I am writing to you today as a regulator, to present my idea on how to address the current issues surrounding the Nationally Recognized Statistical Rating Organizations (the “Agencies”).

As you know one of the problems with the Agencies is that they are reluctant to downgrade a company’s debt because there is an inherent conflict in the system. The conflict exists because the Agencies derive a great portion of their revenue from the very firms they supply ratings to. In addition to this conflict I also recognize that the Agencies rate firms based on their financial strength and it is difficult for the Agencies to immediately identify serious signs of financial weakness because this weakness is typically a slow moving process.

The most prominent example of this conflict was the situation at Enron. Back in the year 2001, just prior to Enron’s bankruptcy filing, the equity shares of Enron were declining precipitously as was the price of its debt and during this time the bond ratings remained as investment grade. The Agencies failed to recognize what the capital markets recognized which was there was considerable risk in both Enron’s equity and debt. To that end, some brokerage firms were recommending Enron debt to their retail customers and we are now seeing these same brokerage firms using the investment grade rating of Enron’s debt as part of their defense to the suitability charges against them. My point is that in many cases the markets are able to identify risk well before the Agencies.

I recognize that for various reasons it is difficult to impose new regulation on the Agencies. My solution to this problem would be to offer a compromise. In lieu of initiating new regulation upon the Agencies the SEC or Congress would recommend that the Agencies establish a second rating system in addition to the traditional system. This system would be based on market prices and subsequent market yields. Let’s call it the “Market System”.

The Market System will simply have two categories; Investment Grade and High Risk. The system will be controlled, paid for and administered by the Agencies. However, the Market Ratings will not have any effect on a corporations cost of capital. They are simply a tool for retail investors to use to gauge risk. The yield to maturity (ytm) of each corporate debt security will be measured against a “High Yield Benchmark”. If the ytm of a specific bond were to reach a level that is equal to or greater than that of the High Yield Benchmark the debt security will be rated as “High Risk”. All debt with a ytm less than that of the high yield benchmark would be rated as “Investment Grade.”

The key to this idea is that there would be no need for the Agencies to actually take action to reduce the “Market Rating” rather, all yields would be linked to the high yield
benchmark and as the price of the securities moves into a level that is “High Risk” the “Market Rating” would automatically adjust just as the PE, PEG or any other ratio does when the price of an equity fluctuates. Furthermore, the full service brokerage firms would be required to inform their clients who are holding these issues promptly after the initial time the securities move into the “high risk” level.

I believe that this solution would take the pressure off of the Agencies that currently exists when the Agencies are contemplating a rating change. The market rating would also provide the retail customer with additional information that they could consider before executing a transaction in a corporate debt security.

I also believe that the market system will bridge the gap between the investment grade rating and the junk bond rating and this bridge will create a more orderly price decline when corporate debt moves from investment grade to junk status. Currently there is typically a sharp sell off on the day a bond moves from an investment grade rating to junk status because many mutual fund managers are prohibited from holding junk bonds in their portfolios and consequently many funds sell the bonds on they day of the rating change. I believe the retail customer will benefit as they become aware of the high risk market rating and are able to make an informed investment decision concerning their corporate debt holdings.

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