



Matthew C. Molé
Vice President & General Counsel

99 Church Street
New York, NY 10007
212.553.7958
212.553.0054 Fax
212.962.5045 Fax
e-mail: molem@moody.com

5 December 1994

U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Attention: Jonathan G. Katz

Re: File No. S7-23-94
Release No. 33-7085
Concept Release Regarding Nationally Recognized Statistical Rating
Organizations

Ladies and Gentlemen:

This letter is submitted by Moody's Investors Service, Inc. ("**Moody's**") in response to the request, as set forth in Release No. 33-7085 (the "**Concept Release**") of the Securities and Exchange Commission ("**SEC**" or the "**Commission**"), for recommendations on the Commission's role in using ratings of nationally recognized statistical rating organizations ("**NRSROs**"). The SEC has requested comment on (1) whether the concept of NRSRO should continue to be used in the SEC's regulations, (2) if so, whether and how the term should be defined, and (3) whether the SEC should take steps to regulate NRSROs.

I. INTRODUCTION

A. **Moody's Investors Service**

Moody's is a publisher. Since 1909, it has published rating opinions on the creditworthiness of issuers of securities. Originally, Moody's derived substantially all of its income from subscriptions and did not publish issuer-solicited ratings. In 1970, Moody's initiated the practice of charging issuers for ratings. Moody's determined that this change in practice was necessary in order to enhance its resources in the face of the increasing number and complexity of financial instruments being offered and to respond to the "free rider" problem caused by the broad dissemination of its ratings.¹ Despite this change in the

¹ The "free rider" problem exists because a rating, once published, is easily copied and disseminated to non-subscribers. See Richard Cantor and Frank Packer, *The Credit Rating Industry*, 19 FRBNY Q. REV. 1, 4 (Summer-Fall 1994). In addition, because ratings are generally reflected in the price of a security, an investor may benefit from a rating even if he or she is unaware of the rating.

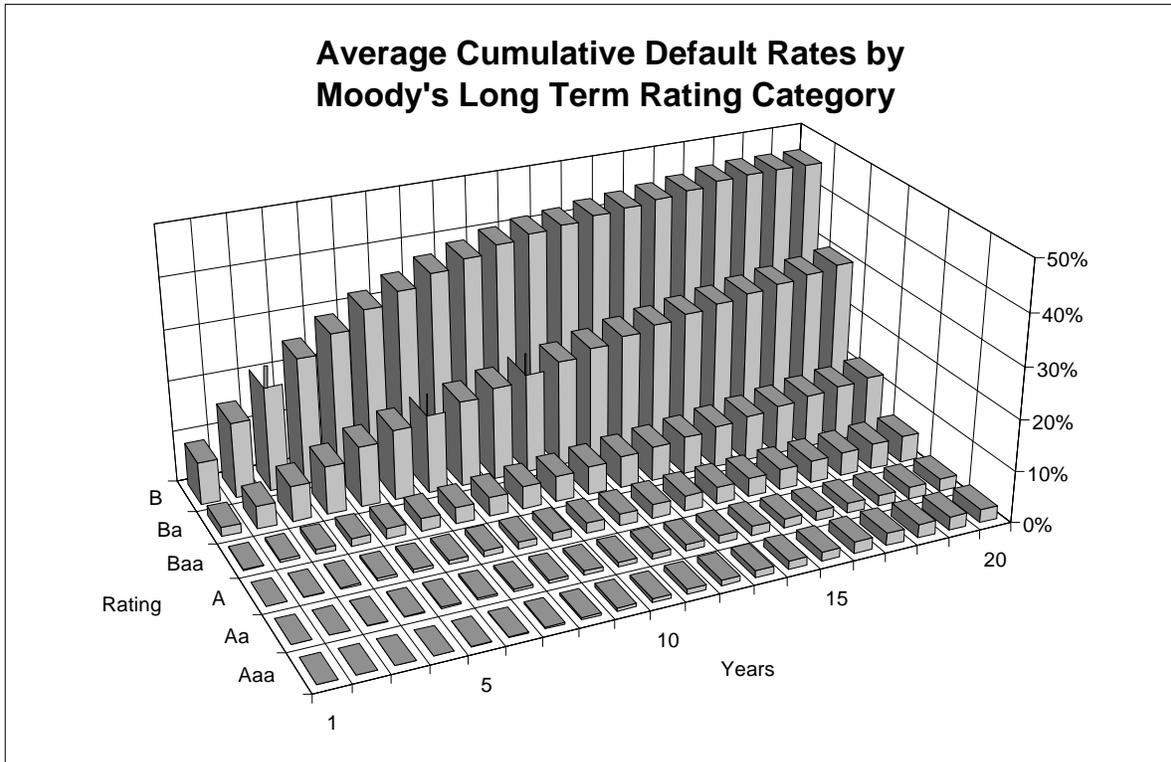
economics of the enterprise, Moody's business was, and remains, rooted in the independence and objectivity that derived from a history of generating revenue solely from subscriptions. Moody's traditions of independence and objectivity, which developed during sixty years of not taking money from issuers, remain firmly embedded in the culture of the organization. Moody's recognizes that the practice of charging issuers creates a risk that such qualities may be compromised, but it is convinced it has erected sufficient structural safeguards to retain its independence and objectivity.

B. The Nature of Ratings

Ratings are expressions of opinion about risk, not statements of, or even predictions about, facts. There is not now, nor can there ever be, a science or an orthodoxy for debt ratings. In the most basic sense, all bonds perform in a binary manner. They either pay on time or default and cause a loss. If the future could be known, there would be only two ratings for bonds: *good* or *bad*. Because the future cannot be known, credit analysis resides in the realm of opinion, not fact. The essence of credit rating is the soundness of the judgment that groups bonds into similar classes of risk.

Research has shown a strong correlation between Moody's ratings and actual default experience. Data accumulated over a period of more than twenty years demonstrates that corporate bonds that have received higher ratings from Moody's tend to default less frequently than lower-rated corporate bonds. The accompanying graph illustrates the results of Moody's most recent corporate bond default study. It shows the frequency of defaults for corporate bonds in different rating categories over time horizons of up to 20 years. Each row of bars represents a different generic rating category. The results of the study confirm that Moody's has assigned ratings in a consistent and accurate manner and ratify the market's confidence in the use of ratings as estimators of credit risk.²

² Jerome S. Fons, Lea Carty, and Jeremy Kaufman, *Corporate Bond Defaults and Default Rates 1970-1993*, MOODY'S SPECIAL REPORT 18 (Jan. 1994); *see also*, *1993 Corporate Default, Rating Transition Study Results*, STANDARD & POOR'S CREDITWEEK 1 (May 2, 1994).



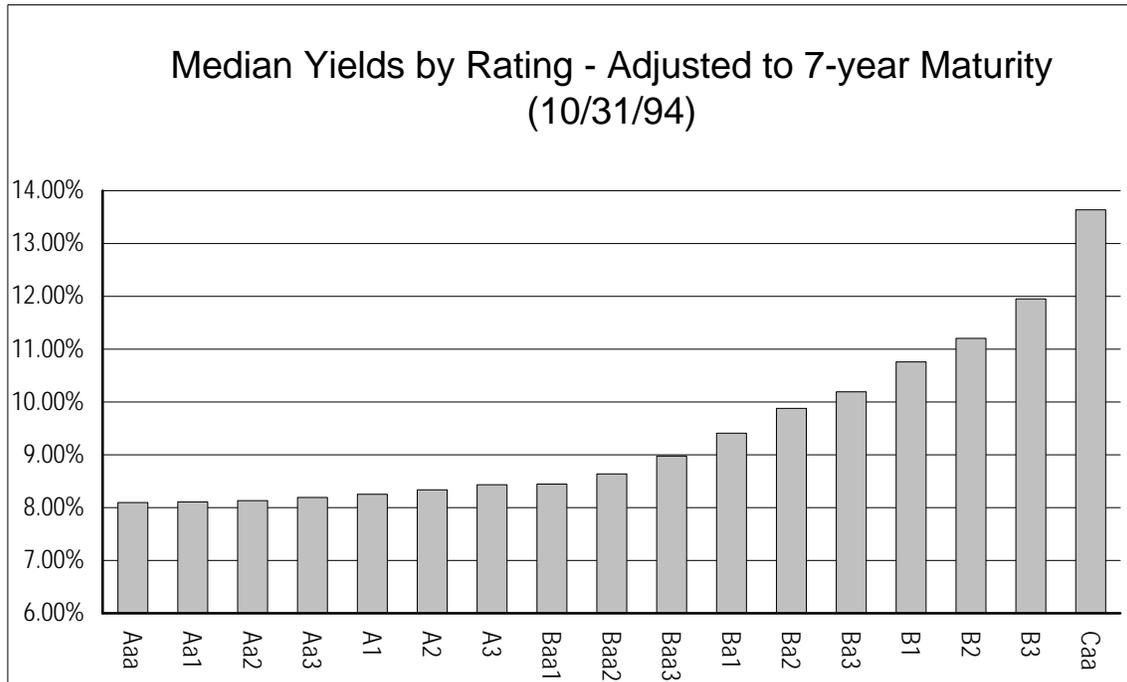
Because of this correlation, Moody's ratings have established credibility by providing a useful tool to investors on an overall basis, even though a rating is not a prediction of absolute outcome in a specific case but only an opinion about relative risk.

As is true of all opinions about risk, debt ratings cannot be proved correct or incorrect simply by the occurrence or non-occurrence of the event upon whose risk they opine. Default on a bond rated **Aaa** upon issuance does not prove that the original rating was wrong, any more than punctual payment of a bond initially rated **Caa** proves that that rating judgment was wrong. The test of a rating system is the degree to which ratings as a whole correlate with actual default experience over time. Hence, the only "wrongness" that could even remotely be attributed to a rating is the degree to which the rating and subsequent default experience diverge from expectations and undermine or diminish the tight correlation that all rating agencies strive to achieve.

C. The Introduction of the NRSRO Concept

By 1975, Moody's ratings and those of its competitor, Standard & Poor's ("**S&P**"), had been observed to *correlate* closely with actual default experience. In addition, the rating categories of the two agencies had come to represent similar degrees of risk, and the dividing lines, or breaks, between categories had been found to be essentially equivalent. This *congruence* was widely recognized and relied upon by the market. Because the divisions in the rating categories were congruent, the market could compare the ratings of the two

organizations and interpret their agreement or disagreement clearly.³ The market's perception of the correlation and congruence of Moody's and S&P's ratings resulted in their ratings' having a material impact on the prices of rated securities. As the following graph illustrates, investors demand a higher risk premium for lower-rated bonds.



When the SEC introduced the term “NRSRO” in 1975, it was indirectly relying on (i) this observed correlation between Moody's and S&P's ratings, on the one hand, and actual default experience, on the other, and (ii) the perceived congruence of their rating scales. The ratings' correlation with actual default experience made them useful in evaluating relative riskiness, and the congruence of the two rating scales allowed the market to compare ratings in significant ways. Indeed, the “national recognition” — *i.e.*, ability to impact bond prices — achieved by Moody's and S&P early in their history was quite simply a reflection of the correlation and congruence perceived by the market.

The adoption of the NRSRO concept served a useful purpose from the SEC's point of view by allowing it to distinguish between high and low-quality debt without itself becoming involved in credit judgments. The SEC's action, however, had the effect of elevating the opinions of certain publishers to a special status. Because the SEC was apparently attentive to the risk of establishing a limited class of entities with a revenue stream perceived to be derived from the status thus conferred by the NRSRO designation, it also designated other rating

³ This congruence appears to have continued. A 1992 study of ratings issued after 1989 found a 0.967 correlation between Moody's and S&P's ratings. Vivien Beattie and Susan Searle, *Bond Ratings and Inter-Rater Agreement*, J. OF INT'L. SECS. MARKETS 167, 170 (Summer 1992).

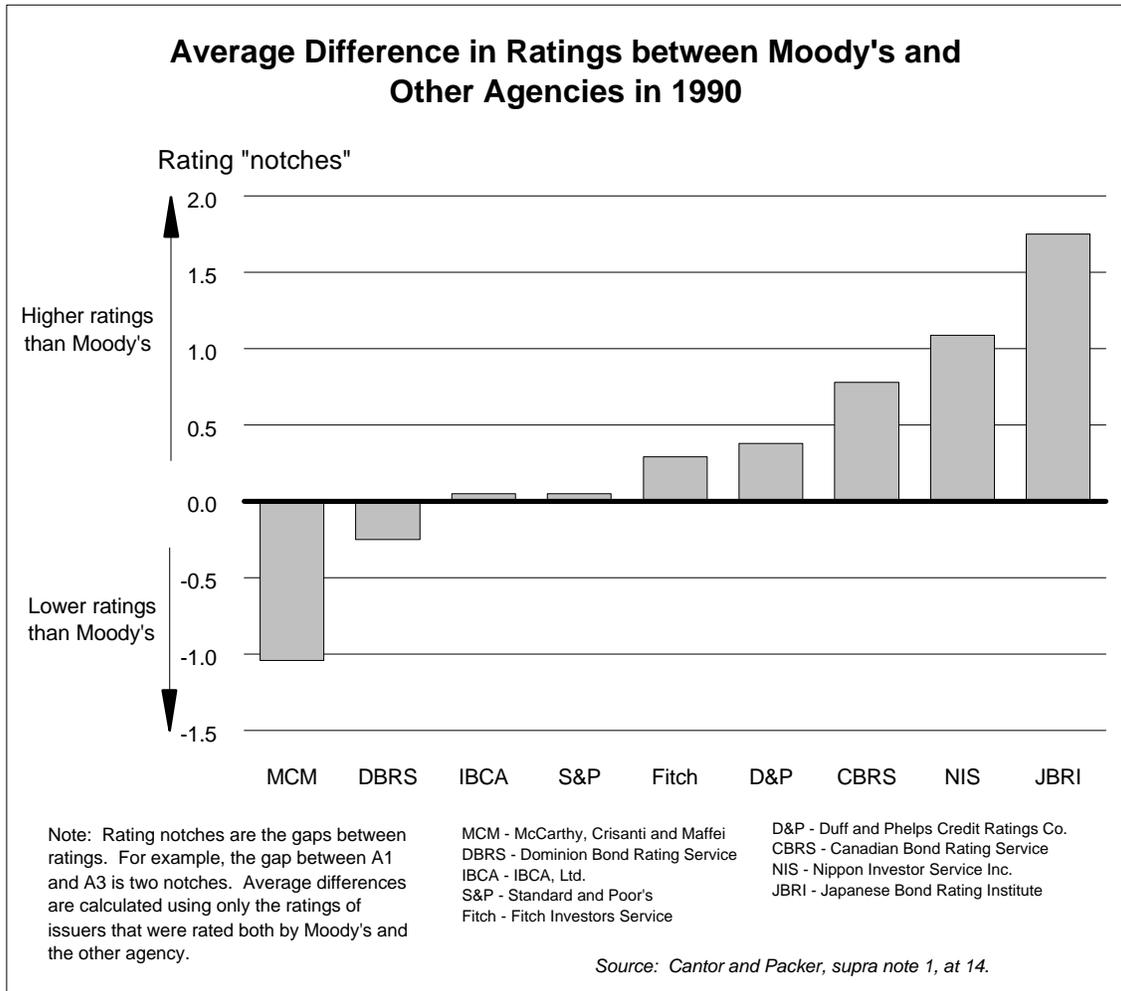
agencies as NRSROs. The SEC apparently determined that the degree of “national recognition” achieved by these other agencies was sufficient for regulatory purposes without examining whether there existed in the case of each the fundamental determinants of national recognition relied upon by the market: (i) an impact of their ratings on bond prices, (ii) a correlation of their ratings with actual default experience, and (iii) a congruence of their rating scales with those of existing NRSROs, or at least the absence of any *illusory* congruence.

II. THE NRSRO CONCEPT

A. Conceptual Underpinnings of the NRSRO Concept

The Concept Release requests comment on whether the SEC should continue to rely on the NRSRO concept in its rules. Moody’s believes that the NRSRO concept already carries a heavy burden and that rather than extending use of the concept, the SEC should curtail — and eventually eliminate — its reliance upon credit ratings and the NRSRO concept in general. At its core, the NRSRO concept depends upon the assumption that all NRSROs’ rating scales are essentially congruent and that all NRSROs’ ratings essentially correlate equivalently with actual default experience over time. The assumption of congruence of rating scales has been found by academics to be incorrect.⁴ As the following chart demonstrates, there exist significant departures from congruence:

⁴ See Cantor & Packer, *supra* note 1, at 14 (“[t]his rough equivalence in the rating standards of Moody’s and Standard and Poor’s does not seem to extend to other rating agencies”); Beattie & Searle, *supra* note 3, at 170 (finding that differences between pairs of rating agencies to be generally statistically significant and in some cases highly significant; Moody’s and S&P ratings were found to be most closely correlated).



As evidenced by the chart above, the SEC appears to have created in the capital markets merely the *illusion* of equivalence among the various agencies, their ratings and their rating standards. This illusion, Moody's believes, creates the opportunity for rating shopping (*see* Moody's letter (a copy of which is attached hereto) submitted in response to the SEC's request for comments set forth in Release No. 33-7086 (the "**Disclosure Letter**"). In addition, because of the manner in which the SEC uses NRSRO ratings in its regulations, investors may be led — fallaciously — to conclude that all NRSRO ratings of a certain level express opinions denoting equivalent levels of risk.

B. Independence

Moody's is deeply concerned that extending and codifying the regulatory use of ratings will undermine the critical independence of the rating agencies. This independence is the foundation of their utility in the capital markets. The increasing use of ratings as a tool of regulation is a matter of concern, and the adoption of a regulatory scheme for rating agencies would dramatically intensify that concern. Stripped of their independence, the rating agencies would inevitably come under official influence, with the result that their utility would be

destroyed and the economically useful role that they have played for almost a century would come to an end.

The independence and integrity of the rating agencies is at the core of their economic role. Rating agencies developed in response to investors' desire for opinions unfiltered by issuers, financial intermediaries, or official institutions. It was precisely their reputation for independence and integrity that was and is the basis for the respect that the rating agencies have to date enjoyed. A rating agency's standing is — and should be — in direct proportion to the market's perception of its integrity and reliability, not to its place in a regulatory scheme serving some official or governmental purpose. *The impact of a rating agency on the markets should be exclusively a function of the value that the market attaches to its opinions over time.*

The role of the rating agency is inherently controversial; in other words, rating agencies are by their nature “unofficial.” It is the rating agency's task to make independent and sometimes controversial observations regarding powerful and prestigious issuers. Over the course of the past two decades, rating agencies have felt obliged, on the basis of their credit analyses, to downgrade the obligations of auto makers, oil companies, cities and states, money center banks, government agencies, and foreign governments. It is in the nature of the business that such decisions, which affect an issuer's reputation and borrowing costs, may be neither welcomed nor applauded — not by issuers, not by underwriters, not by governments, and not by the current holders of the issuers' securities.

Governments may have compelling and legitimate public policy interests that appear to transcend the principle of rating agency independence. These other policy interests make it difficult to imagine an “official” rating agency's downgrading a government agency, a major bank, or a foreign government. One may easily imagine that such actions might from time to time be brought to the attention of a regulator who might in turn feel obliged to ensure that “appropriate” procedures had been followed and “reasonable” standards applied. There would be little need for overt interference in rating decisions; regulatory inquiry alone would have a chilling effect. The power to regulate is inevitably the power to influence.

C. The First Amendment

The principal rating agencies are publishing firms that express opinions. When the SEC designates rating agencies as NRSROs, thereby conferring privileged status upon certain expressions of opinion at the expense of others, it must carefully weigh the dictates of the First Amendment. As the Supreme Court has observed time and again, “above all else, the First Amendment means that government has no power to restrict expression because of its message, its ideas, its subject matter, or its content.”⁵

⁵ *Police Dep't. v. Mosley*, 408 U.S. 92, 95 (1972) (citations omitted); *accord Arkansas Writers' Project, Inc. v. Ragland*, 481 U.S. 221, 229-230 (1987) (quoting *Mosley* with approval); *Carey v. Brown*, 447 U.S. 455, 465 (1980) (citing *Mosley* with approval).

Opinions concerning the creditworthiness of issuers of securities may, at first blush, appear removed from the purposes of the First Amendment. However, there is no doubt that the credit ratings of issuers of publicly traded securities are matters of public concern.⁶ This is most obvious in the case of governmental issuers. If the *New York Times* opines that the City of New York will soon be unable to pay its debts, that opinion is protected by the First Amendment. Just as surely, a rating agency's opinion to the same effect must be equally protected. The ratings of private sector entities, moreover, often are also matters of profound public concern. For example, in 1981 the creditworthiness of Chrysler Corporation became the focus of fierce political debate as Congress wrestled with the question of whether to guarantee Chrysler's borrowings. At other times, the creditworthiness of other companies — such as money center banks, defense contractors, and airlines — have all become issues of public concern. The rating agencies' independent and objective evaluations of these companies are important sources of opinion on these subjects.

D. Effect on Process

The use by the SEC and other government agencies of ratings for regulatory purposes has in effect made NRSROs gatekeepers to large segments of the capital markets. By giving regulatory benefits to certain securities with the requisite NRSRO ratings and designating multiple NRSROs, the SEC has unintentionally encouraged issuers to shop among them for the most favorable rating. This places economic pressure on rating agencies to erode analytic standards in order to gain, or to avoid losing, market share. This unintended consequence will be exacerbated by additional reliance on ratings in the SEC's regulations.

To attempt to block this tendency with SEC intervention and the creation of a regulatory scheme would necessarily entail the promulgation of rating standards — a set of “generally accepted rating principles” or “GARP.” In contrast to the accounting field, which has the Financial Accounting Standards Board to establish GAAP, there is no established private-sector body or set of generally accepted standards on which the SEC could rely: the SEC would have to be the standard-setter. The SEC should not attempt to establish GARP because any such attempt would fail to capture the judgmental aspects of the rating process. There is not now, nor can there ever be, a science or an orthodoxy for debt ratings. Any attempt on the part of government to codify a “correct” methodology for bond rating would founder on this principle. To impose an ill-conceived GARP in an attempt to prevent rating “mistakes”, and thereby reduce the risk of loss to investors, would ignore both the way in

⁶ Courts have held that financial information concerning public companies is of public concern and therefore entitled to First Amendment protection. See, e.g., *First Equity Corp. v. Standard & Poor's Corp.*, 690 F. Supp. 256, 258 (S.D.N.Y. 1988) (in rejecting a fraud claim against S&P for misdescription of an issuer's convertible bonds, the court held that “a publisher is not liable for false reports of matters of public interest absent knowledge of falsity or reckless disregard of the truth.”) (quoting *Libertelli v. Hoffman-LaRoche, Inc.*, 7 Media L. Repr. (BNA) 1735, 1736 (S.D.N.Y. 1981)), *aff'd on other grounds*, 869 F.2d 175 (2d Cir. 1989); see also Note, *What Standard of Care Should Apply to the World's Shortest Editorials?: An Analysis of Bond Rating Agency Liability*, 75 CORNELL L. REV. 411, 454 (1990).

which the rating agencies currently function and the role of reliable, independent credit opinions in the capital markets.

In addition, even if a set of GARP could be articulated, its definition by regulatory or administrative fiat would be insufficiently responsive to the rapid evolution of the capital markets and would raise fundamental First Amendment concerns. GARP imposed by regulation would, at a minimum, stifle the flexibility and innovation that have made the U.S. capital markets widely admired throughout the world. The pace of financial innovation would be limited by whatever time-consuming procedures that would be required in order to revise or amend GARP.

E. Existence of Alternatives

The principal objection to abandonment of the SEC's reliance on ratings and the NRSRO concept appears to be the lack of any other mechanism by which regulators may distinguish between instruments of differing quality. Moody's believes that this objection is insufficient to justify the continued — and expanding — reliance on ratings to achieve regulatory objectives.

Moody's recommends that the SEC review its current reliance on ratings with a view toward phasing out such reliance where appropriate. Traditional credit ratings are measures of credit risk, and as such they should not be used as measures of total investment risk, as volatility measures, as substitutes for disclosure, or for any other purpose other than that for which they were originally intended.

For example, the SEC should explore, as an alternative to using ratings in the net capital rule, basing haircuts on a price volatility measurement. Such a volatility measurement would more accurately capture the SEC's concerns regarding securities held by broker-dealers than does a traditional credit rating.

The SEC should, in addition, consider abandoning the use of ratings as "substitutes" for disclosure (*e.g.*, Form S-3, Form F-2, Form F-3 and the Multi-Jurisdictional Disclosure System). As more fully discussed in the Disclosure Letter, ratings presuppose adequate disclosure. Rating agencies are users of issuers' filings with the SEC. Therefore, the existence of a rating on a registered security should not be used as a substitute for disclosure. Such a use undermines the proper function of rating agencies as users of disclosure documents and does a disservice to investors desiring full and adequate disclosure.

Finally, the SEC should not use ratings or NRSROs to perform quasi-regulatory functions, as is the case in Rule 3a-7.⁷ The SEC should consider amending Rule 3a-7 to

⁷ In adopting, Rule 3a-7, the SEC apparently recognized that the use of ratings in the rule might influence the rating agencies' decision-making process. On balance, however, the SEC concluded that "the rule simply would take advantage of the role played today by the agencies and is not likely to distort the agencies' decision-making processes." See SEC Division of Investment Management, PROTECTING INVESTORS:

capture more appropriately the SEC's concerns regarding self-dealing and overreaching by insiders, misvaluation of assets, and asset coverage. Although Moody's shares the SEC's concerns and takes such considerations into account in its rating process, there is no guarantee that all NRSROs will share the same concerns in the future. Such a reliance on NRSROs will inevitably force the SEC into the rating business — in order to ensure that all NRSROs are addressing all of the SEC's concerns on a regular basis. As more fully discussed below, such an intrusion into the rating opinion business would raise significant First Amendment concerns and ultimately impinge on the independence of rating agencies.

III. A REGULATORY SCHEME FOR NRSROS

A. First Amendment

The Concept Release asks whether the SEC should define the term "NRSRO" and whether there should be a regulatory scheme for NRSROs. Moody's has argued above that the NRSRO concept must be weighed carefully against First Amendment considerations.⁸ This same Constitutional concern would be greatly exacerbated by any process pursuant to which the SEC purported to select and "license" NRSROs. It would extend even more clearly to any effort by the SEC to regulate the process by which rating agencies form rating opinions or the substance of the ratings themselves.

Quite simply, the SEC cannot Constitutionally determine *who* may express rating opinions or *how* opinions are to be expressed, because ratings are expressions of opinion protected by the First Amendment. For the government to regulate rating agencies based upon the content of their publications, it must do so to pursue a compelling state interest and use the least restrictive means available.⁹ Courts, however, have repeatedly recognized that "*(p)romoting the accuracy or objectivity of news reporting is not a compelling governmental interest that justifies content-based discrimination against a news organization.*" *Times-Picayune Publishing Corp. v. Lee*, 15 Med. L. Rptr. (BNA) 1713, 1719 (E.D. La. 1988) (citations omitted) (emphasis added).

B. Economic Issues

Even if license-type regulation of rating agencies were Constitutional, a regulatory scheme for rating agencies would be unlikely to survive any cost/benefit analysis or public policy scrutiny. The system of rating securities in the United States has worked extremely well for nearly a century. There is no evidence of systemic defects or of market failure. On the

A HALF-CENTURY OF INVESTMENT COMPANY REGULATION at 91 (1992). Subsequent experience and the emergence of rating shopping suggest that the SEC's determination may have been in error.

⁸ See *Arkansas Writers' Project*, 481 U.S. at 228-29 (overturning law creating tax exemption for select members of press based upon publications' subject matter because law unconstitutionally "treat[ed] some magazines less favorably than others," and describing law as "particularly repugnant to First Amendment principles" because discrimination was content-based).

⁹ See, e.g., *Arkansas Writers'*, 481 U.S. at 231.

contrary, the evidence from history is that the system works extremely well without any form of government intervention.

Ratings functioned well before the creation of the NRSRO concept. It was apparently for this reason the SEC decided to rely on them in its rules. They continue to function well today. The system has worked so well that it has been widely copied in the international capital markets.

Rating agencies evolved in a largely unregulated market. Moody's and S&P have developed and sustained reputations for producing reliable ratings. Like other industries in which reputation is a firm's major asset (*e.g.*, law and accounting), the dominant firms have survived a long time. This suggests that established firms have a strong market incentive to preserve their reputations by continuing to provide reliable and objective ratings.

The record of Moody's and S&P for most of this century, and the absence of any major scandal, indicate that there is no problem to be fixed at the level of the rating agencies. Moreover, the costs of a complex bureaucratic oversight mechanism would greatly increase the expense of producing the same high-quality rating opinions that are produced now without such a mechanism. Much or all of the increase would be passed on to issuers. The greatest burden would fall on issuers whose ratings are hardest to assess — small companies, newer companies, and high technology companies.

C. Practical Problems

Any effort to define what an NRSRO is or to regulate rating agencies would also encounter substantial practical difficulties.

First, the SEC has to date relied largely upon "national recognition" as the basis for conferring NRSRO status on a rating agency (*i.e.*, the SEC has employed a market assessment tool rather than command and control regulation). When new agencies have applied for designation as NRSROs, the SEC has, we believe inappropriately, concentrated on rather vague criteria, including an agency's (a) organizational structure, (b) financial resources, (c) size and quality of staff, (d) independence and reputation for integrity, (e) rating procedures, and (f) procedures to prevent abuse of nonpublic information, instead of focusing on the performance of a rating agency. While the SEC's criteria may be appropriate for a licensing system, they are not appropriate measures of market recognition and rating agency performance over time, and they present significant Constitutional concerns to the extent that they attempt to control who may express rating opinions or how such opinions may be expressed.

No formal regulatory system will ever be able to evaluate rating agency performance as well as do the capital markets and the marketplace for ideas. The SEC should not substitute its judgments for those of the capital markets.

Second, in order to provide for a transparent regulatory system in which applicants could know what qualifications they must meet, status as an NRSRO would have to be defined

by things that can be captured in “objective” criteria, rather than in such subjective factors as reputation for integrity. Objective criteria such as adequate capitalization are easier to measure, but they do not bear on an agency’s ability to make good judgments. If the relevant criterion is in fact national — or even global — recognition, the SEC should not substitute its judgment for actual performance or for the mechanisms of the market. The “objective” factors to which the SEC would inevitably look have nothing to do with market acceptance, and the SEC’s subjective judgment of what constitutes market acceptance may not be entirely accurate over time.¹⁰

Third, if given the power to regulate rating agencies by Congress, the SEC staff would not be able to administer this mandate properly because there is no — and can be no — GARP against which rating agencies’ practices and opinions could be judged.¹¹

Notwithstanding these substantial practical difficulties, if the SEC determines that it must define the term “NRSRO”, it should base the definition on a test that focuses on the three fundamental determinants of market recognition:

- (i) an empirically observable material impact of an agency’s ratings on security prices,
- (ii) an empirically observable tight correlation with actual default experience over time, and
- (iii) the absence of any *illusory* congruence of rating scales (*i.e.*, no agency’s rating scale should give the impression of being congruent with an existing NRSRO’s rating scale unless the scales are in fact congruent).

D. Political Interference

SEC regulation would increase substantially the risk of political interference in rating agencies’ analytic judgments. In particular, SEC regulation would harm the rating agencies’ ability to operate in the international market because an SEC determination to regulate rating agencies would inevitably lead foreign regulators to do so as well. In fact, the mere publication of the Concept Release has caused certain foreign governments actively to consider governmental intrusion into the rating process. While we are confident that the SEC has no intention to influence individual ratings, other governments may affirmatively seek to use

¹⁰ As Moody’ stated in its letter, dated January 27, 1978, to the SEC regarding the SEC’s request for comments on the question of the possible incorporation of ratings in filings with the SEC (Release No. 33-5882, File No. S7-727):

There are only a few “nationally recognized” independent rating agencies who have been serving investors for many years. If ratings were permitted or required to be included in filings, Moody’s believes that it might well be considered unfair to limit the permissive inclusion of such ratings to those issued by the presently existing agencies. Should another rating agency enter the field, would the Commission take the position that it would be improper to include the new firm’s ratings in filings because that firm was not yet nationally recognized? If the new agency’s ratings could not be included, the SEC’s action would virtually preclude new entrants into the rating business.

¹¹ See *supra* p. 8.

regulatory authority to influence ratings substantively. Moreover, even if every jurisdiction regulated Moody's in good faith, Moody's would nevertheless be subjected to conflicting regulation in different jurisdictions, thereby increasing the cost of producing ratings and reducing the comparability of ratings across geographic boundaries.¹²

The SEC itself would inevitably be subjected to domestic political pressure by municipal governments and major issuers to intervene in the rating process. Even in the absence of regulatory authority, the SEC has been importuned to act by issuers disappointed with their ratings. For example, Congressional hearings were held in 1975 and 1976 over rating agencies' decisions to downgrade the bond ratings of New York City and the Municipal Assistance Corporation (the so-called "Big MAC"), and the SEC was urged to intervene. In fact, legislation was introduced in the House by the chairman of the SEC's oversight subcommittee in 1976 that would have given municipal issuers the right to appeal their ratings to the SEC. More recently, in 1993 officials of the City of Detroit challenged a decision to downgrade the city's debt, alleging racism. Were the SEC to assert regulatory authority over rating agencies, these kinds of complaints would inevitably multiply and escalate, and the SEC would be called upon to referee virtually every dispute between rating agencies and issuers.

IV. OTHER ISSUES

A. Fee Structure

The Concept Release requests comments on the practice of rating agencies' charging fees to issuers. Issuer fees are necessary because of the "free rider" problem resulting from the broad dissemination of ratings to non-subscribers.

Like newspaper publishers who adopt practices to ensure that advertisers cannot influence editorial content, Moody's has instituted practices to protect and preserve its objectivity. First, it established a fixed, non-negotiable pricing schedule designed to prevent any actual or perceived undue influence from issuers or intermediaries. Second, Moody's maintained its practice, deeply rooted in its publishing history, of refusing to permit an issuer or any other third party to suppress Moody's opinion. Moody's will not allow an issuer to control whether or when a rating will be assigned and published. To do otherwise would convert an objective opinion about credit risk into a selling tool controlled by an issuer. Accordingly, Moody's does not publish a rating only when an issuer requests a rating. Moody's firmly believes that a rating agency's coverage of all securities issued in a market segment increases the value of its opinions to investors. More importantly, this coverage — achieved through the assignment of unsolicited ratings — protects Moody's independence.

The Concept Release also requests comment on the practice of basing fees on the size of an issue. Moody's believes that current market practices are appropriate and should not be altered. Moody's believes that a pricing system developed and accepted by the market is likely

¹² The comparability of ratings across geographic boundaries — like comparability across industry classification, time, and type of instrument — is an essential element of ratings' utility.

to be fairer and more adaptable to dynamic changes in the capital markets than one based on static government regulation.

Because large issues of securities receive a larger benefit from ratings than do small issues of securities (in the form of greater absolute savings in the issuers' costs of funds), it is appropriate for rating fees to be based on issue size. Moreover, forbidding such a sliding scale would result in the reallocation from larger issuers to smaller issuers of a portion of the costs of providing ratings. This would obviously impede capital formation by small issuers without any commensurate public benefit.

B. "Limited Scope" Ratings

The SEC requests comment on the use of so-called "limited scope" ratings that may denote an assessment of only certain aspects of the credit risk of an instrument. As discussed in the Disclosure Letter, the SEC cannot, consistent with the First Amendment, prescribe the form in which private publishers of opinion express their views. Moreover, the SEC's concerns about new rating products and new rating designations will be addressed in the marketplace through the appropriate functioning of market mechanisms.

C. The Need for Legislative Authority

Assuming for the sake of argument that the Constitutional infirmity could be overcome, if the SEC wished to regulate rating agencies, it would still need to get authority from Congress. The federal securities laws do not currently give the SEC this authority.¹³ We believe, however, that, for the reasons cited above, in the Disclosure Letter and on the basis of the Supreme Court's decision in *Lowe*, any statute purporting to authorize the SEC to regulate rating agencies would be unconstitutional.

The SEC does, however, have broad authority under the 1933 Act, the Securities Exchange Act of 1934, and the Investment Company Act of 1940 to deal with market participants who misuse ratings. To the extent that the SEC believes, as it suggests in Release No. 33-7086, that securities are being structured in a manner intended to misuse ratings, it should direct its attention to those market participants who engage in such practices, rather than to the ratings themselves or to those who publish them.

¹³ In *SEC v. Lowe*, 472 U.S. 181 (1985), the Supreme Court held that the Investment Advisers Act of 1940 (the "*Advisers Act*") did not permit the SEC to regulate publishers of impersonal investment advice. At present, Moody's is voluntarily registered as an investment adviser. Moody's does not, however, concede that its publication of ratings constitutes investment advice within the meaning of the Advisers Act or that it is required to register as an adviser. The definition of "investment adviser" in S. 3580, the original bill that became the Advisers Act, excluded publishers of newspapers of general and regular circulation. After hearing testimony that the definition would continue to include rating agencies, such as Moody's, the exclusion was extended to business and financial publications. See *id.* at 194-95; see also Richard Y. Roberts, *Formal Regulatory Handle Needed for NRSRO Designation*, Speech Before the SIA Compliance & Legal Seminar, at 14 (Apr. 6, 1992) (in speaker's opinion, the Advisers Act does not authorize the SEC to regulate rating agencies).

D. Amendment to Rule 436(g)

The SEC requests comment on whether Rule 436(g) should be amended so that funds may include ratings in registration statements without having to provide a written consent imposing expert liability upon the organization publishing such ratings. As more fully discussed in the Disclosure Letter, Moody's believes that issuers should be permitted to include all material ratings in registration statements without providing a consent imposing expert liability upon the publisher of such ratings.

V. CONCLUSION

For the reasons set forth above, Moody's believes that the SEC's use of the NRSRO concept and its reliance on ratings in its regulations is unsound and should be curtailed, eventually eliminated, and replaced with measures that more accurately address the SEC's precise concerns. Any attempt at defining the term "NRSRO" or extending regulatory authority over such entities would be equally unsound as a result of Constitutional obstacles, practical difficulties, and the unnecessary burdens that such a regime would impose on rating agencies, issuers, intermediaries, and — ultimately — investors, and that could not be justified on any economic or public policy grounds.

If you have any questions or need additional information, please contact me at (212) 553-7958 or Lucy A. Collett, Associate General Counsel, at (212) 553-7132.

Very truly yours,

MOODY'S INVESTORS SERVICE, INC.

By
Matthew C. Molé