

Industry Briefs **Banking****Regulatory Update**

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Rating Agencies and the Use of Credit Ratings

On 6/4/03, the SEC issued a concept release entitled *Rating Agencies and the Use of Credit Ratings under the Federal Securities Laws*, as part of its review of the role of credit rating agencies in the operation of the securities markets. The SEC noted that it has relied on credit ratings from market-recognized credible rating agencies for distinguishing among grades of creditworthiness in various regulations under the Federal securities laws. Those credit rating agencies, known as “nationally recognized statistical rating organizations” (“NRSROs”), are recognized as such by SEC staff through the no-action letter process. Currently, there are four NRSROs: (a) Moody’s Investors Service, Inc.; (b) Fitch, Inc.; (c) Standard & Poor’s, a division of The McGraw-Hill Companies, Inc.; and (d) Dominion Bond Rating Service Limited (“DBRS”).

The SEC stated that even though it originated the use of the term “NRSRO” for a narrow purpose in its own regulations, ratings by NRSROs are widely used as benchmarks in Federal and state legislation, rules issued by financial and other regulators, foreign regulatory schemes, and private financial contracts. The SEC’s initial regulatory use of the term “NRSRO” was solely to provide a method for determining capital charges on different grades of debt securities under the SEC’s net capital rule for broker-dealers, Rule 15c3-1 (*Net Capital Rule*) under the Securities Exchange Act of 1934 (“Exchange Act”).

The SEC noted that on 1/24/03, it submitted to Congress a report on the role and function of credit

rating agencies in the operation of the securities markets in response to the Congressional directive contained in §702 of the Sarbanes-Oxley Act of 2002 (“SOA”). The report was designed to address each of the topics identified for SEC study in §702, including:

- The role of credit rating agencies and their importance to the securities markets;
- Impediments faced by credit rating agencies in performing that role;
- Measures to improve information flow to the market from credit rating agencies;
- Barriers to entry into the credit rating business; and
- Conflicts of interest faced by credit rating agencies.

The report also addresses certain issues regarding credit rating agencies, such as allegations of anticompetitive or unfair practices, the level of due diligence performed by credit rating agencies when taking rating actions, and the extent and manner of SEC oversight of credit rating agencies, that go beyond those specifically identified in the SOA. The SEC noted that as it enters the next phase of its review, a fundamental threshold matter is the appropriate degree of regulatory oversight that should be applied to credit rating agencies. The SEC stated that at one end of the spectrum, it could cease using the NRSRO designation, exit the business of rating agency oversight, and devise alternative means to fulfill its regulatory objectives. At the other end, it could implement, perhaps with additional legislative

authority, a much more pervasive regulatory scheme for credit rating agencies that addresses the full range of issues raised in the report.

The SEC requested comments by 7/28/03, on various issues relating to credit rating agencies, including whether credit ratings should continue to be used for regulatory purposes under the Federal securities laws, and, if so, the process of determining whose credit ratings should be used, and the level of oversight to apply to such credit rating agencies. The concept release discusses the following broad issues that have been raised during the SEC's ongoing review of credit rating agencies:

- Alternatives to the NRSRO designation;
- Recognition criteria;
- Examination and oversight of NRSROs;
- Conflicts of interest;
- Alleged anticompetitive, abusive, and unfair practices;
- Information flow; and
- Other.

Following the discussion of each issue, the SEC provided a possible approach it could develop to address the issue, as well as a series of questions that would assist the SEC in its review.