

SECURITIES AND EXCHANGE COMMISSION

[Release Nos. 33–8236; 34–47972; IC–26066; File No. S7–12–03]

RIN 3235–AH28

Rating Agencies and the Use of Credit Ratings Under the Federal Securities Laws

AGENCY: Securities and Exchange Commission (“Commission”).

ACTION: Concept release; request for comments.

SUMMARY: As part of the Commission’s review of the role of credit rating agencies in the operation of the securities markets, the Commission is seeking comment 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.

DATES: Comments should be received on or before July 28, 2003.

ADDRESSES: To help us process and review your comments more efficiently, comments should be sent by hard copy or e-mail, but not by both methods. Comments sent by hard copy should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0609. Comments also may be submitted electronically at the following electronic mail address: rule-comments@sec.gov. All comment letters should refer to File No. S7–12–03. This file number should be included in the subject line if electronic mail is used. Comment letters will be available for public inspection and copying in the Commission’s Public Reference Room, 450 Fifth Street, NW., Washington, DC 20549. Electronically submitted comment letters will be posted on the Commission’s Internet Web site (<http://www.sec.gov>).¹

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SUPPLEMENTARY INFORMATION:

¹ We do not edit personal identifying information, such as names or electronic mail addresses, from electronic submissions. You should submit only information that you wish to make publicly available.

I. Introduction ²

Since 1975, the Commission 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. These credit rating agencies, known as “nationally recognized statistical rating organizations,” or “NRSROs,” are recognized as such by Commission staff through the no-action letter process. There currently are four NRSROs ³—Moody’s Investors Service, Inc.; Fitch, Inc.; Standard & Poor’s, a division of the McGraw-Hill Companies, Inc.; and Dominion Bond Rating Service Limited (“DBRS”).⁴ Although the Commission originated the use of the term “NRSRO” for a narrow purpose in its own regulations, ratings by NRSROs today 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 Commission’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 Commission’s net capital rule for broker-dealers, rule 15c3–1 under the Exchange Act (the “Net Capital rule”). Over time, as the reliance on credit rating agency ratings increased, so too did the use of the NRSRO concept.

In recent years, the Commission and Congress have reviewed a number of issues regarding credit rating agencies and, in particular, the subject of regulatory oversight of them. In 1994,

² For a detailed discussion on credit rating agencies and the Commission’s use of credit ratings under the Federal securities laws, see the *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*, U.S. Securities and Exchange Commission, January 2003 (hereinafter, the “Report”). The Report is available on the Commission’s Web site at <http://www.sec.gov/news/studies/creditingreport0103.pdf>.

³ Since 1975, four additional rating agencies have been recognized as NRSROs. However, each of these firms has since merged with or been acquired by other NRSROs. These four additional rating agencies were Duff and Phelps, Inc., McCarthy, Crisanti & Maffei, Inc., IBCA Limited and its subsidiary, IBCA, Inc., and Thomson BankWatch, Inc.

⁴ On February 24, 2003, the Commission’s Division of Market Regulation (the “Division”) responded to a request by DBRS that the Division will not recommend enforcement action against broker-dealers that consider ratings by DBRS as NRSRO ratings when computing net capital pursuant to rule 15c3–1 under the Securities Exchange Act of 1934 (“Exchange Act”). See letter from Annette L. Nazareth, Director, Division, Commission, to Mari-Anne Pisarri, Pickard and Djinis LLP (February 24, 2003). This letter is available on the Commission’s Internet Web site at <http://www.sec.gov/divisions/marketreg/mr-noaction/dominionbond022403-out.pdf>.

the Commission solicited public comment on the appropriate role of credit ratings in rules under the Federal securities laws, and the need to establish formal procedures for recognizing and monitoring the activities of NRSROs.⁵ Comments received by the Commission led to a rule proposal in 1997 which, among other things, would have defined the term “NRSRO” in the Net Capital rule.⁶ However, the Commission has not acted upon that rule proposal. More recently, the initiation of broad-based Commission and Congressional reviews of credit rating agencies following the collapse of Enron has resulted in the need for a fresh look at the issue.

On January 24, 2003, the Commission submitted to Congress its 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 section 702 of the Sarbanes-Oxley Act of 2002 (the “Sarbanes-Oxley Act”).⁷ The Report was designed to address each of the topics identified for Commission study in section 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.⁸ 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 Commission oversight of credit rating agencies, that go beyond those specifically identified in the Sarbanes-Oxley Act.

As the Commission 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. At one end of the spectrum, the Commission 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, the Commission

⁵ See *Nationally Recognized Statistical Rating Organizations*, Release No. 34–34616 (August 31, 1994), 59 FR 46314 (September 7, 1994).

⁶ See *Capital Requirements for Brokers or Dealers Under the Securities Exchange Act of 1934*, Release No. 34–39457 (December 17, 1997), 62 FR 68018 (December 30, 1997).

⁷ See the Report, *supra* note 2.

⁸ *Sarbanes-Oxley Act of 2002*, Pub. L. 107–204, § 702(b), 116 Stat. 745 (2002).