Comments on behalf of
The Association of Corporate Treasurers

in response to Concept Release [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 Trustee Exemptions

(Securities and Exchange Commission, June 2003)

I Introduction

The Association

The Association of Corporate Treasurers was formed in London, England, in 1979 to encourage and promote the study and practice of corporate finance and treasury management and to educate those involved in the field.

Today, it is an organisation of professionals in corporate finance, risk and cash management operating internationally.

A professional body and not a trade association, it has over 3,000 Fellows, Members and Associate Members. More information is available on our website, www.treasurers.co.uk.

With more than 1,200 students in more than 40 countries, its education and examination syllabuses are recognised as the global standard setters for treasury education.

Members of the Association work in many fields and in many countries. The majority of Fellows work in large UK public companies, responsible for the treasury and corporate finance functions. Such companies are both rated issuers and, as investors/counterparties, users of ratings.

The ACT usually comments from the corporate and not the financial services sector standpoint where these may be in conflict. As an Association it is often able to make comments which individual members or their companies may feel constrained from making.

This Consultation

The ACT welcomes the opportunity to submit views on this important topic.

We would be pleased to further expand any point made herein or to assist the Commission in any other way.

These comments are on the record and may be freely quoted.

August 2003

II Preliminary comments

Consultation of international importance

Although it cannot be a main focus of the SEC's process, we recognise that the US regulators are widely seen, if not officially recognised, as the "lead regulators" in the rating agency field. In the absence of specific international agreement, this is valuable to international financial markets. Rating agencies subject to US regulation try to operate to similar standards and methodologies wherever they operate and this effectively provides an international standard and simplifies international comparisons. Inefficiencies would result were this to be impeded by conflicting local regulation around the world. Confidence in US processes is important in avoiding this.

Credit ratings in general

Published credit ratings are of course used for many purposes, not just for regulatory compliance. They are important at the macro-level in the area of financial stability and, crucially, have great impact at the micro-level in their impact on rated issuers and instruments.

The published credit ratings of the major NRSRO-approved rating agencies were originally intended to enable investors/counterparties to form a view on the credit risk of an individual issuer/counterparty/instrument in connection with a proposed investment or transaction. Despite the wider use noted above, the fundamental use is still for investment decision making. Issuers – the major payers by far for ratings by NRSROs – pay because of the expected use for investment decision making.

Many issuers are themselves also, as investor and counterparties, users of ratings. However, we believe that the interests of issuers should be taken into account by regulators, not just those of users of ratings or the use of ratings for regulatory capital purposes/

Rating agency regulation

Regulators, in considering the use of published credit ratings for regulatory purposes, should not seek lightly to introduce new liabilities/costs into this pre-existing process, nor to change the basis on which it is done or the fees paid by its users. Credit ratings are not a free good available to be used for any purpose. However, in so far as credit raters use privileges granted by society (such as the exemptions under Reg FD) the public may have legitimate expectations of raters. In view of the importance of credit ratings in the area of financial stability, regulators concerned with this may reasonably impose some limited framework of regulation.

In preparing this response we have been aware of the SEC's role as the regulator recognising NRSROs for ratings for use in regulating securities houses etc. that can be seen as a narrow role. This contrasts with the pivotal role of rating agencies in the financial markets as a whole, for non-diversified investors and in their impact on issuers.

We believe that some limited extension of regulation of rating agencies is necessary and desirable in view of the foregoing and we comment on this in response to several questions.

US Policy

In general we have not commented on matters of US domestic policy such as which agencies should be responsible for specific classes of regulation, but have focused on wider aspects of market regulation and practice.

III Summary of principal points

Distinguish types of rating

In framing regulation of credit rating agencies we believe that it is essential to distinguish between three types of ratings

- those issued based purely on published information without contact with the issuer,
- those based on published information where the issuer has been contacted for clarification needed to interpret published information for the purposes of the rater's evaluation model and the skills necessary to make the judgements this calls for have been deployed, and
- those based on extensive discussion with management of the issuer and disclosure of confidential, non-published information.

This distinction may not necessarily be important for diversified investment portfolios or regulatory purposes related to diversified investments. However it is very important for narrow portfolios and related regulations *and for affected issuers*.

The same agency may publish ratings assessed under all three practices. It should therefore be required that they are distinguished (and certainly the first two are distinguished from the last) whenever and wherever they are published or quoted. It is not enough for this to be indicated only when the rating is first issued.

Recognised and non-recognised rating agencies

Issue of ratings can at one level be left to the general law to govern.

A regulatory framework may be needed for ratings issued – or developed internally – for use for regulatory, for example capital adequacy, purposes. All ratings issued by such an rating agency recognised under that framework (or made available for sale to other users even though developed primarily for internal use) should be subject at least to the same framework of regulation. The likelihood of user confusion is otherwise great.

There should be elements of substantial regulation of a rating agency included – not merely recognition of its ratings as widely used.

Regulation

Regulation can usefully lay down that methodology should be published and that systems should be in place to ensure that it is understood and followed as well as to give assurances regarding conflicts of interest, disclosure of non-published information received from issuers, etc..

Regulation should not prescribe methodology.

Comparability of ratings

Different (published) methods of rating may produce different ratings, which is not a problem. Given the published methodologies, the differential rating itself contains information which may be useful to the market.

However it is important that particular systems (and the compliance with them) produce comparable ratings wherever the work itself is done.

It would be convenient for users if the basic rating scale were common among publishers – particularly if the number of recognised rating agencies increases. This should not stop raters issuing additional ratings classifications to further refine the opinion.

Conflicts of interest

There are significant areas for potential conflicts of interest and we believe that issuers should have systems in place to control this risk.

Abuse of issuer non-disclosed information

The credit analysts rating a company based on access to management and information are in a very privileged position. They meet with top issuer management and are made an insider to the business. Such rating agencies need to have in place systems to ensure confidential treatment of this information, including restriction on relationships with other parts of the same agency (or related businesses) which might deal with equities and with journalists and other outsiders (including ratings subscribers). Analysts and others in a rater who have had access to confidential information about an issuer which would potentially give them an advantage should be prohibited from working in other areas of securities markets etc. for a reasonable period.

Tariffs and contracts

Issuers have no effective economic power in agreeing contracts and tariffs with rating agencies for solicited ratings. In many ways the rating agencies are like utility operators with a local monopoly. Contracts with rating agencies are contracts of adhesion without the opportunity for negotiation of terms. Where there are only a tiny number of practically useable rating agencies, abusive collaboration between agencies is not necessary for abuse by an individual agency in its relationship with an issuer. At the very least, unnecessary barriers to entry should be avoided.

IV Comments on consultation questions

(Section letters and question numbers are those used in the Concept Release)

A. Alternatives to the NRSRO Designation

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

In view of the importance of published credit ratings to individual issuers and investors and to financial stability generally, we believe that regulatory recognition of and oversight of rating agencies is desirable not merely because of the use of ratings in regulatory provisions.

2: If so, what alternatives could be adopted to meet the regulatory objectives of the Commission rules…?

N/A

3: [On] allowing broker-dealers to use internally-developed credit ratings to determine capital charges under the Net Capital Rule…

As recognised in proposed supervision of international banks ("Basel II"), there is no reason why large and sophisticated institutions should not be able to use their own models to achieve satisfactory ratings for regulatory purposes – for their own large portfolio/diversified activities and for those of others to whom they sold their internal ratings (on a timely basis). These are likely to be purely statistical exercises based on published, usually historical, information – satisfactory on a statistical basis for deriving aggregated data, but insufficiently sensitive for application to single, individual purposes or narrow portfolios.

… firewalls between the broker-dealer employees who develop internal credit ratings and those responsible for revenue production?

No comment.

… should a broker-dealer be required to obtain regulatory approval of its credit rating procedures and rating categories…?

If so, what factors…

For the purposes of the Net Capital Rule and similar purposes, statistical ratings are likely to be satisfactory for large diversified portfolios provided that the methodology used is published, understood, reliably applied and the rater has in place appropriate quality control checks. A supervisory authority should be satisfied that these features are in place.

[This should not stop publication for other uses of ratings derived from non-disclosed, proprietary models by un-regulated raters. Internal rating processes, usually statistical, remain important to individual investors and, undisclosed, may allow them to differentiate their performance by making different judgements on issuer/instrument risk as a matter of investment selection. In neither case are such ratings appropriate for regulatory purposes.]

On the other hand, in application to less diversified portfolios (for investment or regulatory purposes) and, particularly, in their effect on rated issuers and instruments purely statistical ratings are, in principle, likely to be inherently less well adapted.

Ratings arrived at after statistical analysis and supplemented by appropriate discussion with management of the issuer and receipt of non-public information, especially about forecasts, plans, etc. are likely, in principle, to be superior (and no less appropriate for regulatory purposes). The regulatory authority should satisfy itself regarding systems etc. as in paragraph 1 of our answer to this sub-question.

It is important that purely statistical ratings be distinguished from ratings arrived at after proper consultation with management of the issuer wherever and whenever they are published.

… what would be the impact on broker-dealers…? …

No comment

… 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?

The rater could itself be a broker-dealer or a "rating agency". In principle this could make for more competition regarding use of ratings *for regulatory purposes* regarding large diversified portfolios.

To what extent should the Commission exercise additional regulatory oversight of this activity (e.g., to control potential conflicts of interest)?

If the ratings are purely statistical, conflicts of interest, timing apart, are unlikely to arise and oversight can be limited to approval of some systems and infrastructure items.

For ratings involving judgements, some limited further provisions regarding conflicts are necessary – see comments on questions in Section D.

4: What are the advantages and disadvantages of allowing broker-dealers to use credit spreads to determine capital charges…? …

Credit spreads are not appropriate for determining risk for regulatory purposes. Credit spreads within a market range are in large part determined from the risk assessment process. It would therefore be circular for credit spreads to be used to *determine* assessed risk.

Feed-back effects could cause potentially significant perturbations.

Spreads are set by many factors other than risk which determine supply and demand for a particular instrument. If a spread should fall randomly, the proposal could mean an instrument would be categorised as less risky, demanding less capital to back it so there is a greater willingness to hold the instrument, so its spread is likely to fall further, etc.

Are there other model-based statistical scoring systems and/or market-based alternatives that would be viable alternatives to NRSRO ratings?

See comments on questions 3, 14 and elsewhere.

5: What are the advantages and disadvantages of requiring the SROs to set appropriate standards for broker-dealers to use in determining rating categories for net capital purposes? …

We make no comment in so far as this applies to ratings for own use. We would be concerned if this applied to published or re-sold ratings as fragmentation of the rating system would be very difficult for issuers to handle – particularly issuers with a complex or unusual situation ("story credits").

6: What are the advantages and disadvantages of eliminating the "objective test" from Rule 2a-7… for the purposes of determining asset quality?

Change would alter the nature of money-market fund investment but we make no comment on the desirability or otherwise of this. Nothing would stop certain funds establishing a policy similar to the existing regulation, giving investors a choice.

7: What are the advantages and disadvantages of relying upon specified investor sophistication…? …

No comment.

8: Are there alternatives other than those discussed above that might be better substitutes for the NRSRO designation in particular Commission rules?

No comment.

9: If the Commission discontinued using the NRSRO designation, should an entity other than the Commission recognize NRSROs for uses other than Commission rules? If another entity, which entity? How would the transition from the Commission to that entity take place?

We believe that oversight of rating systems used for regulatory purposes (whether recognition of credit rating agencies or internal systems) is desirable. More widely it is important on general financial stability grounds and from the standpoint of the effects of rating on individual issuers and instruments.

The agency involved is a policy matter on which we make no comment.

10: If, on the other hand, the Commission should continue to use the NRSRO designation in some Commission rules, could that designation be eliminated from other rules? If so, which rules?

No comment.

B. Recognition Criteria

11: Are the criteria currently used by Commission staff to determine whether a credit rating agency qualifies as an NRSRO appropriate? …

See below.

12: Is it appropriate to condition NRSRO recognition on a rating agency being widely accepted…? …

There is a "chicken and egg" issue here. The danger is potential effects on competition - that the "widely accepted" rule acts to discourage the growth of new publishers of ratings. There are large feedback effects.

We prefer systems based supervision – see below.

While we advocate this on policy (competition) grounds, the downside is greater supervisory cost even though we see the areas as suitable for "light" supervision.

In previous evidence to the Commission (see Appendix 1) we have explained why issuers may find much greater costs from any growth in the number of publishers of ratings. We do support such growth provided that purely statistical ratings are distinguished from ratings arrived at after proper consultation with management of the issuer wherever and whenever they are published. This would in practice permit issuers to manage the number of raters with which they deal with closely – usually in solicited ratings – limiting the cost and management time of rating agency communications. It might also restore some power to issuers to avoid being price-takers as regards rating fees and conditions (see response to the solicitation of additional comments, below)

If the "widely accepted" criterion is kept, however, we are surprised that the term "investors" does not precede "issuers" in the list of examples of users.

13: Should the Commission condition NRSRO recognition on a rating agency developing and implementing procedures reasonably designed to ensure credible, reliable, and current ratings?

In principle we see no objection to supervision focused on approval of systems (including for quality control and controls on the timing of disclosure and maintenance of confidentiality until disclosed) used by statistical raters rather than "wide acceptance". We advocate above similar supervision of internal rating systems for regulatory purposes.

At a minimum, should each NRSRO have rating procedures designed to ensure that a similar analysis is conducted for similarly situated issuers and that current information is used in the rating agency's analysis? What minimum standards should the Commission use to determine whether the agency's ratings are current?

Similar analysis for similarly situated issuers is sensible for purely statistical ratings (usually based on historical data).

On currency of ratings we believe that "soft regulation" is to be preferred here. A requirement that ratings be kept "current" is desirable – but this should be seen in terms of best practice guidelines rather than black-letter regulation.

In looking at currency, it is important to distinguish between purely statistical ratings (which should always be marked as such wherever and whenever published) which may be reviewed on publication of new information and certainly of new annual reports on one hand, and those arrived at after appropriate discussion with management, provision of plans, forecasts, etc. on the other. The discussions while often an annual routine may also be *ad hoc*. This type of rating is particularly important for more complex or special situations ("story credits").

Should each NRSRO use uniform rating symbols, as a means of reducing the risk of marketplace confusion?

A basic set of rating symbols would provide a useful simplification and we advocate this. However, this should not stop individual publishers of ratings using their own additional symbols etc. to make other distinctions between rated instruments/issuers.

When reviewing a rating agency's procedures for obtaining information on which to base a rating action, should the Commission establish minimum due diligence requirements for rating agencies? How could these minimum requirements be developed? By the Commission? By the industry, with Commission oversight?

We believe that all of these criteria, and similar criteria for internal ratings for regulatory purposes, are best developed by the industry with Commission oversight and subject to exposure of proposals for public comment etc. As there may be more users of internal ratings than publishers of ratings, Commission oversight would (among other advantages) ensure that the former did not dominate.

14: Should the extent of contacts with the management of issuers (including access to senior level management of issuers) be a criterion used to determine NRSRO status? Should the Commission limit the credit ratings that can be used for regulatory purposes to credit ratings that include access to senior management of an issuer? If so, why?

No, in each case, generally, to the first two sub-questions when applied for large diversified portfolios.

Purely statistical ratings should be acceptable for regulatory purposes where diversified portfolios are concerned. Because ratings are used for many purposes, such purely statistical ratings should always be marked as such wherever and whenever they are published.

A proper level of contact with the issuer (including disclosure of confidential information, forecasts, plans, etc. and discussion with senior management) in principle gives superior ratings for narrow portfolio purposes for investment and regulatory capital purposes and from the point of view of the impact on the particular instrument/issuer. This is particularly important for the more unusual or complex situations ("story credits").

[We do not regard published credit ratings as investment "recommendations" and see no inappropriate effects in securities markets generally on disclosure of confidential information, under appropriate safeguards, to rating agencies. We agree with the Commission's analysis in making special provision for credit rating agencies under Reg FD.]

A rating issued after "unsatisfactory" discussions with the company – for example meetings but no full disclosure – should require the rating always to be marked, possibly as a purely statistical rating, or in some other way.

There is always the risk that raters make unreasonable demands on management time. However given that this process normally only applies to solicited ratings and provided there is, in principle, competition with other rating agencies we do not think that this requires especial safeguards.

15: To the extent a credit rating agency uses computerized statistical models, what factors should be used to review the models? Could a credit rating agency that solely uses a computerized statistical model and no other qualitative inputs qualify as an NRSRO?

Supervisory oversight of ratings models is not in general necessary – just oversight that criteria are published, the model is internally consistent and that quality control procedures are in place. The market should determine the acceptability of particular models (which can be tested for historical effectiveness). There is scope for investor confusion given the potential number of raters and rating systems, but the market may be left to sort that out.

However, diverse issuers may have aspects of their reports which make interpretation of the figures into the models categories difficult and calling for judgement. Accordingly factors discussed in subsequent questions can be important. Thus it is considered that a rating agency that solely uses statistical models and without the ability properly to consider these issues should not qualify as issuing ratings for regulatory purposes for other than in relation to large diversified holdings.

16: Should the size and quality of the credit rating agency's staff be considered when determining NRSRO status? Should the Commission condition NRSRO recognition on a rating agency adopting minimum standards for the training and qualifications of its credit analysts? If so, what entity should be responsible for oversight of qualifications and training?

Any rating agency which publishes ratings which have a subjective element raises issues which would not apply to a purely statistical rater – particularly in areas which could give rise to conflicts of interest.

Even a rating derived purely from a statistical model may have had judgements made in interpreting information into the model. For example information from various footnotes and ancillary disclosures may be needed or recourse may be had to descriptive rather than numerical parts of reports. Information about non-US issuers may need particularly careful attention.

For this reason, producing a rating cannot be seen as a purely clerical function. Staff should include appropriately qualified persons who can bring the necessary expertise to bear.

In this context, raters should be encouraged to seek to talk directly to issuers about how their data is interpreted into the model in difficult cases. It needs to be recognised that there is no compulsion on issuers to talk at all to issuers of unsolicited ratings but a decision to talk to them or not is just another part of a company’s decision about its interaction with the financial community generally.

All raters publishing or selling ratings, on the other hand, should be willing to answer questions (and receive comments) from issuers concerned about the appropriateness of treatments.

An important point here is consistency and comparability between analysts working the same firm – including those working in different countries. Recognised rating agencies should be required to make some declaration about the standards, training and competence of their staff. Given the small number of recognised rating agencies, it may be considered there should be some guidance on minimum standards – but this is probably better left to a code produced by the industry than specified by regulation.

How could the Commission verify whether a member of a rating agency's staff is or was previously subject to disciplinary action by a financial (or other) regulatory authority?

No comment.

17: Should the Commission condition NRSRO recognition on an entity's meeting standards for a minimum number of rating analysts or a maximum average number of issues covered per analyst? For example, should the Commission question whether a single analyst can credibly and reliably issue and keep current credit ratings on securities issued by hundreds of different issuers? Or would this level of scrutiny involve the Commission too deeply in the business practices of rating agencies?

Soft regulation is appropriate here. For example, on receipt of a complaint, the Commission might ask a rater to illustrate the adequacy of its procedures and in case of gross inadequacy this might call into question the rater's recognition. But in general, and subject to our comment in the response to question 16, the market is the better supervisor in this area. Again a key issue is consistency and comparability between analysts working for the same firm (including those based in different countries).

18: Is a credit rating agency's organizational structure an appropriate factor to consider when evaluating a request for NRSRO status? Should the agency that seeks recognition consent to limiting its business to issuing credit ratings or could it conduct other activities, such as rating advisory services?

On organisational structure, yes, it is relevant particularly where the rater is part of or affiliated with another organisation.

Provided that adequate "Chinese walls" are in place, in relation to specific issuers or instruments, rating advisory services which understand the particular criteria used by a rater and the model it uses in statistical analysis are a useful service to issuers. Advice etc. given to issuers should not be disclosed to staff making judgements in any particular case.

Further, persons involved in rating decision activity should not be in any way be remunerated by reference to the results of dealing or corporate finance businesses with which the rating organisation is affiliated.

Such persons should not be permitted to join equity research or investment teams for a relatively long period after they last receive non-public information about an issuer which may be relevant to the new employment. A gap of up to two years may be appropriate, though a lesser period may be accepted to preserve freedom of employment. This should apply to moves to another business in the same group as the rating agency or to another organisation entirely.

19: Should the Commission consider a credit rating agency's financial resources as a factor in determining NRSRO status? If so, how? Should NRSRO recognition be conditioned on a rating agency meeting minimum capital or revenue requirements?

There are two aspects here – capital and revenue.

In any rater which is not a purely statistical rater, it is important that ratings are not seen to be influenced by individual issuers or customers for ratings reports.

Thus the rater should be seen to be financially stable with adequate capital and revenue. And no particular issuer or customer for ratings reports should be seen to represent more than a small portion of revenue (see comment on question 42).

20: Should a rating agency that confines its activity to a limited sector of the debt market be considered for NRSRO recognition? Should a rating agency that confines its activity to a limited (or largely non-U.S.) geographic area also be considered?

In principle we see no reason to be restrictive – although the more limited the business scope, the more difficult it may be to meet our criteria on revenue set our in the response to questions 19 and 42.

21: Should the Commission consider a provisional NRSRO status for rating agencies that comply with NRSRO recognition criteria but lack national recognition?

If the “widely accepted” criterion is retained, which we do not advocate, this would be appropriate. It should be time-limited.

22: Should the Commission develop supplemental criteria to evaluate ratings quality that would be applicable to both rating agencies performing traditional fundamental credit analysis and those primarily reliant on statistical models?

No. Light regulation is needed in this area. See also comment on question 51.

23: Should the Commission consider other criteria in making the NRSRO determination, such as the existence of effective procedures reasonably designed to prevent conflicts of interest and alleged anticompetitive, abusive, and unfair practices, and improve information flow surrounding the ratings process?

Yes. See answers to other questions, particularly 18 and 20.

24: Should the Commission expect NRSROs to follow generally accepted industry standards of diligence? If so, should the Commission encourage the establishment of a committee of market participants to develop those standards? Or should they be devised through other means?

A code of best practice, differing according to whether a rater is purely statistical or rates after appropriate access to senior management etc. and developed by the industry with appropriate exposure for public comment is an appropriate route here.

25: Should the Commission expect NRSROs to follow generally accepted industry standards of diligence? If so, should the Commission encourage the establishment of a committee of market participants to develop those standards? Or should they be devised through other means?

Positive recognition is preferred to no-action. An administrative level appeal is a useful idea.

26: Should the Commission publicize applications for NRSRO recognition, and seek public comment on the credibility and reliability of the applicant's ratings?

Yes.

27: Should the Commission establish a time period to serve as a goal for action on applications for NRSRO recognition? If so, [what] would an appropriate time period be…

Two months for public comment and one clear month after for Commission's adjudication seems fairly to balance applicant expectations for no unnecessary delay with opportunity for public comment.

C. Examination and Oversight of NRSROs

28**: Should NRSRO recognition be conditioned on an NRSRO's meeting the original qualification criteria on a continuing basis? If so, should a failure to meet the original qualification criteria lead to revocation of NRSRO recognition? Should some other standard of revocation apply?**

Yes. But light regulation should provide that the (annual) certificate of the rater should be acceptable and that the Commission should only have cause to make enquiries on the certificate being unacceptable on its face or on receipt of (credible) complaint. Revocation or suspension should be a credible sanction.

29: What would be the appropriate frequency and intensity of any ongoing Commission review of an NRSRO's continuing compliance with the original qualification criteria?

See answer to question 28.

30: Should NRSRO recognition be conditioned on a rating agency's filing annual certifications with the Commission that it continues to comply with all of the NRSRO criteria?

Yes. It is often easier to sanction for filing an inaccurate (or false) certificate than for an underlying alleged offence.

31: Should the Commission solicit public comment on the performance of each NRSRO, including whether the NRSRO's ratings continue to be viewed as credible and reliable? If so, how frequently should public comment be solicited (*e.g.*, annually)?

In general no, only in case of a significant level of complaint but such a reserve power would be important.

If the market of *users* does not believe a suite of ratings the business would probably be very slow to drop away as the bulk of agency revenue is from *issuers*. Only major investor insistence on use of another rating agency would be likely quickly to change issuer behaviour and it is unlikely that a sufficient number of investors would act in anything like a reasonable time frame. “Shopping around” will always be difficult in any market with such a small number of service providers.

Follow up of complaints – from issuers and users – is a way of allowing the market potentially to make a difference without reliance on the (defective) operation of the market as such.

The Commission should in any case retain the right to follow up cases of clear failure to identify significant and material credit issues impacting on capital markets.

32: Should NRSROs be subject to greater regulatory oversight?

Yes.

If so, what form should this additional oversight take?

See answers to other questions, variously.

If necessary, should the Commission seek additional jurisdictional authority from Congress?

We make no comment on US institutional arrangements.

33: Should NRSRO recognition be conditioned on a rating agency's registering as an investment adviser under the Advisers Act? …

No comment.

34: Should NRSRO recognition be conditioned on recordkeeping requirements specifically tailored to the ratings business? Should NRSRO recognition be conditioned on a rating agency's maintaining records relating to the ratings business, including those relating to rating decisions?

Limited retention requirements are appropriate – for example all documents etc. relating to a current rating should be retained. A question is how far back should records be kept as storage costs are not insignificant Given that the main rating agencies seek to “rate through an economic cycle” then it would seem appropriate to keep some history for at least this period. In some cases, particular documents or notes should be retained for longer. An industry code of practice may be the answer here.

Of course in some cases retention is a necessary but not sufficient condition. File and forget is often inappropriate. When (new) rating agency staff interviewing issuer management express total ignorance of information and analysis made available in earlier years – possibly on initial rating, possible even only last year – about important, complex topics it can have a devastating effect on issuer confidence in the rating process. Irritation is only increased when the agency staff say that they have no access to older documents/meeting notes/records of site visits, etc.. This is particularly true if the discussion is not at a routine annual meeting but to talk about a potential (negative) rating action - when feelings more resembling rage may be manifested.

35: Are there minimum standards or best practices to which NRSROs should adhere? If so, how should these be established? By the Commission? By the industry, with Commission oversight? Should they be incorporated into the conditions for NRSRO recognition? Would it, or would it not, be a productive use of Commission resources to develop the expertise to review, *e.g.*, issues related to the quality and diligence of the ratings analysis?

Minimum standards should be a concern for the Commission itself, with industry input.

A *best practice c*ode is better developed by the industry with Commission oversight and public exposure for comment (see answers to questions 13 and 24).

In either case, there should be a requirement for agency analysts at least to *read* important material furnished by the issuer with members of a rating committee at least seeing a summary or appraisal of them. (See last paragraph of our comment on Question 34.)

36: If a currently recognized NRSRO gave up its NRSRO recognition because of concerns regarding the regulatory and liability environment, what effect, if any, would that action have on the market?

We consider this scenario to be extremely unlikely.

However, if a major agency withdrew this would be potentially de-stabilising for the capital markets. Such decisions would be a commercial matter for the agency. It is another reason why unnecessary barriers to new raters coming into a market that will always have only a small number of players should be avoided – to avoid over dependence on one or two firms.

D. Conflicts of Interest

37: Should the Commission condition NRSRO recognition on an NRSRO's agreeing to document its procedures that address potential conflicts of interest in its business including, but not limited to, potential issuer and subscriber influence? If so, what other potential conflicts should these procedures address?

Yes to the first sub-question.

Given that a change in rating of an instrument or an issuer can have material price effects and major impact on issuers, potential conflicts of interest (insider trading etc.) re information on proposed changes can arise.

Furthermore, indirect influence/conflicts can arise through parent/affiliate businesses and proper procedures must be in place to avoid this.

In response to question 19 we have referred to the need for revenue diversification to avoid influence by particular customers.

Procedures are needed to ensure that any ratings advisory business associated with the rater has no influence on particular ratings. (It can of course be a source of information on how the ratings criteria in use by a firm may need adaptation to a particular type of circumstance.)

Our comments in response to Question 18 on the need for an appropriate period to elapse before a rating analyst having had access to confidential information from an issuer may work in any other area where such information may be material, are relevant.

38: To what extent could concerns regarding potential conflicts of interest be addressed through the disclosure of existing and potential conflicts of interest when an NRSRO publishes ratings?

This is important, especially in respect of connections with/influence by associated parties. It is no substitute for proper procedures.

39: Should NRSRO recognition be conditioned on an NRSRO prohibiting employees involved in the ratings process (*e.g.,* rating analysts and rating committee members) from participating in the solicitation of new business and from fee negotiations? Would conditioning NRSRO recognition on a rating agency's establishing strict firewalls between employees in these areas and credit analysts address potential conflicts? Should the Commission also address the credit analyst compensation structure to minimize potential conflicts of interest?

Yes in each case.

Remuneration structures are key here. In practice, a potential issuer client can find talking to a real live analyst etc. helpful about process issues. If the sales unit only is talking, it can seem more questionable. However, those involved in ratings should have no element of remuneration significantly related to sales levels. The inherent issue that even an analyst may have a direct interest in firm survival, remains.

40: Should NRSRO recognition be conditioned on an agreement by a rating agency not to offer consulting or other advisory services to entities it rates? Could concerns regarding conflicts of interest be addressed by limiting or restricting consulting or advisory services offered by rating agencies?

On rating advisory services, see answer to Question 37.

Credit ratings should be segregated organisationally and by appropriate Chinese walls from equity analysis or market making activities going on in the same organisation or group. Physical segregation is probably necessary.

41: Should NRSRO recognition be conditioned on a prohibition on credit rating analysts employed by NRSROs from discussing rating actions with subscribers? If not prohibited, should the Commission adopt limits on contacts between analysts and subscribers? Or are existing remedies — antifraud, contractual, or otherwise — sufficient to deter inappropriate disclosures to subscribers?

This is an area of concern to issuers where rating agencies have been given access to non-published information. It can cause great anxiety. The prudent company clearly marks confidential written/graphic/video matter and samples and signals confidential oral briefing.

Confidentiality agreements prohibit disclosure of non-public information about the issuer. We are not aware of any inappropriate communication from analysts to subscribers, which could suggest that existing arrangements seem to be sufficient to deter it.

Discussion should be confined to rating actions taken and to methodology. Rating analysts are not commonly expert communicators and the worry remains that non-verbal communication may reveal more than the analyst intends – even if they are fully conscious at the time of discussion as to precisely what information supplied by the issuer was labelled as undisclosed. There are dangers here.

We believe that the industry should be encouraged to develop a code of best practice regarding communication with subscribers but can see that it may be necessary to prohibit non-written communication and to require retention of written material. (Similar stipulations should apply to communication with other interlocutors, for example journalists.)

Breaches of the confidentiality provisions if they should occur could have serious impact on an issuer and should be taken seriously. A requirement for the rater on becoming aware of a breach to report it to the issuer and relevant market authorities would be wise. Once a breach has occurred consequences would generally be uncontrollable.

On the other hand, the impact on the rater is negligible.

42: Should NRSRO recognition be conditioned on a rating agency having adequate financial resources (*e.g.*, net assets of at least $100,000, or annual gross revenues of at least $1,000,000) to reduce dependence on individual issuers or subscribers?

Yes.

Consultation on levels should take place with the industry and any proposals be subject to exposure for public comment. (See comments on question 19).

It is desirable that capital levels are such that revenue less direct costs of rating from any individual issuer is small in relation to capital.

With solicited ratings fees in the current range, USD 1m of revenue could equate to just a very small number of large issuers. The chances of conflict of interest being more difficult to handle at this level of concentration are greater.

On the other hand, too high a threshold would potentially limit entry of competition.

The Commission's idea of provisional recognition would seem to be appropriate in this context. It is not without its own difficulties – a rater coming to the end of a provisional period may feel tempted to offer inducements to one or two new clients to put it over any minimum revenue threshold.

43: Should NRSRO recognition be conditioned on a rating agency not deriving more than a certain percentage of its revenues (*e.g.*, 3%) from a single source to help assure that the NRSRO operates independently of economic pressures from individual customers?

Yes. (See comments on question 19, 42 above).

44: Are there other ways to address potential conflicts of interest in the credit rating business or to minimize their consequences?

No comment

E. Alleged Anticompetitive, Abusive, and Unfair Practices

45: Should the Commission identify specific anti-competitive practices that NRSROs would agree to prohibit as a condition to NRSRO recognition? If so, what are those practices?

The ultimate victim of anti-competitive behaviour is the paying customer.

Subscribers (users of ratings) pay little for this and anti-competitive effects may reside in subscription costs than in the lack of choice of rating agency.

Issuers provide the bulk of rating agency revenues. Anticompetitive effects may be seen in pricing and terms for rating issuers/instruments but more importantly in how an agency deals with the issuer's information and produces a rating, as well as lack of choice of rating agency.

Potential entrants to the market can be intermediate victims of the process.

It should be recognised that a rater may be able to charge a lower fee for a new issue by a previously rated issuer or a subsidiary of an issuer, even though that may make it difficult for a new agency to compete for the new rating.

There should, however, be no right for a rater to insist on rating (other than on a non-paid for, statistical rating basis and marked as such) any particular issue as a condition of rating another.

46: Would it be sufficient to condition NRSRO recognition on the adoption of procedures intended to prevent anticompetitive, abusive, and unfair practices from occurring?

Yes, generally, especially as any list of prohibited actions would soon be overtaken by new practices. We must recognise too that other law/regulation may impinge on certain occurrences.

Our comments on issuer pricing/negotiating power in our preliminary comments above and on issuer grievances under Solicitation of Additional Comments, below, are relevant.

Lack of competition in areas such as this is more likely to show up in poor standards and sloppy attention to the details of particular issuers' positions. While complaining about rating tariff increases, issuers have often felt they would prefer to pay a slightly higher fee if this allowed agencies to employ (and keep) better qualified staff with more open minds and better ability to reach judgements rather than merely following formulae which may be inappropriately applied.

47: Should NRSRO recognition specifically be conditioned on an NRSRO's agreeing to forbear from requiring issuers to purchase ancillary services as a precondition for performance of the ratings service?

Yes. Permitted, this would give rise to conflicts of interest.

We recognise that this would tend to stop rating being a “loss leader” in a house’s range of activities.

48: Should NRSRO recognition specifically be conditioned on an NRSRO's not engaging in specified practices with respect to unsolicited ratings (*e.g.*, sending a bill for an unsolicited rating, sending a fee schedule and "encouraging" payment, indicating a rating might be improved with the cooperation of the issuer)?

Unsolicited ratings put the rater in a position of mere volunteer who cannot look for remuneration from the issuer. Such ratings should be marked as purely statistical ratings without satisfactory access to senior management and confidential information – wherever and whenever they are published.

Bills issued for unsolicited services or supply are a feature of scams in many parts of the world and companies should have systems in place to deal with them. Where the general laws of a jurisdiction do not prohibit such billing we do not believe that credit rating agencies should be singled out for special prohibition.

Revenue receipt from an issuer should never be a part of remuneration of anyone involved in the rating process and indicating a rating might be improved appears to be a corrupt practice.

Our previous comments to the Commission regarding unsolicited ratings are relevant to this and are appended (Appendix 1).

F. Information Flow

49: Should the Commission address concerns about information flow from rating agencies? If so, should the Commission condition NRSRO recognition on a rating agency's agreeing to establish procedures to assure certain disclosures relating to its ratings business, such as those described above? Are there other disclosures that could be appropriate?

Recognised rating agencies should disclose rating criteria etc. as discussed variously above.

Disclosure of potential conflicts (if any) is important too.

50: Specifically, should NRSRO recognition be conditioned on a rating agency disclosing the key bases of, and assumptions underlying its rating decisions? If so, should these disclosures be made pursuant to standards developed by the industry, or otherwise?

Satisfactory disclosure of ratings criteria is important. This would of course not involve disclosure of matter relevant to rating of any particular issuer.

While it should not be a regulatory requirement, development of a code of best practice by the industry – not of ratings criteria but for their disclosure – would be appropriate.

51: Would it be advisable for the Commission to condition NRSRO recognition on a rating agency's agreeing to disclose performance information periodically? If so, what type of performance information would be most useful? How often should it be disclosed?

Rating agencies publish various analyses of default rates/loss rates against their various ratings and how those ratings move through time.

An industry developed code of best practice on this – not of how to do comparisons but on disclosure of methodology and non-suppression of less flattering comparisons – would be useful.

52: Should NRSRO recognition be conditioned on a rating agency's disclosing whether or not an issuer participated in the rating process?

Yes.

However, we see little difference between a purely statistical rating and one with limited input from the issuer.

Such ratings should be marked as such wherever and whenever they are published.

It is important, from the point of view of the narrow portfolio investor and the issuer, that ratings made after discussion with senior management of the issuer and disclosure of forecasts/plans etc. are distinguished from the two previous categories. This is more important than whether or not the rating was solicited.

Our previous comments to the Commission are relevant to this and are appended (Appendix 1).

Or, could issuers be required to make such disclosures?

It should be up to issuers whether they want a solicited rating with full disclosure and discussion with management or are only prepared to help an agency decide how published information is best presented to their model or want no involvement at all.

(See comment in response to Questions 14)

53: Concerns have been raised that certain credit rating agencies make their credit ratings available only to paid subscribers, and that it would be inappropriate to require users of credit ratings to subscribe for a fee to an NRSRO's services to obtain credit ratings for regulatory purposes. What steps, if any, should the Commission take to address these concerns? For example, should NRSRO recognition be conditioned on a rating agency's agreeing to public dissemination of its ratings on a widespread basis at no cost, as is currently the case?

See comments above on provision of internal ratings from one firm to another.

Recognition should not depend on the scope of publication and whether it is free or not, but on the other criteria discussed herein. If contemplating a *requirement* to publish credit ratings for regulatory purposes, there is need to be aware of the impact upon the issuer and others who pay for their services. It would be unhelpful if rising fees caused by regulatory uses and demands for widespread free use of NRSRO-approved credit raters caused issuers to look to newer agencies focused on investor needs only.

The requirement to distinguish purely statistical ratings (and those made with limited management contact) from those after proper discussion etc. with management is important.

54: Should NRSRO recognition be conditioned on a rating agency's implementing procedures to assure public notification when it ceases rating/following an issuer. If so, what form of public notification would be appropriate?

Yes. Outdated ratings can be a cause of mischief.

Notification depends on the client base. If it is a section of the public (including, for example, small broker-dealers) direct advice to that section is appropriate. Otherwise publication on its website and through the media through which it usually communicates ratings would be appropriate.

An equally important shift would be from a rating made after appropriate discussion with senior management and disclosure of confidential information including forecasts and plans to one not made with that benefit. Ratings of the latter type should always be marked as such whenever and wherever they are published.

G. Other

55: What steps, if any, can the Commission take to improve the extent and quality of disclosure by issuers to rating agencies or to the public generally, and in particular, regarding: (a) ratings triggers in financial covenants tied to downgrades; (b) conditional elements of material financial contracts; (c) short-term credit facilities; (d) special purpose entities; and (e) material future liabilities.

All the matters referred to are properly the concern of operating and financial reviews (or equivalents) and other disclosures. They should be being disclosed to the public at large and not merely rating agencies.

Purely statistical rating agencies should depend on public disclosures.

Rating agencies which rate after discussion with senior management and disclosure of confidential information including forecasts and plans would be expected to have included discussion of risks and contingencies in those discussions. Contracts for “solicited” ratings in this category should provide for full disclosure. While it is unlikely, if there are unsolicited /unremunerated ratings in this category and so not already subject of an agreement between the rater and the issuer, an appropriate contract should be signed before the rating agency publishes the rating. We recognise that this gives the issuer veto over whether a full rating is published but the rater should be free to publish as a statistical only rating.

56: Is it appropriate for the Commission to take steps to minimize the ratings "cliff" that has been represented to be particularly pronounced in the commercial paper market? If so, what steps should the Commission take?

Investors in short-dated paper usually are looking for security and liquidity. This would itself produce the ratings “cliff”. It is always open for people to market a type of fund investing in lower-rated short-dated paper for those who want the yield and can accept the risk.

There is a similar divide between investment grade and sub-investment grade long-term ratings.

In each case there seems to be objective justification in view of differential expectations of default/expected losses seen at the different ratings of the major NRSRO ratings.

V Solicitation of Additional Comments

(See also the section III, Prelinary comments, above.)

Transparency/accountability

This has been dealt with in several aspects above There are certain specifics we would add.

One of the procedures which goes to maintaining consistency and avoiding influence/conflicts of interest relates to "rating committee" in raters other than statistical raters is the "rating committee". Assurance that these are not formalities is important – they must be more than mere recitals or chats in corridors.

Rating appeals are part of the process of initial ratings and potentially in relation to subsequent rating actions. Recognising that raters should have an obligation to issue a new rating promptly, a real mechanism for the issuer to be able to discuss the proposed change quickly with the rater is important, particularly where the rating is published as being after proper discussion with the issuer. The impact on an issuer of an incorrect rating in this category is great – although this is probably not important for ratings used for regulatory purposes and by diversified portfolio investors.

Issuer inhibition

It should be recognised that, other obligations to communicate with the market notwithstanding, an issuer may be reluctant to announce potential bad news - or to share it with a rater. Raters' contracts with issuers should have a requirement for prompt disclosure to them of such news.

Dual ratings

We have no problem with an issuer or instrument being rated differently by different raters – each of which rates after proper discussion with senior management. Given that we advocate that recognised raters be required to publish their methodologies, the informational content of differential ratings can be valuable to the market. (Purely statistical ratings or ratings without proper discussion with management are just that and different ratings by different raters would be expected in some cases in view of the mechanistic nature of the ratings/relative poverty of information available.)

Consistency of rating

It is desirable that ratings of a particular instrument or issuer are not volatile. Accordingly, it is important that raters have the objective of rating, to some extent, "through a cycle", as the major agencies do. Perhaps this may be more difficult for purely statistical raters. However it should be the objective of those rating after appropriate discussion with senior management.

This can impact on apparent currency of ratings. The rater has to decide whether the rated entity has in some way fallen below (or risen above) what would have been expected at this point of the cycle. It may thus move ratings less frequently than a statistical rater – but this should not affect the reliability of the ratings.

As referred to above, systems in place should ensure that ratings by different offices of a rater – including those in different countries - are consistent. It is not a concern that raters using different methodologies reach different conclusions – the ratings differential has information content.

Provision of confidential information to rating agencies by issuers

These comments apply to raters rating after appropriate discussions with senior issuer management and provision of confidential information such as forecasts and plans. The key ratings to which the market attends are those in this category.

We believe that this is a key part of the rating process.

We believe that the effects of this are as set out by the Commission in the rationale under Reg. FD for the exclusion of confidential information provided to ratings agencies. The key is that the confidential information remains subject to the confidentially undertakings in the contract between the rater and the issuer but the confidential information's impact is taken into account in the rating. We are aware of questions raised by other commentators about disclosures to "subscribers" who have access to analysts. But such conversations are subject to the confidentiality undertakings to the issuer and we have had no cases of breach of this drawn to our attention. This is particularly important as raters seek stability in ratings (see "Consistency of rating" above). Downgrading of this information flow would have a deleterious effect on ratings. As outlined in our previous submission to the Commission (see Appendix 1) an incorrect rating (either too good or too bad) is in the long-run damaging to an issuer.

Interaction of ratings with equity markets

Most securities markets restrict issuers of listed equity's ability to communicate during "closed periods" (prior to results announcements, for example). Rating agencies issuing rating actions during such a period is sometimes felt to have a disproportionate effect on stock prices at a time when the company has difficulty in avoiding a "false market" in its shares. We believe this interaction deserves further serious study (although we repeat that we do not believe that ratings represent "investment recommendations") in view of trhe conflicts it throws up.

Rating tariffs and contracts

In practice, for solicited ratings, *issuers* are price takers. That the agencies have pricing power is illustrated by the steady, significant tariff increases and segmentation of the issuers' programmes so as to increase the number of charging points over the past decade.

Contracts issuers sign with rating agencies are contracts of adherence without any ability for negotiation. Furthermore, the contracts purport to be of long duration and issuers agree to whatever future tariff changes may be made. Despite the possibility of competition, in practice issuers do not have the opportunity for "shopping around" for lower prices or better contract terms.

Issuance into many markets is not feasible without ratings from major agencies.

This is not an issue relating to agencies re regulatory capital, but it is important in the markets. For this reason we believe that unnecessary barriers to entry of new agencies should be avoided so that issuers have a real choice of changing agencies – acknowledging the costs in management time of briefing a new agency.

Issuer grievances

Issuers who are in receipt of a downgrade in a solicited rating may be expected to be less than delighted. But they *may* have a genuine grievance.

If an issuer feels that a rating agency has behaved in a cavalier manner or made a good faith misclassification (usually in response to a new development within the issuer or its environment), then the issuer's only recourse is to the rater's appeals process which is established and operated entirely by the rater. Without an open process at this stage, the issuer can still feel aggrieved after the appeal and can only make known its dissatisfaction through the press and other media.

The impact of the occasional "wrong" rating on a rater or the institutions using published ratings for regulatory purposes is negligible – but the impact on the issuer is potentially grave Frequently, the damage is done by publication and later correction – especially if delayed – is less than effective.

For rating agencies to have a proper review/re-rating process by a new team who would have to meet the issuer promptly and virtually start from scratch would clearly be costly but the importance to companies may be such that they would pay for it in important cases.

Unless there were effective alternative raters available in the market place, individual issuer's power to hold raters to account in this area is negligible. (Because of the implied consent for the agency to publish ratings actions, in most jurisdictions a company would have to show malice to succeed in an action against the agency – which is in practice impossible, no matter how great the damage caused.)

Some of our members have argued that these matters are so important to individual issuers and the number of rating agencies so small that aggrieved issuers should be able to ask a regulator or an industry tribunal to review (at the issuer's expense) the application of the rating method, including the use by the agency of all the information made available, taking evidence from the issuer and with power to draw attention to any lapses of or deficiencies in the agency's own process. This would be expensive and issuers would rarely take advantage of it. The availability of such a review may focus rating agency attention, however. We do not have a firm view on this but believe that it could usefully be the subject of further enquiry.

Appendix 1

Response to Interim Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets (as required by S. 702(b) of the Sarbanes-Oxley Act of 2002, U.S. Securities and Exchange Commission, January 2003)

[Sent by e-mail 4 March 2003]

The ACT is the UK's professional body for those responsible in companies for corporate finance and treasury. We have over 3000 members and associate members working in companies and in the financial services industry.

We have followed the SEC's published material on the review of rating agencies with interest. The US agencies service the UK and European markets too and the nature and form of US regulation of the agencies is important to us. Indeed, our February Journal includes a summary of the SEC's January paper.

We know that you are due to publish further material soon. However, we felt that there is one narrow topic on which we should comment now as we feel there may be few bodies which would comment from the rated company's point of view. Individual companies may be more constrained in commenting.

The topic is competition among agencies and the possibility of more recognised agencies.

For UK and European companies seeking ratings, the market demands ratings from two of the recognised agencies.

A company devotes a lot of time to the relationship with rating agencies. While there may be only one formal meeting with the agencies a year, that takes a lot of preparation and care is taken that the agencies are kept up to date and briefed during the year, before company announcements etc. The companies stand by to answer any questions from the agencies and the agencies can ask to meet any executives of a company. In the UK, the FSA acknowledges that companies give the agencies that level of access and information – although it probably technically contravenes the current Listing Rules.

It is not practical to provide that level of involvement with more than a couple of agencies. Introducing a company to a new agency is even more time consuming and intensive. More so for harder-to-understand credits (so-called "story credits") – and it is particularly in such cases that the agencies can add value, of course.

The fees paid by the company for rating is relatively modest and the barrier to dealing with more agencies is rather management time than direct cost.

So we feel that structurally it would be hard for new agencies to spring up which cover the broad European corporate market. In the past those who have tried have started with unsolicited ratings – which they have, in draft, pitched mischievously (too high or too low – both equally damaging to the company) in the hope that the companies would seek to rectify it and end up giving them price-sensitive information and build a relationship they would eventually have to pay fees for.

So from the rated company's point of view, prospective new agencies may serve to keep agency fees low and to keep the agencies on their toes. However – and the reason for this note – we feel that they are not really potential new service providers from the general rated company point of view.

It seems likely that similar considerations would apply in the broad US market for corporate ratings.

This note is on the record and may be freely quoted.

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