

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.

Discussed below are broad issues that have been raised during the Commission's ongoing review of credit rating agencies. Following the discussion of each issue is a possible approach the Commission could develop to address that issue, as well as a series of questions, the answers to which would assist the Commission in its review. The Commission wishes to encourage comments from market participants, other regulators, and the public at large.

## II. Discussion

### A. Alternatives to the NRSRO Designation

Some commenters<sup>9</sup> believe that the NRSRO designation acts as a barrier to entry into the credit rating business. Others have raised concerns about the extent of the Commission's legal authority to regulate or impose requirements on NRSROs. Commenters argue that the Commission does not have explicit regulatory authority over NRSROs, and that it would be inappropriate for the Commission to impose a more comprehensive regulatory framework on rating agencies absent legislation. Others have argued that NRSRO rating activities are journalistic and are consequently afforded a high level of protection under the First Amendment. According to these commenters, suggestions that the Commission inspect or otherwise impose regulatory burdens on NRSROs would implicate the NRSROs' First Amendment rights. They further believe that new legislation providing the Commission with additional authority over NRSROs would face the same First Amendment challenges.

In light of these concerns, some commenters have recommended that the Commission consider ceasing its use of the NRSRO designation. Before doing so, however, the Commission would need to identify alternatives capable of achieving the regulatory objectives currently served by use of the NRSRO designation in certain Commission rules.<sup>10</sup> (Other regulatory or legislative

bodies would need to determine appropriate substitutes for that designation in any non-Commission rules or legislation.) To further that discussion, the Commission staff has identified possible alternatives to the NRSRO designation for significant Commission rules that utilize that concept. For example:

- *Rule 15c3-1 under the Exchange Act.* The Commission could allow broker-dealers to use internally-developed credit ratings for purposes of determining the capital charges on different grades of debt securities under the Net Capital rule. Strict firewalls could be required between the broker-dealer employees who develop internal credit ratings and those responsible for revenue production. In addition, a broker-dealer could be required to obtain regulatory approval of its credit rating procedures and rating categories before it could use internal credit ratings for calculating capital charges. The Commission also could allow broker-dealers to calculate capital charges using model-based statistical scoring systems and/or market-based alternatives, such as credit spreads. Finally, the Commission would require the securities industry self-regulatory organizations ("SROs") to set appropriate standards for broker-dealers to use in determining rating categories for net capital purposes.

- *Rule 2a-7 under the Investment Company Act of 1940.* Rule 2a-7 limits money market funds to investing in "high quality" securities. The rule contains minimum quality standards based on an objective test—ratings issued by NRSROs—and on a subjective test—the credit analysis performed by the adviser to the money market fund. The Commission could eliminate the objective test from rule 2a-7, and rely solely on the subjective test.

- *Form S-3 under the Securities Act of 1933.* The Commission could allow a registrant to use Form S-3 for offerings of certain nonconvertible securities and asset-backed securities where specified investor sophistication or large size denomination criteria are met. With regard to asset-backed securities, the Commission also could permit Form S-3 to be used where specified asset and structure experience criteria are met.

The Commission seeks commenters' views in evaluating the advisability and feasibility of eliminating the NRSRO designation from Commission rules, the possible alternatives identified above,

and/or any other possible alternatives to the NRSRO designation. In particular, the Commission seeks commenters' views in response to the following questions:

*Question 1:* Should the Commission eliminate the NRSRO designation from Commission rules?

*Question 2:* If so, what alternatives could be adopted to meet the regulatory objectives of the Commission rules that currently incorporate the NRSRO designation? What are their respective strengths and weaknesses?

*Question 3:* Specifically, what are the advantages and disadvantages of allowing broker-dealers to use internally-developed credit ratings to determine capital charges under the Net Capital rule? Is it appropriate to require strict firewalls between the broker-dealer employees who develop internal credit ratings and those responsible for revenue production? Should a broker-dealer be required to obtain regulatory approval of its credit rating procedures and rating categories before it could use internal credit ratings for calculating capital charges? If so, what factors should the Commission review in determining whether to grant such approval? If the Commission substitutes internal credit ratings for the NRSRO designation in the Net Capital rule, what would be the impact on broker-dealers, including small broker-dealers, and what costs would be associated with this change? If there would be an inordinate financial impact on small broker-dealers, are there market-based solutions that could reduce the compliance costs for them? For example, should the Commission permit large broker-dealers to sell their internal credit ratings to small broker-dealers for these purposes? If so, would this help to provide a more competitive marketplace for credit ratings? To what extent should the Commission exercise additional regulatory oversight of this activity (e.g., to control potential conflicts of interest)?

*Question 4:* What are the advantages and disadvantages of allowing broker-dealers to use credit spreads to determine capital charges under the Net Capital rule and/or other Commission rules? How could capital charges be determined using credit spreads? For example, could the Commission base capital charges on the yield differential between particular debt securities and U.S. Treasury securities of comparable maturity, such that a larger differential results in a larger haircut? How could credit spreads be determined for newly-issued, thinly-traded, or privately-issued securities? Or for variable rate and other short-term synthetic securities

<sup>9</sup> The term "commenters" includes those who formally submitted comments in response to the Commission's 1994 concept release and 1997 rule proposal, as well as those contributing to the Commission's recent review of credit rating agencies, including participants at the Commission's November 2002 hearings.

<sup>10</sup> The NRSRO concept is currently utilized in the following Commission rules: 17 CFR 228.10(e), 229.10(c), 230.134(a)(14), 230.436(g), 239.13,

239.32, 239.33, 240.3a1-1(b)(3), 240.10b-10(a)(8), 240.15c3-1(c)(2)(vi)(E), (F), and (H), 240.15c3-1a(b)(1)(i)(C), 240.15c3-1f(d), 242.101(c)(2), 242.102(d), 242.300(k)(3) and (l)(3), 270.2a-7(a)(10), 270.3a-7(a)(2), 270.5b-3(c), and 270.10f-3(a)(3).