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Formal Regulatory Handle Needed for NRSRO Designation: Part I

SIA Compliance & Legal Seminar
Scottsdale, Arizona
April 6, 1992

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*/ The views expressed herein are those of Commissioner Roberts and do not necessarily represent those of the Commission, other Commissioners or the staff.

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Regulatory Handle Needed for NRSROs: Part I

I. Introduction

As some of you may be aware, during a Commission meeting dealing with the adoption of amendments to Rule 2a-7 under the Investment Company Act, I expressed concern with the Commission's increased reliance on the judgment of so-called nationally recognized statistical rating organizations ("NRSROs"). I initially became concerned with the NRSRO designation process, and the absence of standards therefore, during the Commission's rulemaking proceedings leading to the adoption of the Multijurisdictional Disclosure and Modifications to the Current Registration and Reporting System for Canadian Issuers ("MJDS").[1]

The MJDS rules hinge more favorable regulatory treatment on the issuance of a high rating by an NRSRO; and as a result, the two Canadian rating agencies, the Canadian Bond Rating Service ("CBRS") and the Dominion Bond Rating Service Limited ("DBRS"), were prompted to seek designation by the Commission as an NRSRO. Thus the Commission's increasing dependence on the judgment of NRSROs has

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1 See Release Nos. 33-6902; 34-29354; 39-2267; IC-18210; 56 Fed. Reg. 30,036 (July 1, 1991).

resulted in the designation of a rating agency as an NRSRO being not only of domestic interest, but of international interest as well.

To illustrate further, in addition to CBRS and DBRS, the Commission has received numerous inquiries from domestic and international rating agencies, as well as inquiries from foreign governments, regarding the criteria and process used to designate rating agencies as NRSROs. It is obvious that Commission NRSRO designation has become a sensitive and controversial issue of global significance, particularly in the absence of published standards for such designation. Today, it is my intention to discuss some of the alternatives available that could provide for more appropriate treatment of rating agencies under our federal securities laws.

II. Historical Development of the Term "Nationally Recognized Statistical Rating Organization"

The term "NRSRO" originally was adopted by the Commission solely for purposes of distinguishing different grades of debt securities under its net capital rule, Exchange Act Rule 15c3-1.[2] Rule 15c3-1 requires broker-

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[2] See Adoption of Amendments to Rule 15c3-1 and Adoption of an Alternative Net Capital Requirement for Certain Brokers and Dealers, Exchange Act Release No. 11497 (June 26, 1975).

dealers, when computing net capital, to deduct from net worth certain percentages of the market value ("haircuts") of their proprietary securities positions. A primary purpose of the haircuts is to provide a margin of safety against losses incurred by broker-dealers as a result of market fluctuations in the prices of their proprietary positions. Various provisions of Rule 15c3-1 set forth: (1) the haircuts for commercial paper that has been rated in one of the three highest categories by at least two NRSROs; (2) the haircuts for nonconvertible debt securities that are rated in one of the four highest rating categories by at least two NRSROs; and (3) the haircuts for cumulative, nonconvertible preferred stock rated in one of the four highest rating categories by at least two NRSROs.[3]

In 1973, the Commission first considered the use of ratings of "nationally recognized statistical rating services" for regulatory purposes in certain revisions to its capital rules. Specifically, the Commission decided to recognize the use of the ratings of "nationally recognized statistical rating services" as a basis for determining the haircuts for commercial paper and non-convertible debt securities under Rule 15c3-1. This initial

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3 Paragraphs (c)(2)(vI)(E), (F) and (H) of Rule 15c3-1.

determination to rely on ratings was based on the general recognition that ratings are primarily criteria of investment quality, measuring credit risk but ignoring interest risk, purchasing power risk, and the price risk inherent in convertibles selling above face value. Essentially, ratings were considered yardsticks of the relative safety of interest and principal payments.

In considering whether the Commission, by using ratings in Rule 15c3-1, would be indirectly taking a position on the investment worth of particular securities, it was noted that various securities exchanges, including the New York Stock Exchange, used rating agencies to determine haircuts for purposes of their net capital rules. After some study, a determination was made that the proposed use of ratings in prescribing haircuts for commercial paper and debt securities was solely to avoid setting haircuts that would be harsher than necessary for many securities and would not result in the Commission taking a position as to the investment worth of particular securities.

Two somewhat related purposes were sought to be accomplished by using the ratings of nationally recognized rating agencies. First, ratings

provided a means of distinguishing between commercial paper that generally is underwritten and issued by those dealing in the commercial paper market and illiquid, short term promissory notes of companies for which there generally is no secondary trading market. The latter having no value for net capital purposes. Second, by recognizing securities that are highly rated by rating agencies, as opposed to those with no rating or with low ratings, the Commission is able to recognize that group of securities which are considered creditworthy by broker-dealers and institutional investors as well as by the rating agencies themselves.

III. The Expanded Use of the Term "NRSRO"

A. Internationally

The globalization and securitization of the international financial markets have expanded the role of credit ratings in countries other than the United States. Credit ratings currently are incorporated into regulatory schemes in, among other countries, Australia, Canada, France, Japan, the United Kingdom, Mexico, and Switzerland, and in the Eurobond market. Nevertheless, credit ratings have not yet obtained the

degree of importance in the domestic markets of other countries as they have in the United States.

B. Domestically

> [T]he regulatory use of credit ratings in the [United States] is both longer-established and more far-reaching than in other countries. . . . This emphasis on credit ratings reflects both the importance of the [United States] corporate bond and [commercial paper] markets and the regulatory response to dislocation of the securities markets in the early 1930s, and again in the 1970s.[4]

In the federal securities laws and rules and regulations thereunder, the use of certain debt ratings by NRSROs as the basis for awarding benefits that otherwise are not available to securities that are unrated or rated in a lower rating category has expanded well beyond the original, intended use of the concept in the net capital rule. For example, Congress, in certain mortgage-related legislation,[5] and the Commission, in

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4 Harris, Inside information for outsiders, Fin. Times, July 22, 1991, at 11.

5 The Secondary Mortgage Market Enhancement Act of 1984, Pub. L. No. 98-440.

its regulations promulgated pursuant to the Securities Act,[6] the Exchange Act,[7] and the Investment Company Act,[8] have chosen to use the ratings of NRSROs to distinguish "investment grade" debt securities from those which are "non-investment grade." Moreover, the Board of Governors of the Federal Reserve System in its Regulation T also uses the term "NRSRO."[9] In each of these instances, "NRSRO" is defined as it is used in the net capital rule. The Commission, however, never has issued a definition of the term "NRSRO."

When ratings originally were used in the net capital rule, it was determined that it was appropriate to limit recognition to only those rating agencies which were recognized nationally. At that time, it was decided that it was appropriate to recognize only Standard & Poor's Corporation, Moody's Investor Service, and Fitch Investors Service. This decision was based, in part, on findings that, when considered together, these three agencies rated most of the commercial paper and corporate

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6 See, e.g., Regulation S-K; Form S-3; Forms F-2 and F-3.

7 See, e.g., Rule 10b-6; Rule 15c3-1; Form 17-H.

8 See, e.g., Rule 2a-7; Rule 10F-3.

9 12 C.F.R. Part 220.2.

debt issued in the United States, although frequently an issue was rated by only one of the three rating services. Nevertheless, the possibility that other rating agencies subsequently would be added to the list was not ruled out if they were to gain national recognition by receiving broad acceptance from the investment community, broker-dealers and issuers.

Currently, any rating agency that wishes to be designated as an NRSRO for purposes of our securities laws must send a letter to the staff of the Commission's Division of Market Regulation (the "Division") requesting that its application for recognition be approved. If the organization's structure and debt rating process, among other things, satisfies criteria the Division finds generally necessary for recognition of the entity as an NRSRO, the Division will prepare a letter stating that it will not recommend an enforcement action to the Commission if broker-dealers consider the particular rating agency an NRSRO for purposes of the net capital rule. By memorandum, the Division advises the Commission of its intention to send the no-action letter to the rating agency unless the Commission objects to this action. If the Commission does not object, the Division will send the rating agency a no-action letter

designating the agency as an NRSRO for purposes of various paragraphs of the net capital rule.

As discussed above, the term "NRSRO" has been used, in addition to its use in the net capital rule, in various other provisions of the Commission's rules and regulations, as well as in legislation and in Regulation T. Moreover, because in each of these instances, "NRSRO" is defined as it is used in Rule 15c3-1, the effect of the Division's no-action letter is to designate the rating agency as an NRSRO under other provisions of the Commission's rules and regulations that use the term "NRSRO," in addition to the agency's designation for purposes of the net capital rule.

Since the designation of the first three NRSROs, the Division has been contacted by other agencies seeking such designation. These agencies have sought the designation because the proliferation in the use of the term, especially its use in Rule 2a-7 and in the MJDS, has turned such status into a competitive advantage. Using the "no-action" letter process described above, the Division has recognized four additional NRSROs (i.e., Duff & Phelps, MCM, IBCA, and Thompson BankWatch).

While the Division's no-action process has worked well in the short-term, given the fact that NRSRO designation has risen to the level of an international trade issue, a more formal process appears to be necessary for the long-term. I believe that uniformity and comparability of ratings will be available only if each rating agency designated as an NRSRO is required to meet the same minimum published standards. Nevertheless, I recognize that one must balance such concerns with recognition that all rating agencies add value to the market by developing their own qualitative approach to credit analysis.

IV. Recommendations for the Regulatory Treatment of Rating Agencies

There are several alternatives for addressing the question of what is the appropriate regulatory treatment of rating agencies for purposes of the federal securities laws.

A. Alternative 1: Revision of the Current System so that the Division no longer relies on the ratings of NRSROs for purposes of the net capital rule nor designates rating agencies as NRSROs

I am inclined to believe that doing away with the concept of "NRSRO" in the Commission's rules and regulations is not a realistic solution to dealing with the question of rating agencies. As discussed

above, the practice of using ratings for regulatory purposes has become well established and is growing. When the Division first proposed using ratings, it carefully evaluated the appropriateness of their use in the net capital rule and determined that ratings of nationally recognized rating agencies could be of value. Since that time, the use of ratings has been deemed valuable for purposes of other Commission rules and regulations, as well as the rules of other regulatory bodies in the United States and abroad. Therefore, at this time, I would not recommend discontinuing the use of the term "NRSRO".

B. Alternative 2: Continuation of the Current System of Designating Rating Agencies as NRSROs

With the expanded use of the term "NRSRO" in other Commission rules and regulations, obtaining designation as an NRSRO has become of increased importance to rating agencies and also has resulted in increased scrutiny of rating agencies and their ratings. When the Commission first used the term "NRSRO" in the net capital rule, it designated three rating agencies as NRSROs (i.e., Fitch, Moody's, and S&P). In the next seven years, it added two more to the list (i.e., Duff & Phelps and MCM, the latter, of course, is no longer an NRSRO). Since October of 1990, the

Commission has designated two additional rating agencies as NRSROs (i.e., BankWatch and IBCA); and the Division currently has, as I mentioned earlier, active requests pending for the recognition of a number of additional foreign and domestic rating agencies. Nevertheless, rating agencies remain the only participants in the securities markets to be largely unregulated, despite the fact that their importance and influence is growing and is heavily documented.

Now, just because some securities activity is not regulated by the Commission, does not necessarily mean that I am interested in regulating that activity. However, the combination of the Commission's increasing reliance on NRSROs in our rules and regulations and of the growing number of rating agencies seeking NRSRO designation, particularly internationally, does lead me to believe that the Commission should have minimum published standards for NRSRO designation. I am unaware how the Commission could promulgate standards for NRSRO designation and for eligibility for continued designation without bringing NRSROs under direct Commission oversight.

Currently, all rating agencies designated as NRSROs are registered as investment advisers pursuant to the Investment Advisers Act ("Advisers Act"). Because of this registration as investment advisers, the Commission receives the information the agencies are required to file as part of their registration under the Advisers Act. Additionally, the agencies are subject to inspection as part of the Division of Investment Management's examination program for investment advisers. However, if challenged, I am not entirely certain that the Commission could require rating agencies to register under the Advisers Act.

The only other means of authority that the Commission has over the rating agencies is through the no-action letters designating the agencies as NRSROs. Each rating agency designated as an NRSRO is directed to bring to the Division's notice any material change in the facts of the no-action letter. If the Division determines that the facts so warrant, it can then withdraw the letter.

In reality, however, despite the importance of rating agencies and ratings to the securities markets, the Commission receives little information about the rating agencies and their operations. Often, the

Division receives only informal information about the rating agencies, usually through business publications or from competing rating agencies. For example, the Division learned about McGraw-Hill Inc.'s, S&P's parent company, acquisition of J.J. Kenny Co., a brokers' broker, from a Wall Street Journal article.[10]

As discussed above, although the NRSROs and their ratings have significant impact on the Commission's rules and on the securities markets, I do not believe that the Division has any meaningful authority over these organizations and their rating practices. Due to the continued growth in the use of ratings in the Commission's rules and the important role of rating agencies in the securities markets, it appears to me that the Commission should pursue a course of action that will bring NRSROs within the direct regulatory oversight of the Commission.

C. Alternative 3: Propose Amendments to Rule 15c3-1 that would define the term "NRSRO," require the registration of NRSROs, and set forth certain minimum standards to govern the operations of NRSROs

Although, as discussed above, the term "NRSRO" originally was used in the net capital rule, the rule does not define the term. Therefore, I

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10 See McGraw-Hill Plans to Buy J.J. Kenny, Wall St. J., Dec. 13, 1989, at A4.

would urge the Division to consider recommending to the Commission amendments to Rule 15c3-1 that would define the term "NRSRO." Based on its work in the area, the Division has developed sufficient knowledge of the ratings industry to allow it to formulate a definition of this term. Additionally, these potential amendments to the net capital rule should require that NRSROs register with the Commission in their capacity as NRSROs and that they establish and maintain certain minimum criteria in order to be considered NRSROs and in order to continue their NRSRO eligibility.

I believe that the promulgation of such amendments is necessary to ensure that the use of ratings in the Commission's rules and regulations continues: (1) to enhance the financial safety and soundness of regulated entities, (2) to promote investor protection, and (3) to serve as a proxy of market liquidity and efficiency.

Obviously at this juncture, I am discussing only a proposal. Any such proposal would of course be published and subject to the comment process. Further, even if any such proposal was eventually finalized, no

rating agency would be forced to seek NRSRO designation. That action is voluntary. A rating agency must elect to "opt-in" for regulatory treatment.

V. Conclusion

In conclusion, at least as a more formal solution to the need that I believe exists for direct Commission oversight of NRSROs, I urge that the Division consider recommending to the Commission that it propose amendments to the net capital rule. These amendments should: (1) define the term "NRSRO", (2) require the registration of these entities with the Commission, and (3) set forth certain minimum standards or criteria that rating agencies must meet in order to obtain and maintain this designation.