognized Statistical Rating Organizations (NRSROs). If warranted by the results of OCIE's examination work and TM's analysis, TM should recommend that the Commission propose appropriate rules designed to prevent an NRSRO's consulting and advisory services from potentially adversely affecting the quality of credit ratings.

Recommendation 15:

The Chairman, in concert with the other Commissioners, shall review the Office of Inspector General's findings on monitoring of credit ratings and, as appropriate and as part of their broader analysis of issues pertaining to Nationally Recognized Statistical Rating Organizations (NRSROs), direct the Division of Trading and Markets (TM), in consultation with the Office of Compliance Inspections and Examinations, the Office of Economic Analysis, the Office of International Affairs (OIA), the Office of Risk Assessment, and the Office of the General Counsel, to recommend appropriate rules to implement a comprehensive credit rating monitoring requirement for Nationally Recognized Statistical Rating Organizations (NRSROs). TM should also meet with OIA periodically (e.g., quarterly) to discuss the effects that any foreign laws or rules regarding credit rating monitoring are having, or may have, on the NRSROs.

Recommendation 16:

The Office of Compliance Inspections and Examinations should perform examination work into whether, and under what circumstances, credit rating

analysts face undue influence and the effects of such undue influence on the credit ratings issued by Nationally Recognized Statistical Rating Organizations.

Recommendation 17:

The Division of Trading and Markets (TM), in consultation with the Office of Compliance Inspections and Examinations (OCIE), the Office of International Affairs (OIA), and the Office of Risk Assessment, should assess the effects of undue influence on the quality of credit ratings and the potential benefits of a credit analyst rotation requirement. Depending on the results of OCIE's examination work and TM's analysis, TM should recommend rules to address the risk of undue influence. TM should also meet with OIA periodically (e.g., quarterly) to discuss the effects that any foreign laws or rules on credit rating analyst rotation are having, or may have, on the Nationally Recognized Statistical Rating Organizations. If necessary, the Commission should seek legislative authority to implement the proposed rules designed to address the risk of undue influence.

Recommendation 18:

The Chairman, in concert with the other Commissioners, shall review the Office of Inspector General's findings on credit ratings disclosures and, as appropriate and as part of their broader analysis of issues pertaining to Nationally Recognized Statistical Rating Organizations (NRSROs), direct the Division of Trading and Markets, in consultation with the Office of Compliance Inspections and Examination, the Office of Economic Analysis, and the Office of Risk Assessment, to recommend additional rule amendments to enhance the disclosures surrounding the credit ratings process, including, for example, the key assumptions used in credit ratings methodologies and procedures, and any shortcomings of or limitations on credit ratings.

Recommendation 19:

The Office of Compliance Inspections and Examinations should conduct examinations to evaluate whether the revolving door problem is negatively impacting the quality of credit ratings.

Recommendation 20:

The Division of Trading and Markets (TM), in consultation with the Office of Compliance Inspections and Examinations (OCIE), the Office of International Affairs (OIA), and the Office of Risk Assessment should assess the problems

presented by the revolving door. Depending on the results of OCIE's examination work and TM's analysis, TM should (1) recommend rules to establish requirements to address the revolving door issue as it relates to Nationally Recognized Statistical Rating Organizations (NRSROs); and (2) meet with OIA periodically (e.g., quarterly) to discuss the effects that any foreign laws or rules designed to address the credit rating agency revolving door problem are having, or may have, on NRSROs. If necessary, the Commission should seek legislative authority to implement the proposed rules designed to address the revolving door issue.

Recommendation 21:

The Chairman, in concert with the other Commissioners, shall review the Office of Inspector General's findings on the Rule 17g-5 information disclosure program and Regulation Full Disclosure (FD) and, as appropriate and as part of their broader analysis of issues pertaining to Nationally Recognized Statistical Rating Organizations (NRSROs), direct the Division of Trading and Markets, in consultation with the Division of Corporation Finance, the Office of Compliance Inspections and Examinations, the Office of Economic Analysis, and the Office of Risk Assessment, to assess the potential effects on competition in the credit rating industry of the re-proposed amendments to Rule 17g-5 and the proposed amendment to Regulation FD and, if appropriate, recommend changes to the rule proposals.

Recommendation 22:

The Chairman, in concert with the Commissioners, shall review the Office of Inspector General's findings on forum shopping for credit ratings and, as appropriate and as part of their broader analysis of issues pertaining to Nationally Recognized Statistical Rating Organizations, direct the Division of Trading and Markets, in consultation with the Office of Compliance Inspections and Examinations, the Office of Economic Analysis, the Office of International Affairs, and the Office of Risk Assessment, to recommend rules designed to reduce the potential harmful effects on the quality of credit ratings caused by forum shopping.

Recommendation 23:

The Chairman, in concert with the other Commissioners, shall review the Office of Inspector General's findings on public comment on a firm's application and the status of competition and, as appropriate and as part of their broader analysis of issues pertaining to Nationally Recognized Statistical Ratings Organizations,

(NRSROs) direct the Division of Trading and Markets, in consultation with the Office of Compliance Inspections and Examinations, the Office of Economic Analysis, and the Office of Risk Assessment, to incorporate the seeking and consideration of public comments into the Securities and Exchange Commission's NRSRO oversight process.

Recommendation 24:

The Division of Trading and Markets, in consultation with Office of Compliance Inspections and Examinations, the Office of Economic Analysis, the Office of International Affairs, the Office of Risk Assessment and the Office of the General Counsel, should incorporate the additional concepts identified by the Office of Inspector General's review into the Commission's annual report to Congress on Nationally Recognized Statistical Rating Organizations.

Comments from the Office of the Chairman

MEMORANDUM

TO: H. David Kotz
Inspector General

FROM: Mary L. Schapiro
Chairman

SUBJECT: Response to OIG Report No. 458 – *The SEC's Role Regarding and Oversight of Nationally Recognized Statistical Rating Organizations (NRSROs)*

DATE: August 27, 2009

I. Introduction

This is in response to the Office of Inspector General's (OIG's) draft report entitled *The SEC's Role Regarding and Oversight of Nationally Recognized Statistical Rating Organizations (NRSROs)* (the Report). As you know, ordinarily the SEC's divisions and offices to which OIG recommendations are directed respond to draft reports. This typically does not include the Chairman or other Commissioners. However, because of the scope of the audit, you make numerous policy-focused recommendations in the Report that are appropriately directed to me, as the Commission's Chairman. It is in this capacity that I am providing you with my response, which should be viewed as supplementing the responses that you receive from SEC divisions and offices.

II. Recommendations Directed to the Chairman

In the Report's Finding 4, you conclude that "[t]he Commission should address several policy issues in order to improve NRSRO oversight." These policy issues are:

Appendix V

- Consider seeking legislation that would require NRSRO auditors to be subject to PCAOB oversight (Recommendation 12)
- Consider additional rules to specifically require that NRSROs systematically monitor credit ratings, and upgrade or downgrade ratings as appropriate (Recommendation 15)
- Consider additional rules to enhance disclosures surrounding the credit ratings process, including for example, the key assumptions used in credit ratings methodologies and procedures, and any shortcomings of or limitations on the credit ratings (Recommendation 18)
- Assess the potential effects on competition in the credit rating industry of the re-proposed amendments to Rule 17g-5 and the proposed amendment to Regulation FD and, if appropriate, recommend changes to the rule proposals (Recommendation 21)
- Consider rules designed to reduce the potential harmful effects on the quality of credit ratings caused by forum shopping (Recommendation 22)
- Consider rules that would allow the public to comment on a credit rating agency's NRSRO application, and periodically thereafter on the NRSRO's performance (Recommendation 23)

As noted in the Report, many of these recommendations have been considered for some time or are currently being actively analyzed. I expect the Commission to consider a full range of additional rules – finalizing some previous proposals and proposing new ones – within the next few weeks. Accordingly, I concur with your recommendation that each of these issues is worthy of consideration. To follow up, my office will work with staff from SEC's divisions and offices to provide you with our assessment and the conclusions that we reach after due consideration. As always, if you would like additional information, please feel free to contact me.

Comments from the Division of Trading and Markets

MEMORANDUM

TO: H. David Kotz
Inspector General, Office of the Inspector General

FROM: Daniel Gallagher
Acting Co-Director, Division of Trading and Markets

RE: The Management Response of the Division of Trading and Markets to the Office of Inspector General Report No. 458, The SEC's Role Regarding Oversight of Nationally Recognized Statistical Rating Organizations

Appendix I Management Response to the Recommendations Directed to the Division of Trading and Markets

Appendix II Legal Analysis of the Division of Trading and Markets Regarding the Decision of the Securities and Exchange Commission to Grant the Application of the Credit Rating Agency Referenced in Finding 1

DATE: August 27, 2009

I. INTRODUCTION

Thank you for the opportunity to respond to the recommendations in your August 18, 2009 draft report – The SEC's Role Regarding Oversight of Nationally Recognized Statistical Rating Organizations (the "Report"). At the outset, we want to extend our appreciation for the professional and collegial process undertaken by your staff in conducting the audit. The responses to recommendations directed to the Division of Trading and Markets ("TM") are attached as Appendix I.

In this cover memo, we briefly describe TM's efforts in support of the Securities and Exchange Commission's ("Commission") oversight of nationally recognized statistical rating organizations ("NRSROs") and highlight some issues raised by the Report. As you will see, the Division generally agrees with the Report's

recommendations. There are some issues, however, on which we respectfully take a different view.

II. TM EFFORTS IN SUPPORT OF THE COMMISSION'S NRSRO OVERSIGHT

Before discussing the Report's Findings, we believe it is important to describe TM's efforts to support the Commission's oversight of NRSROs under the Credit Rating Agency Reform Act of 2006 (the "Rating Agency Act"). As noted in the Report, Congress enacted the Rating Agency Act in September 2006 and mandated that the Commission adopt final rules establishing a registration and oversight program for NRSROs within 270 days. TM staff moved quickly to conceive a program and worked diligently during the notice and comment rulemaking process to ensure the Commission met the statutory deadline by adopting final rules in June 2007. Upon adoption, seven credit rating agencies applied simultaneously to register as NRSROs. TM staff processed each application in a thorough manner, as indicated by the detailed memos to the Commission cited in the Report, but also quickly enough to allow the Commission time to review the staff's recommendations and act on the applications within the 90-day period mandated by the Rating Agency Act. The issues identified by the staff in the memos to the Commission have provided the Office of Compliance, Inspections and Examinations ("OCIE") with useful information to focus their reviews of the NRSROs.

In August 2007, TM and staffs from OCIE and the Office of Economic Analysis ("OEA") commenced extensive examinations of the three largest NRSROs – Fitch Ratings, Ltd., Moody's Investor Services, Inc., and Standard & Poor's Ratings Services – to review their activities in rating structured finance products linked to subprime mortgages. TM staff attended multi-day on-site visits to the NRSROs to conduct interviews of personnel, reviewed and analyzed thousands of pages of information from deal files, and assisted in drafting the examination report. Before the examinations were complete, TM staff began developing a second round of rulemaking for NRSROs, which was informed, in part, on preliminary findings from the examination and that aimed to address the role that NRSROs played in the credit market turmoil. These rules were proposed in June 2008 and adopted by the Commission in February 2009. Also in June 2008, the Commission issued its first annual report to Congress as mandated by the Rating Agency Act, which TM staff played a lead role in drafting. Finally, in February 2009, the Commission proposed additional NRSRO rules upon the recommendation of TM. Currently, TM is working on further proposals and final rulemaking for Commission consideration.

On the international front, TM staff serves on the new permanent standing committee on credit rating agencies of the Technical Committee of the International

Organization of Securities Commissions (“IOSCO”). This committee, comprised of supervisors from jurisdictions in Europe, Asia and the Americas, has two primary responsibilities: (1) to discuss, evaluate and consider regulatory and policy initiatives vis-à-vis credit rating agency activities and oversight, in an effort to seek cross-border regulatory consensus through such means as the IOSCO credit rating agency code; and (2) to facilitate regular dialogue between securities regulators and the credit rating industry.

III. TM VIEWS ON THE FIVE FINDINGS IN THE REPORT

A. Finding 1

TM concurs in part with many of the recommendations resulting from Finding 1 and with the legal conclusion in the finding that the Rating Agency Act would need to be amended to allow the Commission to perform an examination during the NRSRO application process. However, TM respectfully disagrees with the legal conclusion in the finding that the Commission should not have granted one credit rating agency’s NRSRO application. As explained further in Appendix II, the Commission’s consideration of NRSRO applications is to be based primarily on information submitted by the applicant in Form NRSRO. An applicant is to be granted registration if the application is complete. To successfully deny an application, the Commission must make substantial factual and legal findings. The issues identified by TM in reviewing the application did not provide a legally viable basis for denying the application (it should be noted that these were the staff’s views and did not necessarily reflect the views of the Commissioners). Moreover, the legislative history of the Rating Agency Act makes clear that it was designed to increase competition in the credit rating industry by lowering barriers to achieving NRSRO status. For these reasons, TM recommended that the Commission grant the registrations and that the issues identified by the staff be followed-up when the firm was examined. The Commission agreed with the recommendation.

B. Finding 2

TM concurs with the recommendations resulting from Finding 2. TM will strengthen the internal controls for reviewing forms and reports furnished to the Commission and, if TM discovers that a form or report lacks required information or is not certified in the manner prescribed by rule, TM will reject it and request that the NRSRO furnish a corrected form or report. TM also will consult with the Commission on how it prefers to handle routine requests for extensions of time to furnish these forms and reports (e.g., by the staff no-action process, exemptive authority delegated to TM, or by vote of the Commission). TM believes it acted appropriately in using the no-action process as a legal matter and as a mechanism to achieve efficiencies and conserve

Commission resources. Nonetheless, TM will consult with the Commission on how it prefers that these requests be handled in the future.

C. Finding 3

Finding 3 proposes, among other things, that the Commission consider whether the Rating Agency Act should be amended to permit an examination of a credit rating agency during the NRSRO application process. Recommendation 9 states that, if the Commission believes this would be an appropriate change to the Rating Agency Act, the Commission should direct TM, OCIE, and the Office of General Counsel to “seek legislative authority to conduct examinations as part of the NRSRO application process.” TM staff is not authorized to ask Congress to enact legislation, but we would be able to provide technical assistance to Congress should it decide to propose such legislation.

D. Finding 4

Finding 4 identifies a number of policy questions that should be considered in order to enhance the Commission’s oversight of NRSROs. In some cases, the Report recommends that TM, in consultation with OCIE and other offices, analyze whether steps should be taken to address potential practices that could adversely impact the quality of credit ratings. TM notes that the Commission has adopted rules to address the potential conflicts identified in the recommendations (e.g., being paid by issuers to determine credit ratings). Nonetheless, TM agrees that, if OCIE finds during its examination work that the conflicts are not being adequately addressed by the Commission’s rules, TM will analyze the evidence supporting OCIE’s finding and determine whether it would be appropriate to recommend that the Commission take further action through additional rulemaking or other measures.

E. Finding 5

Recommendation 24 resulting from Finding 5 states that TM, in consultation with other Commission offices, should address eight new topics in the Commission’s annual report to Congress. TM notes that the Rating Agency Act specifically prescribes the topics that are to be addressed in the report and that the report is from the Commission. Consequently, TM defers to the Commission the decision on whether the annual report should address these topics. However, TM would need to re-allocate substantial resources in terms of staff time to undertake the work necessary to include the suggested topics. This would divert staff resources from work TM believes is a priority to support the Commission’s NRSRO oversight responsibilities. TM believes Finding 5 raises important policy and programmatic questions and that there may be other ways to address several of the questions posed.

APPENDIX I

Management Response to the Recommendations Directed to the Division of Trading and Markets

As indicated below, the Division of Trading and Markets: (1) concurs with recommendations 5, 6, 8, 14, 15, 17, and 20; (2) concurs in part with recommendations 1, 2, 3, 4, and 7; and (3) does not concur with recommendation 24.

Recommendation 1: The Division of Trading and Markets (TM) should ensure that all significant issues identified in the application review process are resolved before it recommends that a Credit Rating Agency (CRA) be registered as a Nationally Recognized Statistical Rating Organization. One way to resolve issues would be to require that the Office of Compliance Inspections and Examinations complete an examination of a CRA before TM makes a recommendation on the application to the Securities and Exchange Commission (which would require additional legislative authority, see Recommendation 9).

Management Response: Within the limitations of the 90-day time period during which the Commission may review a complete application, TM will endeavor to resolve all outstanding significant issues identified during the application process to the extent practicable and consistent with the statutory requirements of the Credit Rating Agency Reform Act of 2006 (“Rating Agency Act”). As explained in more detail in Appendix II, the Rating Agency Act mandates that the Commission grant a credit rating agency’s application for registration as a nationally recognized statistical rating organization (“NRSRO”) within 90 days or commence proceedings to determine whether the application should be denied. The Commission must make specific findings to deny an application for registration. Further, there is no express authority in the Rating Agency Act to examine a credit rating agency prior to it being registered as an NRSRO; nor is there time to conduct such an examination given the 90 days prescribed in the statute. If an application meets the requirements of the Rating Agency Act, and there is not sufficient evidence to support the findings necessary to deny an application, TM will continue to advise the Commission of significant issues and make them known to the Office of Compliance, Inspections and Examinations (“OCIE”) for follow-up. TM agrees with the Report’s finding that new legislation would be necessary to allow OCIE to conduct an examination of a credit rating agency during the NRSRO application process.

Appendix V

Recommendation 2: The Division of Trading and Markets, in consultation with the Office of Compliance Inspections and Examinations (OCIE), and the Office of Economic Analysis, should evaluate whether action should be taken regarding the Credit Rating Agency (CRA) that was granted designation as a Nationally Recognized Statistical Rating Organization (NRSRO), despite the numerous significant problems identified with its application. These actions could include, as deemed appropriate, making a referral to the Division of Enforcement for consideration of censure, suspension, or other remedies specified in Section 15E(d) of the Securities Exchange Act of 1934. The evaluation should consider any new information obtained (e.g., from the OCIE examination of the CRA) since the CRA's application approved.

Management Response: The Commission's authority to examine NRSROs rests with OCIE. OCIE, based on its findings during an examination, may make a referral to the Division of Enforcement ("Enforcement"). Enforcement has been delegated the Commission's authority to investigate potential violations of the securities laws, and Enforcement makes recommendations to the Commission regarding such violations. Both OCIE and Enforcement consult with TM, as they deem appropriate, during these processes if rules administered by TM are implicated. TM will provide any guidance they request relating to NRSROs.

Recommendation 3: The Division of Trading and Markets should ensure that all pending issues identified during the application process involving the Credit Rating Agencies that the Securities and Exchange Commission designated as Nationally Recognized Statistical Rating Organization are resolved within six months of the date of issuance of the Office of Inspector General's audit report.

Management Response: TM will do an analysis of how many of the outstanding issues identified in the applications have not been resolved to date. TM will endeavor to resolve issues that do not require examination within six months. Issues that only can be resolved through examination will be referred to OCIE, and TM will work with OCIE to ensure that those issues are resolved in a timely manner.

Recommendation 4: The Division of Trading and Markets, in consultation with the Office of Economic Analysis, and the Office of Compliance Inspections and Examinations, should develop measures for determining whether subscriber fees charged by the credit rating agencies are reasonable.

Management Response: TM will consult with the Commission to determine whether it believes this work should be undertaken. TM notes that when

proposing the first round of NRSRO rules, the Commission stated that it “preliminarily believes that the determination of whether a fee for accessing or obtaining credit ratings is reasonable would depend on the facts and circumstances.” See Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 55231 (February 2, 2007), 72 FR 6431 (February 9, 2007). Thereafter, when adopting final rules, the Commission stated it had determined not to define “reasonable fee” at that time in order to gain experience on the issue. See Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 55857 (June 5, 2007), 72 FR 33564 (June 18, 2007).

Recommendation 5: The Division of Trading and Markets (TM), in the consultation with the Office of Compliance Inspections and Examinations, the Office of Economic Analysis, and the Office of Risk Assessments, should request that the Office of General Counsel develop guidance regarding the types of deficiencies, (e.g. overly broad disclosures) that should prompt TM either to (1) seek consent from the applicant to waive the 90-day statutory time period for granting an application for registration as a Nationally Recognized Statistical Rating Organization (NRSRO), or (2) recommend instituting proceedings to determine whether registration should be denied.

Management Response: TM will request that the Office of General Counsel provide such guidance.

Recommendation 6: The Division of Trading and Markets and the Office of Compliance Inspections and Examinations should take appropriate actions to inform Nationally Recognized Statistical Rating Organizations about the Commission’s expectations regarding the expertise and experience of their compliance officers.

Management Response: The Commission has not adopted rules, issued guidance, or taken other actions regarding the expertise of individuals designated by NRSROs as the compliance officer under Section 15E(j) of the Exchange Act (15 U.S.C. 780-7(j)). Further, there is no self-regulatory organization for NRSROs that could provide such guidance. TM, in consultation with OCIE (e.g., through its CCO Outreach Program), will take appropriate action to inform the NRSROs of the Commission’s expectations with respect to the NRSROs’ designated compliance officers should the Commission make them known through rules, guidance, or other Commission actions.

Recommendation 7: The Division of Trading and Markets should ensure that it seeks Commission orders regarding Nationally Recognized Statistical Rating Organizations when required by statute or the Commission's rules.

Management Response: TM has delegated authority to issue no-action guidance with respect to issues arising under the Securities Exchange Act of 1934, including provisions relating to NRSROs. TM will seek guidance from the Commission on how it would prefer to address routine requests for extensions of time to furnish Form NRSROs and the annual reports required pursuant to Rule 17g-3 (e.g., by the staff no-action process, exemptive authority delegated to TM, or by vote of the Commission).

Recommendation 8: The Division of Trading and Markets should ensure that credit rating agencies applying for designation as Nationally Recognized Statistical Rating Organizations (NRSROs) and firms that have registered as NRSROs comply with the Commission's rules and requirements regarding the filing and certification of financial information.

Management Response: TM will take steps to strengthen its controls around the receipt of Form NRSROs and Rule 17g-3 Annual Reports. In cases where the forms or reports are determined to be incomplete or certified in a manner other than prescribed by rule, TM will request that the form or report be corrected and re-furnished.

Recommendation 14: The Division of Trading and Markets (TM), in consultation with the Office of Compliance Inspections and Examinations (OCIE), the Office of Economic Analysis, the Office of International Affairs, and the Office of Risk Assessment, should assess the impact of the provision of consulting and advisory services on the quality of credit ratings and how best to minimize the potential harmful effects, without unduly limiting competition among the Nationally Recognized Statistical Rating Organizations (NRSROs). If warranted by the results of OCIE's examination work and TM's analysis, TM should recommend that the Commission propose appropriate rules designed to prevent an NRSRO's consulting and advisory services from potentially adversely affecting the quality of the credit ratings.

Management Response: If OCIE finds through the course of its examination work that, notwithstanding current Commission rules, there is evidence that the provision of consulting services by NRSROs is adversely impacting the integrity of their credit ratings, TM will analyze the evidence and, if appropriate and consistent with the Commission's

authority, develop recommendations for the Commission that would be designed to address the problem. TM notes that the Commission has already adopted Rule 17g-5, which is designed to address conflicts of interest, including the conflict arising from the provision of consulting and advisory services.

Recommendation 15: The Chairman, in concert with the other Commissioners, shall review the Office of Inspector General's findings on monitoring of credit ratings and as appropriate and as part of their broader analysis of issues pertaining to Nationally Recognized Statistical Rating Organizations (NRSROs), direct the Division of Trading and Markets (TM), in consultation with the Office of Compliance Inspections and Examinations, the Office of Economic Analysis, the Office of International Affairs (OIA), the Office of Risk Assessment, and the Office of General Counsel, to recommend appropriate rules to implement a comprehensive credit rating monitoring requirement for Nationally Recognized Statistical Rating Organizations (NRSROs). TM should also meet with OIA periodically (e.g., quarterly) to discuss the effects that any foreign laws or rules regarding credit rating monitoring are having, or may have, on the NRSROs.

Management Response: With respect to the recommendation directed to TM, TM agrees to meet periodically with OIA to discuss the effects of foreign laws or rules regarding credit rating agencies. In addition, TM notes that a TM staff member currently chairs Standing Committee 6 of the Technical Committee of the International Organization of Securities Commissions ("IOSCO"). This committee, comprised of supervisors from jurisdictions in Europe, Asia and the Americas, has two primary responsibilities: (1) to discuss, evaluate and consider regulatory and policy initiatives vis-à-vis credit rating agency activities and oversight, in an effort to seek cross-border regulatory consensus through such means as the IOSCO credit rating agency code; and (2) to facilitate regular dialogue between securities regulators and the credit rating industry. TM believes this forum provides an additional opportunity to discuss the effect of foreign laws or rules.

Recommendation 17: The Division of Trading and Markets (TM), in consultation with the Office of Compliance Inspections and Examinations (OCIE), the Office of International Affairs (OIA), and the Office of Risk Assessment, should assess the effects of undue influence on the quality of credit ratings and the potential benefits of a credit analyst rotating requirement. Depending on the results of OCIE's examination work and TM's analysis, TM should recommend rules to address the risk of undue influence. TM should meet with OIA periodically (e.g., quarterly) to discuss the effects that any foreign laws or rules on credit rating analyst rotation is having, or may have, on the Nationally

Recognized Statistical Rating Organizations. If necessary, the Commission should seek legislative authority to implement the proposed rules designed to address the risk of undue influence.

Management Response: If OCIE finds through the course of its examination work that, notwithstanding current Commission rules, there is evidence that the integrity of credit ratings is being adversely impacted by undue influence from issuers paying for credit ratings (or from any other sources), TM will analyze the evidence and, if appropriate and consistent with the Commission's authority, develop recommendations for the Commission that would be designed to address the problem. TM notes that the Commission already has adopted Rule 17g-5, which is designed to address conflicts of interest, including the conflict arising from the being paid by an issuer to determine a credit rating.

See TM's response to Recommendation 15 with respect to the recommendation above about the discussing the effects of foreign laws or rules.

Recommendation 20: The Division of Trading and Markets (TM), in consultation with the Office of Compliance Inspections and Examinations (OCIE), the Office of International Affairs (OIA), and the Office of Risk Assessment should assess the problems presented by the revolving door. Depending on the results of OCIE's examination work and TM's analysis, TM should (1) recommend rules to establish requirements to address the revolving door issue as it relates to Nationally Recognized Statistical Rating Organizations (NRSROs); and (2) meet with OIA periodically (e.g., quarterly) to discuss the effects that any foreign laws or rules designed to address the credit rating agency revolving door problem are having, or may have, on NRSROs. If necessary, the Commission should seek legislative authority to implement the proposed rules designed to address the revolving door issue.

Management Response: If OCIE finds through the course of its examination work that, notwithstanding current Commission rules, there is evidence that the quality of credit ratings is being adversely impacted by the "revolving door," TM will analyze the evidence and, if appropriate and consistent with the Commission's authority, develop recommendations for the Commission that would be designed to address the problem. TM notes that the Commission already has adopted Rule 17g-5, which is designed to address conflicts of interest, including the conflict arising from the being paid by an issuer to determine a credit rating.

Appendix V

See TM's response to Recommendation 15 with respect to the recommendation above about the discussing the effects of foreign laws or rules.

Recommendation 24: The Division of Trading and Markets, in consultation with Office of Compliance Inspections and Examinations, the Office of Economic Analysis, the Office of Risk Assessment, should incorporate the additional concepts identified by the Office of the Inspector General's audit into the Commission's annual report to Congress on Nationally Recognized Statistical Rating Organizations.

Management Response: TM believes the decision on whether to incorporate these concepts into the annual report to Congress rests with the Commission. TM notes that the matters to be addressed in the annual report are prescribed by Congress. Further, incorporating these additional concepts into the annual report would require a substantial re-allocation of staff resources from work that TM believes is a priority in terms of supporting the Commission's NRSRO oversight responsibilities.

* * * * *

APPENDIX II

Legal Analysis of the Division of Trading and Markets Regarding the Decision of the Securities and Exchange Commission to Grant the Application of the Credit Rating Agency Referenced in Finding 1

I. INTRODUCTION

The Division of Trading and Markets (“TM”) respectfully submits the following analysis regarding a legal conclusion in Finding 1 of the report The SEC’s Role Regarding Oversight of NRSROs (the “IG Report”).²¹² The legal conclusion related to the Commission’s decision to grant a credit rating agency referenced in Finding 1 (the “CRA”) registration as a nationally recognized statistical rating organization (“NRSRO”) [REDACTED]. In particular, the IG Report reaches the following conclusion:

Accordingly, our audit found that instead of issuing an order designating [the CRA] as an NRSRO, TM should have either recommended that the Commission institute proceedings to determine whether it should deny the applications or sought consent from the [CRA] to waive the 90-day statutory requirement to allow TM additional time to address the issues identified with the application [REDACTED].

In order to resolve the issues identified by TM, the CRA would have needed to consent to a months-long extension of the 90-day period mandated by the Credit Rating Agency Reform Act of 2006 (the “Rating Agency Act”).²¹³ TM’s interactions with the CRA during the [REDACTED] application process made clear that the CRA would not have consented to such an extension.²¹⁴ Consequently, the legal question is whether the

²¹² TM notes that the analysis herein solely represents the views of TM and does not necessarily reflect the views of the Commission or other Divisions and Offices within the Commission.

²¹³ See Pub. L. No. 109-291 (2006). The Rating Agency Act, among other things, amended Section 3 of the Exchange Act (15 U.S.C. 78c) to add certain definitions, added Section 15E to the Securities Exchange Act of 1934 (“Exchange Act”) to implement a registration and oversight program for NRSROs (see 15 U.S.C. 78o-7), amended Section 17 of the Exchange Act to provide the Commission with recordkeeping, reporting, and examination authority over NRSROs (see 15 U.S.C. 78q), and amended Section 21B(a) of the Exchange Act to provide the Commission with authority to assess money penalties against NRSROs in proceedings instituted under Section 15E of the Exchange Act (see 15 U.S.C. 78u-2). Section 15E(a)(2)(A) requires the Commission to grant an application for registration as an NRSRO or commence proceedings on whether to deny the application within 90 days from the date the application is furnished to the Commission or a longer period if the applicant consents (15 U.S.C. 78o-7(a)(2)(A)).

²¹⁴ For example, at the time, the Commission was comprised of four commissioners. As of the 90-day deadline, three of the Commissioners had voted on the application. The remaining Commissioner

Commission should have instituted proceedings to determine whether the application should have been denied based on the information obtained during the application process.

As discussed below, TM believes the only legally viable option for the Commission was to grant the application. Specifically, the Commission is required to grant registration if an applicant “satisfies the requirements” of the Rating Agency Act by: (1) meeting the definition of “credit rating agency;”²¹⁵ and (2) submitting in its application for registration the information required by the Rating Agency Act.²¹⁶ In this instance, the CRA met the definition of “credit rating agency” and had submitted the information required by the Rating Agency Act. Thus, in order to deny the application for registration, the Commission would need to make substantial factual and legal findings (discussed below) and prevail in proceedings where the applicant had notice of the grounds for denial and an opportunity for a hearing.²¹⁷ The findings necessary to deny an application would be difficult to support without the benefit of an examination of the applicant and there is no express authority in the Rating Agency Act to examine an applicant prior to it being registered as an NRSRO. Finally, the concerns raised by TM were mostly qualitative in nature. Prior to the Rating Agency Act, the Commission staff identified credit rating agencies as NRSROs through a no-action letter process that included the staff examining the credit rating agency and making qualitative judgments about its operations. The Rating Agency Act’s over-arching goal, as indicated by its legislative history, is to increase competition in the credit rating industry by lowering the barriers to achieving NRSRO status. In this regard, the Rating Agency Act specifically targeted the staff no-action letter process as an anti-competitive barrier to achieving NRSRO status, including voiding the staff no-action letters. TM’s judgment was that the Commission would not have prevailed in proceedings to deny the application.

II. THE INTENT OF THE RATING AGENCY ACT IS TO LOWER BARRIERS TO ACHIEVING NRSRO STATUS

Prior to enactment of the Rating Agency Act, the Commission staff identified NRSROs through the no-action letter process. Under this process, the Commission staff would perform examinations of a credit rating agency seeking to be identified as an NRSRO, including on-site inspections and reviews of the books and records of the credit

was unavailable to vote on the application on that day. Consequently, TM staff asked the CRA to consent to a two-day extension to allow the remaining Commissioner to vote. The CRA initially resisted granting the Commission the two-day extension. Ultimately, the CRA consented to the two-day extension but made clear that it would not consent to a longer time period.

²¹⁵ See 15 U.S.C. 78c(a)(61).

²¹⁶ See Sections 15E(a)(1)(A), (B) and (C) of the Exchange Act (15 U.S.C. 78o-7(a)(1)(A), (B), and (C)).

²¹⁷ Section 15E(a)(2) of the Exchange Act (15 U.S.C. 78o-7(a)(2)).

rating agency. The Commission described this process in a 1997 proposal to define, by rule, the term “NRSRO”–

In determining whether a rating organization may be considered an NRSRO for purposes of the Commission's rules, the staff considers a number of criteria. The single most important criterion is that the rating organization is nationally recognized, which means the rating organization is recognized in the United States as an issuer of credible and reliable ratings by the predominant users of securities ratings. The Division [of Trading and Markets] also examines the operational capability and reliability of each rating organization in conjunction with this standard of national recognition. Included within this assessment are: (1) the organizational structure of the rating organization; (2) the rating organization's financial resources (to determine, among other things, whether it is able to operate independently of economic pressures or control from the companies it rates); (3) the size and quality of the rating organization's staff (to determine if the entity is capable of thoroughly and competently evaluating an issuer's credit); (4) the rating organization's independence from the companies it rates; (5) the rating organization's rating procedures (to determine whether it has systematic procedures designed to produce credible and accurate ratings); and (6) whether the rating organization has internal procedures to prevent the misuse of non-public information and whether those procedures are followed (emphasis added).²¹⁸

In adopting the Rating Agency Act, Congress found the staff's approach to be an anti-competitive barrier to achieving NRSRO status. For example, the fifth finding in Section 2 of the Rating Agency Act states that “the 2 largest credit rating agencies serve the vast majority of the market, and additional competition is in the public interest.”²¹⁹ The Senate Report that accompanied the Rating Agency Act notes that the Department of Justice filed a comment letter stating that the Commission's 1997 proposal to define the term “NRSRO” (described above) would “likely create a nearly insurmountable barrier to new entry into the market for NRSRO services.”²²⁰ The Senate Report further noted that witnesses testifying at hearings before the Senate Banking Committee stated, among other things, that the staff no-action letter process was “vague, arbitrary, and anti-competitive” and has served as “a substantial barrier to entry for new entrants and that

²¹⁸ See Capital Requirements for Brokers or Dealers Under the Securities Exchange Act of 1934, Exchange Act Release No. 34-39457 (December 17, 1997).

²¹⁹ See Finding 5 in Section 2 of the Rating Agency Act.

²²⁰ Report of the Senate Committee on Banking, Housing, and Urban Affairs to Accompany S. 3850, Credit Rating Agency Reform Act of 2006, S. Report No. 109-326, 109th Cong., 2d Sess. (Sept. 6, 2006) (“Senate Report”), p. 5.

greater competition would benefit investors by generating more innovation and higher quality ratings at lower costs.”²²¹ In addition, the Senate Report noted that under the staff no-action letter process—

SEC commissioners are not formally involved in the decision whether to recognize new NRSROs. The most important requirement for acquiring the coveted status presents an obvious “Catch 22”: to get the designation you must be nationally recognized, but you cannot become nationally recognized without first having the designation.²²²

Finally, the Senate Report, in describing the purpose of the Rating Agency Act, stated—

The Credit Rating Agency Reform Act establishes fundamental reform and improvement of the designation process. Most importantly, the Act replaces the artificial barriers to entry created by the current SEC staff approval system with a transparent and voluntary registration system that favors no particular business model, thus encouraging purely statistical models to compete with the qualitative models of the dominant rating agencies and investor subscription-based models to compete with fee-based models. The Committee believes that eliminating the artificial barrier to entry will enhance competition and provide investors with more choices, higher quality ratings, and lower costs.²²³

The legislative history of the Rating Agency Act indicates that Congress intended to prescribe a process for achieving NRSRO status that was very different from the no-action letter process employed by the Commission staff. This Congressional intent to supplant the staff no-action letter process is hard-wired into the provisions of the Rating Agency Act. Specifically, the Rating Agency Act voided the staff no-action letters and mandated that a credit rating agency only could be registered as an NRSRO in accordance with the provisions of the Rating Agency Act.²²⁴ In addition, under the Rating Agency Act, the determination of whether a credit rating agency should be granted NRSRO status no longer turns on an analysis of whether it is “nationally recognized,” which, under the old staff no-action letter process, meant that the staff had found the credit rating agency to be recognized in the United States as an issuer of credible and reliable ratings by the predominant users of securities ratings.²²⁵ As the Commission stated in 1997, this was “the single most important criterion” under the staff

²²¹ Senate Report, pp. 6-7.

²²² Id.

²²³ Senate Report, p. 7.

²²⁴ See Section 15E(l) of the Exchange Act (15 U.S.C. 78o-7(1)).

²²⁵ See Capital Requirements for Brokers or Dealers Under the Securities Exchange Act of 1934, Exchange Act Release No. 34-39457 (December 17, 1997).

no-action letter process.²²⁶ Instead of a “national recognition” analysis by the Commission staff, the Rating Agency Act requires an applicant to submit certifications from 10 qualified institutional buyers (“QIBs”) stating that the entity meets the definition of a QIB and has used the credit ratings of the applicant for at least the 3 years immediately preceding the date of the certification.²²⁷

Moreover, as noted above, Section 15E(a)(2)(A) of the Exchange Act mandates that the Commission shall take action on an application within 90 calendar days of receipt of the application and provides that only the applicant can extend that time frame by consenting to a longer period.²²⁸ Furthermore, the provisions of the Rating Agency Act provide no express authority for the Commission to examine an applicant’s books and records to verify whether information provided in an application is accurate or to investigate qualitative concerns. Even if there was such express authority, the 90-day deadline does not provide enough time for the Commission staff to review an application, determine whether there are issues that should be resolved, allocate staff to conduct an examination, conduct the examination to resolve the issues, develop a recommendation for the Commission, and circulate the recommendation to the Commission with enough time to allow it to review the staff’s recommendation and vote on the recommendation.

Further, Section 15E(a)(2)(C) of the Exchange Act provides that the Commission must grant an application for registration if the Commission finds that the requirements of Section 15E of the Exchange Act are satisfied.²²⁹ The requirements of Section 15E of the Exchange Act are: (1) that the applicant be a “credit rating agency” as defined in Section 3(a)(61) of the Exchange Act;²³⁰ and (2) that the applicant submit the information

²²⁶

Id.

²²⁷

See 15 U.S.C. 78o-7(a)(1)(B)(ix). Specifically, this provision requires the applicant to provide certifications from QIBs as specified in Section 15E(a)(1)(C) of the Exchange Act (15 U.S.C. 78o-7(a)(1)(C)). Sections 15E(a)(1)(C)(i) – (iii) of the Exchange Act require an applicant to furnish certifications from a minimum of 10 QIBs, including certifications from no less than two QIBs for each category of obligor for which the applicant intends to be registered. 15 U.S.C. 78o-7(a)(1)(C)(i) – (iii). Section 15E(a)(1)(C)(iv) requires that the certification state that the entity meets the definition of a QIB and has used the credit ratings of the applicant for at least the 3 years immediately preceding the date of the certification in the subject category or categories. 15 U.S.C. 78o-7(a)(1)(C)(iv). Section 15E(a)(1)(D) of the Exchange Act provides an exemption from furnishing the QIB certifications for any applicant that had received, or been the subject of, a no-action letter provided by Commission staff prior to August 2, 2006. 15 U.S.C. 78o-7(a)(1)(D). This indicates that the QIB requirement was designed to replace the staff’s “national recognition” analysis, since credit rating agencies that the staff had determined were nationally recognized under the no-action letter process did not need to submit the QIB certifications.

²²⁸

See 15 U.S.C. 78o-7(a)(2)(A).

²²⁹

15 U.S.C. 78o-7(a)(2)(C).

²³⁰

Section 15E(a)(1) of the Exchange provides, in pertinent part, that a “credit rating agency that elects to be treated as a nationally recognized statistical rating organization” shall furnish the Commission an application for registration. 15 U.S.C. 78o-7(a)(1). Consequently, an entity must

prescribed in Section 15E(a)(1)(B) of the Exchange Act²³¹ in such form as the Commission shall require, by rule or regulation, pursuant to authority conferred in Section 15E(a)(1)(A) of the Exchange Act.²³² Thus, the Commission must find that an applicant has “satisfied” the requirements of Section 15E of the Exchange Act if the applicant is a “credit rating agency” as defined in Section 3(a)(61) of the Exchange Act and has submitted an application on a form prescribed by the Commission that contains the information required under Section 15E(a)(1)(B) of the Exchange Act. It should be noted that the finding necessary to grant a registration – that the requirements of Section 15E of the Exchange Act have been satisfied – does not require that the Commission find that doing so would “be necessary or appropriate in the public interest or for the

be a “credit rating agency” to apply for registration as an NRSRO. *Id.* Section 3(a)(61) of the Exchange Act (15 U.S.C. 78c(a)(61)) defines “credit rating agency” to mean “any person—
 (A) engaged in the business of issuing credit ratings on the Internet or through another readily accessible means, for free or for a reasonable fee, but does not include a commercial credit reporting company;
 (B) employing either a quantitative or qualitative model, or both, to determine credit ratings;
 and
 (C) receiving fees from either issuers, investors, or other market participants, or a combination thereof.” *Id.*

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15 U.S.C. 78o-7(a)(1)(B). Under Section 15E(a)(1)(B), an applicant is required to submit the following information:

- (1) Credit ratings performance measurement statistics over short-, mid-, and long-term periods, as applicable;
- (2) The procedures and methodologies that the applicant uses in determining ratings;
- (3) Policies or procedures adopted and implemented by the applicant to prevent the misuse, in violation of the of the Exchange Act (or the rules and regulations hereunder) of material, nonpublic information;
- (4) The organizational structure of the applicant;
- (5) Whether or not the applicant has in effect a code of ethics, and if not, the reasons therefore;
- (6) Any conflict of interest relating to the issuance of credit ratings by the applicant;
- (7) The categories described in any of clauses (i) through (v) of Section 3(a)(62)(B) of the Exchange Act with respect to which the applicant intends to apply for registration under Section 15E of the Exchange Act (*i.e.*, the classes of obligors identified in the definition of “nationally recognized statistical rating organization”);
- (8) On a confidential basis, a list of the 20 largest issuers and subscribers that use the credit rating services of the applicant, by amount of net revenues received therefrom in the fiscal year immediately preceding the date of submission of the application;
- (9) On a confidential basis, as to each category of obligor described in clauses (i) through (v) of Section 3(a)(62)(B) of the Exchange Act, written certifications described in Section 15E(a)(1)(C) of the Exchange Act, except as provided in Section 15E(a)(1)(D) of the Exchange Act; and
- (10) any other information and documents concerning the applicant and any person associated with such applicant as the Commission, by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors.

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15 U.S.C. 78o-7(a)(1)(A). The Commission adopted Rule 17g-1 (17 CFR 240.17g-1), which requires an applicant to submit this information using Form NRSRO. Form NRSRO is available at <http://www.sec.gov/divisions/marketreg/ratingagency.htm>.

protection of investors” which is commonly required for Commission findings in other contexts, including other provisions of the Rating Agency Act. Congress mandated a different standard. Significantly, as noted above, Congress itself made the finding in the Rating Agency Act that increasing competition would be “in the public interest.”²³³

If an applicant satisfies the application requirements, the Commission can only deny the application if it can make at least one of two findings. The first finding, prescribed in Section 15E(a)(2)(C)(ii)(I) of the Exchange Act, is that the applicant does not have adequate financial and managerial resources to consistently produce credit ratings with integrity and to materially comply with the procedures and methodologies disclosed under paragraphs (1)(B) and with subsections (g), (h), (i) and (j) of Section 15E of the Exchange Act.²³⁴ The second finding, prescribed in Section 15E(a)(2)(C)(ii)(II) of the Exchange Act, is that if the applicant were registered as an NRSRO, its registration would be subject to suspension or revocation under subsection (d) of Section 15E of the Exchange Act.²³⁵ The Rating Agency Act and its legislative history provide no guidance on how the Commission should make either of the findings. For example, the Rating Agency Act and its legislative history do not identify factors the Commission should consider in analyzing whether an applicant has “adequate financial and managerial resources to consistently produce credit ratings with integrity” or the degree of misconduct that would support a finding that the applicant, if registered, would be subject to having its registration suspended or revoked under Section 15E(d) of the Exchange Act.²³⁶ Moreover, given that the Commission cannot undertake an examination of the applicant as part of the application process, the Commission must largely rely on information provided in the application to analyze whether to institute proceedings to determine whether an application should be denied.

²³³ See Finding 5 in Section 2 of the Rating Agency Act.

²³⁴ 15 U.S.C. 78o-7(a)(2)(C)(ii)(I).

²³⁵ 15 U.S.C. 78o-7(a)(2)(C)(ii)(II).

²³⁶ Section 15(d) of the Exchange Act provides that the Commission shall, by order, censure, place limitations on the activities, functions or operations of, suspend for a period not exceeding 12 months, or revoke the registration of an NRSRO if the NRSRO or an associated person: (1) has committed or omitted any act, or has been subject to an order or finding, enumerated in subparagraphs (A), (D), (E), (G), or (H) of section 15(b)(4) of the Exchange Act, has been convicted of any offense specified in section 15(b)(4)(B) of the Exchange Act, or has been enjoined from any action, conduct, or practice specified in section 15(b)(4)(C) of the Exchange Act of; (2) has been convicted of any crime that is punishable by imprisonment for 1 or more years, and that is not described in section 15(b)(4) of the Exchange Act, or has been convicted of a substantially equivalent crime by a foreign court of competent jurisdiction; (3) is subject to any order of the Commission barring or suspending the right of the person to be associated with an NRSRO; (4) fails to furnish the certifications required under Section 15E(b)(2) of the Exchange Act (this section requires an NRSRO to annually certify a number matters); or (5) fails to maintain adequate financial and managerial resources to consistently produce credit ratings with integrity. 15 U.S.C. 78o-7(d).

Finally, the Rating Agency Act requires the Commission to submit an annual report to Congress that, among other things, identifies applicants for registration and specifies the number of, and actions taken on, such applications. In this way, Congress established a mechanism to monitor the extent to which the Commission was denying applications for NRSRO registration. Clearly, the denial of applications was a concern underlying the Rating Agency Act.

III. THE APPLICATION OF THE CRA

Against the backdrop of the legislative history of the Rating Agency Act, TM reviewed the [REDACTED] application of the CRA. Once TM's review was complete, it circulated an action memo to the Commission recommending that the Commission grant the registration because, based on information submitted by the applicant, it was a "credit rating agency" as defined in Section 3(a)(61) of the Exchange Act²³⁷ and it had submitted the information required under Section 15E(a)(1)(B) of the Exchange Act²³⁸ on Form NRSRO, including the 10 QIB certifications. However, in the memo, TM identified a number of issues that it believed should be made known to the Commission. It is important to note that these were the views of the staff and that they did not necessarily reflect the views of the Commissioners. The issues identified by the staff fell into two categories: factual concerns and qualitative concerns.²³⁹

There were two factual concerns raised by TM: (1) "suspicions about the accuracy of financial information provided by the CRA;" and (2) that the CRA initially submitted a number of QIB certifications that did not comply with provisions with the Rating Agency Act and that the process undertaken by the CRA to submit corrected QIB certifications raised questions about their authenticity. While noting reservations about the financial

²³⁷ 15 U.S.C. 78c(a)(61).

²³⁸ 15 U.S.C. 78o-7(a)(1)(B).

²³⁹ In the memo to the Commission, TM also analyzed whether the Commission could find that the fees charged to subscribers by the CRA to access its credit ratings were reasonable. This analysis was not unique to this CRA but rather is undertaken each time a subscriber-paid credit rating agency applies for registration. Specifically, as noted above, Section 3(a)(61) of the Exchange Act defines a "credit rating agency" as, among other things, an entity that issues credit ratings for free or a reasonable fee (emphasis added). 15 U.S.C. 78c(a)(61). Consequently, for each NRSRO applicant that only makes its credit ratings available for a fee, TM engages in an analysis of whether the fee might be unreasonable in which case the entity would not meet the definition of "credit rating agency." *Id.* TM concluded that the Commission could grant the CRA's registration consistent with the definition of "credit rating agency" because the fees charged by the CRA appeared to be reasonable. The IG Report lists this analysis along with the factual and qualitative concerns raised by TM, all of which the IG Report characterizes as "significant issues" that should have been resolved before TM recommended the Commission grant the CRA's registration as an NRSRO. TM believes the IG Report should not include the fee analysis with the other concerns to make this argument because there was nothing about this CRA's fees that made them less reasonable than the fees charged by other subscriber-paid credit rating agencies.

statements and QIB certifications, TM had no evidence to challenge the accuracy of the CRA's financial statements and no evidence other than the QIB certifications (correct and incorrect) to challenge their authenticity. As noted above, the Commission had no express authority (or time) under the provisions of the Rating Agency Act to perform an examination of the CRA to determine whether the facts surrounding these concerns would uncover an actual problem or a benign explanation.

TM raised five qualitative concerns to the Commission: (1) the CRA disclosed in Exhibit 9 to Form NRSRO that it had a [REDACTED] compliance officer who did not have experience as a credit rating analyst; (2) the CRA disclosed in Exhibit 1 rating transition matrices that showed high volatility in its ratings; (3) the CRA disclosed in Exhibit 2 a description of its rating processes that provided much less detail than other registered NRSROs; (4) the CRA disclosed in Exhibit 7 policies and procedures to manage conflicts of interest that "could be enhanced;" and (5) TM noted that certain required policies and procedures had been adopted only recently as part of the CRA's application process.

IV. ANALYSIS

The question presented is: were the factual and qualitative concerns identified by TM of a nature that the Commission should have instituted a proceeding to determine whether registration should be denied? As discussed above, to deny the application, the Commission would need to find that: (1) that the CRA did not have adequate financial and managerial resources to consistently produce credit ratings with integrity and to materially comply with the procedures and methodologies disclosed under paragraphs (1)(B) and with subsections (g), (h), (i) and (j) of Section 15E of the Exchange Act; or (2) that if the applicant were so registered, its registration would be subject to suspension or revocation under subsection (d) of Section 15E of the Exchange Act. As discussed below, TM believes the factual and qualitative concerns raised by TM were not enough for the Commission to institute (and successfully litigate) a proceeding to deny the applicant's registration.²⁴⁰

²⁴⁰ Section 15E(a)(2)(B) of the Exchange Act prescribes the process for conducting a hearing to determine whether an application should be denied. 15 U.S.C. 78o-7(a)(2)(B). Under its provisions, the Commission must give notice of the grounds for the denial under consideration and an opportunity for a hearing. 15 U.S.C. 78o-7(a)(2)(B)(i)(I). The Commission must grant or deny the application at the conclusion of the proceedings. 15 U.S.C. 78o-7(a)(2)(B)(ii). Further, the Commission must conclude the proceeding within 120 days of receiving the application but can extend that time for 90 days if it finds good cause for the extension and publishes its reasons for so finding or for a longer period of time if the applicant consents. 15 U.S.C. 78o-7(a)(2)(B)(iii).

1. *Did the CRA have adequate financial and managerial resources?*

As note above, the first finding to deny an NRSRO registration application is the prescribed in Section 15E(a)(2)(C)(ii)(I) of the Exchange Act.²⁴¹ Under this provision, the Commission would need to find and prove that the applicant does not have adequate financial and managerial resources to consistently produce credit ratings with integrity and to materially comply with the procedures and methodologies disclosed under paragraphs (1)(B) and with subsections (g), (h), (i) and (j) of Section 15E of the Exchange Act (the “adequate financial and managerial resources finding”).²⁴² With respect to the adequate financial and managerial resources finding, the information provided within the four corners of the CRA’s application indicated: (1) that the CRA had been determining credit ratings for an extended period of time; (2) that subscribers were willing to purchase access to these credit ratings as indicted by a consistent level of revenues reported on its financial statements for the previous three years; and (3) that 10 QIBs were willing to certify they had been using the credit ratings of the CRA for at least three years to make some investment decisions. This evidence weighs in favor of concluding that the CRA had adequate financial and managerial resources to consistently produce credit ratings with integrity and to materially comply with the procedures and methodologies disclosed under paragraphs (1)(B) and with subsections (g), (h), (i) and (j) of Section 15E of the Exchange Act.

While some of the factual and qualitative concerns were relevant to the finding, they were not dispositive of the question. Specifically, each could have had an innocent explanation or turn out to be immaterial to the question of whether the CRA had adequate financial and managerial resources. For example, the volatility of the CRA’s credit ratings noted by TM could be indicative of macro economic factors or unique attributes of the applicant’s methodologies and procedures for determining credit ratings (*i.e.*, not the result of a process that lacked integrity). Resolving the question would have necessitated a review of the firm’s procedures and methodologies for determining credit ratings and its books and records to determine whether the firm was following these procedures and methodologies or deviating from them for some improper purpose. This would entail substantial exam work.²⁴³ The question is: does the Rating Agency Act

²⁴¹ 15 U.S.C. 78o-7(a)(2)(C)(ii)(I).

²⁴² *Id.*

²⁴³ For example, staffs from TM, OCIE and the Office of Economic Analysis examined the practices of Fitch Ratings, Ltd., Moody’s Investor Services, Inc., and Standard & Poor’s Ratings Services to review their activities in rating structured finance products linked to subprime mortgages. See Summary Report of Issues Identified in the Commission Staff’s Examinations of Select Credit Rating Agencies, SEC Staff Report (July 2008). This examination included reviewing deal files to analyze whether the firms followed their documented procedures for determining credit ratings and whether the ratings were unduly influenced by conflicts of interest. *Id.* The examination work necessary to complete this review with respect to just one of the firms took many months and involved numerous Commission staff. See Id.

contemplate this kind of review prior to registration? Put another way, would it have been appropriate for the Commission to institute proceedings to deny the application in order to resolve this factual question and the other concerns raised by the TM staff? In TM's judgment, the answer is "no" as such a process would be vulnerable to legal challenge as – in effect – returning to the prior staff no-action letter process. As indicated above, the unambiguous intent of the Rating Agency Act was to end such a pre-registration qualitative review by the staff and, thereby, lower the barriers to achieving NRSRO status.

In addition, the information underlying four of the five qualitative concerns was disclosed to the public in the CRA's Form NRSRO posted on its Internet web site as required by Rule 17g-1.²⁴⁴ Form NRSRO and Exhibits 1 through 9 of the Form must be publicly disclosed by an NRSRO on its Web site within 10 business days of being registered.²⁴⁵ The disclosure of the Form and Exhibits is designed to provide a mechanism for users of credit ratings and market observers to assess the relative quality of a particular NRSRO in terms of, among other things, its ratings performance statistics, procedures and methodologies for determining credit ratings, procedures for managing conflicts of interest, the educational requirements for its credit analysts, and the experience of its designated compliance officer. The disclosures allow users of credit ratings and market observers to make comparisons across NRSROs and reach their own conclusions about the adequacy of a given NRSRO's managerial resources and the quality of its methodologies, procedures and policies. As stated in the Senate Report –

Credit rating agencies that choose to register as NRSROs must disclose important information such as ratings performance, conflicts of interest, and the procedures for determining ratings. This information will facilitate informed decisions by giving investors the opportunity to compare ratings quality of different firms.²⁴⁶

Thus, the fact that the CRA provided a "much less detailed description" of its procedures for determining credit ratings in its public disclosure could cause investors and others not to use CRA's credit ratings. This is how Congress intended the Rating Agency Act to operate – allow market forces (as opposed to the Commission staff) decide which NRSROs perform best in determining accurate credit ratings.

Finally, with respect to the qualitative concerns, consideration must be given to the fact that the registration and oversight program established by the Rating Agency Act

²⁴⁴ 17 CFR 240.17g-1. The fifth qualitative concern was that TM noted that certain required policies and procedures had been adopted only recently as part of the CRA's application process.

²⁴⁵ 17 CFR 240.17g-1(i).

²⁴⁶ Senate Report, pp. 7-8.

and the Commission's rules thereunder was brand new. There was no history of regulatory compliance with these statutory requirements and rules that could be used as a benchmark or template by applicants to refer to in preparing an application or by the Commission to evaluate whether an applicant had adequate financial or managerial resources. Consequently, TM provided the Commission with its qualitative views on the CRA's managerial resources and on its Form NRSRO disclosures, but could not conclude that they failed to satisfy the requirements of the Rating Agency Act. In addition, attention must be paid to the fact that the CRA was a small business and Congress enacted the Rating Agency Act to level the playing field for smaller credit rating agencies.

2. *If the CRA had been registered, would its registration have been subject to suspension or revocation under subsection (d) of Section 15E of the Exchange Act?*

As noted above, the second finding to deny an NRSRO registration is prescribed in Section 15E(a)(2)(C)(ii)(II) of the Exchange Act.²⁴⁷ Under this provision, the Commission would need to find and prove that: if the applicant were registered as an NRSRO, its registration would be subject to suspension or revocation under subsection (d) of Section 15E of the Exchange Act (the "Section 15E(d) finding").²⁴⁸ With respect to the Section 15E(d) finding, the CRA answered "no" to each question in Item 8 of Form NRSRO [REDACTED]

[REDACTED]. This Item asks three questions about whether the applicant or an associated person: (1) has committed or omitted any act, or has been subject to an order or finding, enumerated in subparagraphs (A), (D), (E), (G), or (H) of section 15(b)(4) of the Exchange Act, has been convicted of any offense specified in section 15(b)(4)(B) of the Exchange Act, or has been enjoined from any action, conduct, or practice specified in section 15(b)(4)(C) of the Exchange Act; (2) has been convicted of any crime that is punishable by imprisonment for 1 or more years, and that is not described in section 15(b)(4) of the Exchange Act, or has been convicted of a substantially equivalent crime by a foreign court of competent jurisdiction; or (3) is subject to any order of the Commission barring or suspending the right of the person to be associated with an NRSRO.²⁴⁹ These are the acts or omissions set forth in paragraphs (1), (2) and (3) of Section 15E(d) of the Exchange Act.²⁵⁰ Consequently, based on the information provided in the application, the Commission had no basis to make a finding that the CRA, if registered, would be subject to having its registration suspended or revoked pursuant to these paragraphs of Section 15E(d) of the Exchange Act.

²⁴⁷ 15 U.S.C. 78o-7(a)(2)(C)(ii)(II).

²⁴⁸ Id.

²⁴⁹ Id.

²⁵⁰ See 15 U.S.C. 78o-7(d)(1), (2) and (3).

Paragraph (4) of Section 15E(d) of the Exchange Act provides that the Commission shall take one of the actions prescribed in Section 15E(d) of the Exchange Act if an NRSRO fails to furnish the certifications required under Section 15E(b)(2) of the Exchange Act.²⁵¹ Section 15E(b)(2) of the Exchange Act provides that an NRSRO must furnish to the Commission an annual certification in which it certifies, among other things, that the information and documents in its application continue to be accurate and listing any change that occurred to such information or documents during the previous calendar year.²⁵² Obviously, the Commission could not make a Section 15E(d) finding based on this provision with respect to the CRA's [REDACTED] registration application as the CRA had not been required to furnish an annual certification at the time.²⁵³

Finally, paragraph (5) of Section 15E(d) of the Exchange Act provides that the Commission shall take one of the actions prescribed in Section 15E(d) of the Exchange Act if an NRSRO fails to maintain adequate financial and managerial resources to consistently produce credit ratings with integrity.²⁵⁴ As discussed above, TM does not believe the factual and qualitative concerns could successfully support the adequate financial and managerial resources finding prescribed in Section 15E(a)(2)(C)(ii)(I) of the Exchange Act.²⁵⁵ The finding required in Section 15E(a)(2)(C)(ii)(II) of the Exchange Act is that the applicant, if registered, would be subject to having its registration suspended or revoked because – with respect to paragraph (5) of the Section 15E(d) of the Exchange Act – it fails to maintain adequate financial and managerial resources to consistently produce credit ratings with integrity.²⁵⁶ This would appear to be a tougher standard than the adequate financial and managerial resources finding prescribed in Section 15E(a)(2)(C)(ii)(I) of the Exchange Act²⁵⁷ because the Commission would need to find not only that the NRSRO failed to maintain adequate financial and managerial resources but that its failure to do so was of such a degree that the Commission would revoke or suspend the registration of the NRSRO, if it were registered, as opposed to censuring, or placing limitations on the activities, functions, or operations of the NRSRO. In other words, the finding necessary to successfully deny a credit rating agency's application for registration prescribed in Section 15E(a)(2)(C)(ii)(II) of the Exchange Act is that the applicant's registration would be revoked or suspended if it were registered (i.e., it does not include the lesser penalties of censure, or limiting the activities, functions or operations of the NRSRO as a basis for denying a registration).²⁵⁸ This means Congress intended that the Commission not necessarily suspend or revoke the registration

²⁵¹ 15 U.S.C. 78o-7(d)(4).

²⁵² See 15 U.S.C. 78o-7(b)(2)(A) and (B).

²⁵³ [REDACTED]

²⁵⁴ 15 U.S.C. 78o-7(d)(5).

²⁵⁵ 15 U.S.C. 78o-7(a)(2)(C)(ii)(I).

²⁵⁶ 15 U.S.C. 78o-7(a)(2)(C)(ii)(II).

²⁵⁷ 15 U.S.C. 78o-7(a)(2)(C)(ii)(I).

²⁵⁸ See 15 U.S.C. 78o-7(a)(2)(C)(ii)(II).

of an NRSRO that “fails to maintain adequate financial and managerial resources to consistently produce credit ratings with integrity” (i.e., that an appropriate sanction could be to censure or place limitations on the activities, functions or operations of the NRSRO).

At a minimum, this raises a question about whether there is an implicit “degree” test with respect to the adequate financial and managerial resources finding prescribed in Section 15E(a)(2)(C)(ii)(I) of the Exchange Act.²⁵⁹ In other words, did Congress intend that an applicant not be granted registration if it fails to maintain adequate financial and managerial resources to consistently produce credit ratings with integrity under all circumstances, even though, after registration, an NRSRO could, in some cases, continue to operate as an NRSRO notwithstanding its failure to maintain adequate financial and managerial resources to consistently produce credit ratings with integrity. Alternatively, could the Commission grant an applicant’s registration as an NRSRO even though it fails to maintain adequate financial and managerial resources to consistently produce credit ratings with integrity, provided the appropriate sanction upon registration would not be suspension or revocation of the registration. Unfortunately, the Senate Report provides no guidance on this point.

V. CONCLUSION

For all these reasons, it is the judgment of TM that the Commission made the appropriate decisions as a matter of law to grant the CRA’s application. The factual and qualitative concerns identified to the Commission would not have successfully supported either of the findings necessary to deny an application for registration. Moreover, instituting proceedings based on these concerns ran a significant risk of being challenged as contravening the goal of the Rating Agency Act by, in effect, returning to the prior staff no-action letter process in which examinations were used to make qualitative assessments of a credit rating agency seeking to be identified as an NRSRO. Given the Rating Agency Act’s unambiguous intent to increase competition by lowering the barriers to achieving NRSRO status, TM believes the Commission took the soundest legal course in granting the CRA’s application. The appropriate mechanism to address concerns identified by TM was through the Commission’s examination function under the Rating Agency Act, which was triggered once the applicant became registered as an NRSRO.

²⁵⁹ 15 U.S.C. 78o-7(a)(2)(C)(ii)(I).

Comments from the Office of Compliance Inspections and Examinations

MEMORANDUM

TO: David Kotz
Inspector General, Office of Inspector General

FROM: John Walsh
Acting Director, Office of Compliance Inspections and Examinations

RE: OCIE Response to the Office of Inspector General Report No. 458, *The SEC's Role Regarding and Oversight of NRSROs*

DATE: August 25, 2009

I. Introduction

The Office of Compliance Inspections and Examinations ("OCIE") submits this memorandum in response to the Office of Inspector General's ("OIG") draft report entitled *The SEC's Role Regarding and Oversight of NRSROs* ("Report"). Thank you for the opportunity to respond to the Report. Let me also express our appreciation for the professional courtesy extended by you and your staff during the audit.

You have requested that we indicate whether we "concur" or "non-concur" with each recommendation. In no case do we "non-concur." However, several of the recommendations directed to OCIE will require the deployment of significant staff resources or the resolution of antecedent policy issues. In those cases we have indicated that we "do not object," and describe the steps we will take to follow-up on your recommendation. Otherwise, we state that we "concur" and describe how we intend to implement your recommendation.

The Report also contains several recommendations directed to the Chairman, the Commissioners, and other Divisions or Offices, in which you state that the party to whom you direct your recommendation should consult with OCIE. We have not responded to these recommendations, but you should rest assured that we stand ready to consult with the Chairman, the Commissioners, and other Divisions and Offices and to assist them as they believe appropriate in responding to your recommendations.

Finally, we note that the Report contains non-public information. We request that all such information be redacted from the public version of the Report and have attached, under separate cover, a Memorandum outlining the items that we believe should be redacted.

II. Background

OCIE is proud of the hard work and dedication shown by the Commission staff associated with rating agency oversight over the last several years. In response to the turmoil in the credit markets caused by the Subprime Crisis, former Chairman Cox directed Commission staff to initiate examinations of the three largest rating agencies. Because of the grave risk to the financial markets, these examinations were begun prior to the effective date of the rating agencies' registration with the Commission under the recently adopted NRSRO rules. Over 50 staff from OCIE, the Division of Trading and Markets, and the Office of Economic Analysis worked together to conduct these examinations. They rapidly reviewed hundreds of thousands of pages of documents and electronic communications, conducted interviews, and analyzed the factual record. A Public Report was issued less than a year later. The results of the examinations were significant, contributed to widespread compliance changes at the rating agencies, and helped inform new rulemaking by the Commission. We believe this experience demonstrates the agency's ability to quickly field teams drawn from different offices and divisions, to examine new and difficult areas of responsibility, and to prepare significant work product that has an important effect on the financial markets.

Then, in October 2008, OCIE was tasked with conducting regular examinations of registered NRSROs. Since that time we have been actively conducting examinations. In these examinations we have continued to work closely with staff from the Division of Trading and Markets, and other Divisions and Offices within the Commission.

More recently, as you note in your Report, Chairman Schapiro has assigned new resources to the oversight of rating agencies, including a Credit Ratings Branch in OCIE that will specialize in rating agency examinations. We are currently recruiting staff for this branch, and hope to retain staff with significant credit ratings expertise. We believe this new specialization will enhance even further our oversight of NRSROs.

III. Recommendations Directed to OCIE

Recommendation 6: The Division of Trading and Markets and the Office of Compliance Inspections and Examinations should take appropriate actions to inform Nationally Recognized Statistical Rating Organizations about the Commission's expectations regarding the experience of their compliance officers.

OCIE concurs with this Recommendation. We have implemented an active outreach program for compliance officers and compliance professionals, including national and regional *CCOutreach* programs. These outreach programs play a positive role in communicating the expectations of the Commission, and in enhancing the expertise and professionalism of the compliance community. We will undertake to extend this program to NRSRO compliance personnel.

Recommendation 10: *The Office of Compliance Inspections and Examinations (OCIE) should include the Nationally Recognized Statistical Rating Organizations (NRSROs) in its pilot monitoring program. Given the different sizes (i.e., market dominance) of the various NRSROs and the current examination cycle, OCIE should specifically tailor its monitoring program for each particular NRSRO.*

OCIE does not object to this recommendation. The idea of using monitoring teams to enhance our oversight of NRSROs has merit and warrants careful inquiry. We have deployed pilot monitoring team programs to other types of registrants, and could do so for NRSROs as well. However, full implementation of the recommendation, a monitoring team for each NRSRO, would require substantial additional resources. In addition, we believe further work is needed to determine whether having a monitoring team for each NRSRO would have sufficient oversight value to warrant the necessary expenditure of resources. Therefore, to follow-up on this recommendation, we anticipate working with the Chairman's Office and the Division of Trading and Markets to establish a pilot monitoring program for selected NRSROs, with responsible staff drawn from either OCIE or the Division of Trading and Markets. After an appropriate period of experience with the pilot, we will formulate a recommendation to the Chairman as to whether the program should be extended to all NRSROs, and if so, the resources that would require.

Recommendation 11: *The Office of Compliance Inspections and Examinations (OCIE), in consultation with the Ethics Office and the Office of Administrative Services, should obtain an additional review of the draft OCIE Nationally Recognized Statistical Rating Organization (NRSRO) examination module by an expert in credit rating and NRSRO matters.*

OCIE concurs with this recommendation. We are currently recruiting staff for OCIE's newly formed Credit Ratings Branch and hope to retain staff with significant credit ratings expertise. We plan to seek input from the newly hired staff on the substance of the NRSRO examination module.

Recommendation 13: *The Office of Compliance Inspections and Examinations should perform examination work to determine whether the quality of credit ratings is being adversely affected by Nationally Recognized Statistical Rating Organizations (NRSROs)*

performing consulting and advisory services for issuers, underwriters or obligors that have paid the NRSROs for credit ratings.

Please see our response to Recommendation 19.

Recommendation 16: *The Office of Compliance Inspections and Examinations should perform examination work into whether, and under what circumstances, credit rating analysts face undue influence and the effects of such undue influence on the credit ratings issued by Nationally Recognized Statistical Rating Organizations.*

Please see our response to Recommendation 19.

Recommendation 19: *The Office of Compliance Inspections and Examinations should conduct examinations to evaluate whether the revolving door problem is negatively impacting the quality of credit ratings.*

OCIE does not object to Recommendations 13, 16, and 19. In each of these recommendations, we understand that our examinations would be intended to assist the agency in formulating regulatory policy for NRSROs. We stand ready to assist the Chairman, the Commission, and the Division of Trading and Markets in their regulatory functions, but note that complying with these three recommendations would probably require us to conduct three separate sweep examinations of registered NRSROs. Sweep examinations are resource intensive and can be expected to require the analysis of voluminous internal records such as ratings files, policies and procedures, and e-mails. For example, our 2007-2008 examinations of three NRSROs, which focused solely on sub-prime ratings, required the participation of over 50 Commission staff. In short, conducting the recommended examinations could require additional staff, could be a multi-year endeavor, and could divert examination resources away from other compliance or policy areas that the Chairman or Commission have selected for immediate attention. To follow-up on your recommendations we anticipate working with the Chairman's Office and the Division of Trading and Markets, and will consider your recommendations when determining the appropriate priority and timing for possible sweep examinations involving NRSROs.

Comments from the Office of International Affairs

TO: Office of Inspector General
FROM: Office of the International Affairs
DATE: August 25, 2009
RE: OIA Comments on Draft Report on SEC Oversight of NRSROs

Thank you for the opportunity to comment on the Inspector General's report, "The SEC's Role Regarding and Oversight of NRSROs" (IG Report). The Office of International Affairs (OIA) involvement with credit rating agency (CRA)-related issues to date has been with regard to OIA Director Ethiopis Tafara's previous chairmanship of the Credit Rating Agency Task Force (now the Credit Rating Agency Standing Committee) within the International Organization of Securities Commissions (IOSCO) and OIA's continuing monitoring and analysis of legislative and regulatory changes in foreign jurisdictions regarding CRA oversight. As part of this work, OIA was heavily involved in negotiating the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies (IOSCO CRA Code), which was recently highlighted in the G-20 Communiqué as the international "baseline" consensus regarding CRA oversight. OIA is also currently involved in discussions with a number of the SEC's foreign counterparts on developing cross-border information-sharing and cooperation mechanisms that will allow for more effective oversight of those Nationally Recognized Statistical Rating Organizations (NRSROs) that operate across national borders.

Given OIA's work in this area, we support many of the Inspector General's recommendations, particularly with regard to foci for future NRSRO inspections. However, OIA would like to raise concerns about one section of the IG Report.

Analyst Rotation

Recommendations 16 and 17 of the IG Report deal with mandatory rotation of NRSRO analysts, a requirement currently contained under recently enacted European Union CRA regulation. While we agree with Recommendation 17 that the issue of a credit analyst's relationship with the issuers he or she analyzes is important and one that a regulator should review when overseeing an NRSRO, and while we agree that all policy proposals, including analyst rotation, deserve to be considered, we have doubts that the issues highlighted by the IG Report are addressed by mandatory analyst rotation.

While often linked together even in some academic papers and foreign legislation as “gatekeepers,” the role of an independent auditor and a CRA is very different, and face correspondingly different conflicts of interest and transparency concerns. Auditors might be described as “backwards-focused,” in that they use audit standards set by the Public Company Accounting Oversight Board (PCAOB) to opine on statements that an issuer makes regarding historic facts. By contrast, CRAs are “forwards-focused,” using non-standardized and proprietary methodologies (which current legislation prohibits the SEC from regulating) to predict the likelihood of future events.

The role that a CRA analyst plays within a CRA is also quite different from the role a lead auditor or even an audit partner plays. A lead audit partner may be responsible for the fees collected from an issuer, and compensated accordingly. By contrast, NRSRO analysts are separated from all discussions regarding issuer fees and are not permitted to be compensated based on any fees collected from an issuer they study. Likewise, whereas an audit partner has significant control over the audit’s final conclusions, in most CRAs, the CRA analyst reports his or her analyses to a rating committee, which considers the information provided by the analyst and is responsible for assigning a final rating after a deliberation.

The Sarbanes-Oxley Act of 2002 prohibits a lead audit partner or a concurring audit partner from performing audit services for an issuer for more than five consecutive years. Likewise, SEC rules require periodic rotation for audit firm partners in charge of an audit engagement team and who have responsibility for significant decision-making regarding the audit (among other things). Neither the Sarbanes-Oxley Act nor the Commission’s own rules require rotation of the audit engagement teams.

Lead analysts at NRSROs are in many ways more like the members of an audit team than they are like lead auditors because analysts are not allowed to be involved in selling products or setting fees, and they are not compensated according to how much business is generated by a particular issuer they cover. However, their expertise takes time to develop and is uncommon. While there remains concerns about analysts “going native” vis-à-vis the industries they cover, this seems more plausible with new analysts, who will rely even more heavily on issuers for information regarding an industry of which they might have comparatively little understanding. For this reason, mandatory analyst rotation might actually undermine the independence of a CRA analyst. While there may be value to having new analysts take a “fresh look” at an issuer, this value is likely not tied to analyst independence and its effect on the quality of a rating is likely to be individual-specific.

Accordingly, while we support the IG Report’s recommendation that the Division of Trading and Markets should assess the degree of influence that credit analysts may face from issuers as part of the credit rating process, we have doubts regarding that part of the recommendation that suggests that Trading and Markets should focus exclusively on

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reviewing the potential benefits of an analyst rotation requirement when it is possible that other alternatives may address any problems that are found to exist.

Comments from the Office of Economic Analysis

OEA did not provide a formal comment memorandum, but stated in an e-mail dated August 19, 2009, that it concurs with all recommendations directed to OEA (numbers 2, 4, 5, 14, 15, 18, 22, 23 and 24).

Office of Inspector General Response to Management's Comments

We are pleased that of the OIG report's 24 recommendations, the Office of the Chairman and OCIE concurred with the 13 recommendations directed to these offices. We are also pleased that TM fully concurred with seven, and partially concurred with five, of the 13 recommendations directed to that Division. (Two recommendations, Recommendation 6 and Recommendation 15, were directed to both TM and another office.)

We acknowledge that the Commission has faced, and still faces, many challenges in its oversight of NRSROs, particularly in the wake of the recent financial crisis. We appreciate the increased focus Chairman Schapiro has placed on this issue, making improving the quality of credit ratings one of her priorities. We also appreciate the recent efforts of TM and OCIE staff to improve the Commission's NRSRO oversight by recommending new regulatory proposals and increasing examination efforts.

With respect to TM's partial concurrence with Recommendations 1 through 3, we appreciate TM's willingness to endeavor to resolve significant outstanding issues identified in the NRSRO application process. However, we disagree with TM's position that it appropriately recommended that the Commission grant one CRA's application for NRSRO registration, despite the numerous significant problems TM identified with the application. We believe that TM's view renders the statutory requirements for the Commission's granting a CRA's application for NRSRO registration meaningless. Under the approach adopted by TM, so long as an applicant meets the definition of a CRA and submits the required information in its application, the Commission has no choice but to approve the application and would never institute proceedings to determine whether registration should be denied, as contemplated by the Rating Agency Act. We hope that TM will reconsider its position and implement these recommendations in full.

Further, regarding Recommendations 4 and 7, we are pleased that TM has agreed to consult with or seek guidance from the Commission on these issues. Nonetheless, we believe that it is important that TM have some measures for determining the reasonableness of subscriber fees charged by CRAs and that NRSRO requests for extensions of time for filing forms and annual reports are

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handled in accordance with statutory or regulatory requirements. We would hope, therefore, that these recommendations are fully implemented.

Finally, we are disappointed that TM has not concurred with Recommendation 24, which recommended that the Commission's annual report to Congress on NRSROs be expanded to include additional areas identified by the OIG. We believe that the additional issues identified by our review would make the annual reports more useful and informative to the Congress, investors and the general public. We believe that TM should reconsider its position and implement this recommendation.

Audit Requests and Ideas

The Office of Inspector General welcomes your input. If you would like to request an audit in the future or have an audit idea, please contact us at:

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To report fraud, waste, abuse, and mismanagement at SEC,
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