Olivier Raingeard[1]

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Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC20549-10890
United States

COMMENTS ON THE PROPOSED RULES FOR NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATION

I would like to thank the Commission for having given the opportunity to participate to this consultation. I look forward to continuing dialogue with the Commission and I am willing to answer[2] any questions or queries you may have regarding this comment.

[1] Economist, Ph.D
[2] E-mail address : olivier.raingeard@gmail.com

Summary & main conclusions

- Current issues related to rating agencies - conflicts of interest, transparency and market perceptions, competition… - are broadly similar to those raised in 2002, as the main concerns related to the rating system have not been addressed/resolved by regulatory authorities during previous regulatory processes (Part I, see pages 4-10).

- Specific issues related to structured finance products were already raised/identified by some regulatory authorities. In particular, the Bank for International Settlements published a report in 2005 in which it was stressed the possible issues arising for structured finance products, *i.e.* model risk and conflicts of interest (Part II, see pages 11-12).

- As regulatory authorities did not address sufficiently the issues raised in 2002, they contributed to the current market turmoil. Does the current regulatory process will improve the "rating system"? Some proposed rules of the Commission are welcome and may increase its integrity. Nonetheless, the Commission has to take into account specific elements pointed out in this Comment (Part III):

    - first of all, some amendments/proposed rules are not adequate and the Commission has to consider preliminary ratings, conditions for competition… in order to "improve ratings quality for the protection of investors and in the public interest" (see pages 12-17);

    - secondly, in order to reach this goal, four issues should be taken into account (see pages 17-21): could reputational risk generate a conflict of interest? Could a supervisory body be useful in order to monitor/oversee the rating industry rather than imposing strict rules? Despite of calls for international cooperation, for which reasons is it possible to have doubts that one day it will effectively enter into force? Is it efficient to use rating for regulatory purposes?

Introduction

In 2002, the regulatory process of the rating industry was reinitiated[3], after some corporate failures (Enron and Worldcom collapse materialised this period), with the analysis of the role of rating agencies in financial markets. Three actions took place:

- because investors wanted more transparency from rating agencies, some of them like Moody's and Standard & Poor's carried out surveys [*e.g.* Moody's (2002a, 2002b) and Standard & Poor's (2002)];
- issuers and investors called for more transparency from rating agencies and for regulatory oversight [*e.g.* the AFP survey (2002)];
- regulatory authorities that have/want to regulate rating agencies because of political pressures/mandates and public concerns.

Transparency, market perception, reliability, independence, conflicts of interest, competition were the main themes analysed in 2002. The criticisms levelled at the rating industry mainly concerned the "Main Three". For instance, the hearings conducted by the US authorities in 2002[4] mainly dealt with Standard & Poor's, Moody's and Fitch. This regulatory process led, in the United States, to the Credit Rating Agency Reform Act (2006) in order to "improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency, and competition in the rating industry."[5]

Unfortunately, despite those numerous reports, codes of conduct, new rules … most of the reports analysing the current market turmoil consider rating agencies as a key actor[6]. It appears that, except specific issues linked to the particularities of structured finance, criticisms are broadly the same than the one raised in 2002. Indeed, the proposed amendments of the Commission deal with conflicts of interest (the "issuer pay" model, the notion of "rating recommendation" as ancillary services, the participation of personnel in fee discussions) and with the instruction for Form NRSRO (rating performance measurements, disclosure of rating methodologies): those issues were more or less analysed during the

[3] The SEC tried to improve its oversight on rating agencies, through its NRSRO qualification in 1994 and 1997.

[4] See the hearings conducted by the U.S. Senate in 2002: United States Senate, 2002a, "Rating the Raters: Enron and the Credit Rating Agencies, Hearing Before the Committee on Governmental Affairs United States Senate", Committee on Governmental Affairs, March 2002, One Hundred Seventh Congress, Second Session; United States Senate, 2002b, "Financial Oversight of Enron: the SEC and Private-Sector Watchdogs", Report of the Staff of the Senate Committee on Governmental Affairs, S.Prt. 107-75, October.

[5] *In* U.S. Securities and Exchange Commission, 2008a, "Proposed Rules for Nationally Recognized Statistical Rating Organizations", 17 CFR Parts 240 and 249b, Release n°34-57967; File n°S7-13-08.

[6] See for example the report of The President's Working Group on Financial Markets (2008): "the principal underlying causes of the turmoil in financial markets were (…) a significant erosion of market discipline by those involved in the securitization process, including originators, underwriters, credit rating agencies (…) flaws in credit rating agencies' assessments…"

previous regulatory process. Furthermore, in 2005, the Committee on the Global Financial System studied the role of ratings in structured finance and identified that model risk and conflicts of interest constituted the possible issues arising for structured finance markets and concluded that "the occurrence of worst case scenarios on the basis of mispriced or mismanaged exposures might thus lead to situations in which extreme market events could have unanticipated systemic consequences."[7]

Consequently, regulatory authorities, and the Commission in particular, have to learn from this experience. Some of the proposed rules may address problems related to the credit rating system. Nonetheless, from my point of view, some key issues are not necessarily identified/addressed. This comment is divided into three parts: the first one demonstrates that current issues are broadly similar to those raised in 2002; the second one stresses that the specific issues related to structured finance were already identified in 2005; the last one comments the Commission's proposals and discusses key issues.

Part I - Current regulatory issues are broadly the same than the one raised in 2002

The amendments proposed by the Commission aiming at dealing with conflicts of interest and transparency address concerns raised in 2002. Furthermore, the will expressed in amendments to increase competition is an old issue: regulatory authorities and the Commission in particular have to understand the key role they played.

1 - Amendments to conflicts of interest

Addressing the Particular Conflict Arising from Rating Structured Finance Products by Enhancing the Disclosure of Information Used in the Rating Process

Once again, the "issuer fee model" used by the main rating agencies is criticised. Actually, it is a concern since they have adopted this business model in the 70's! At first sight, it is logical to consider the fact that a rating agency paid by the issuer, which wants to "obtain the best grade", constitutes a conflict of interest. Nonetheless, it seems broadly admitted by market participants that credit rating agencies, i.e. the "Main Three", manage this conflict of interest because credibility is probably one of the most important criterion of this

[7] *In* Bank for International Settlements, 2005, "The role of ratings in structured finance: issues and implications", Committee on the Global Financial System, January.

industry. For example, the Commission (2003) stated that "the practice of issuers paying for their own ratings creates the potential for a conflict of interest. Arguably, the dependence of rating agencies on revenues from the companies they rate could induce them to rate issuers more liberally, and temper their diligence in probing for negative information (…) The larger rating agencies and a number of other market participants agree that the issuer-fee model creates the potential for a conflict of interest, but believe that the rating agencies historically have demonstrated an ability to effectively manage the potential conflict"[8]. For which reasons this potential conflict of interest is still a concern despite of this general acceptance?

As noticed by the Commission, the "issuer/underwriter pay" conflict is more acute in structured finance "because certain arrangers of structured finance products repeatedly brings rating business to the NRSRO"[9]. Besides, the Staff of the Office of Compliance Inspections and Examinations (2008) underlines this weakness: "the combination of the arrangers' influence in determining the choice of rating agencies and the high concentration of arrangers with this influence appear to have heightened the inherent conflicts of interest that exist in the "issuer pays" compensation model."[10]

One should also consider that few rating agencies practices and the development of ancillary services create/exacerbate this potential conflict of interest and contribute to have doubts about the independence of rating agencies. For instance, the fact that rating agencies do not charge fees when issuing a preliminary rating reinforces this "issuer/underwriter influence" on two sides[11]:

- rating agencies "increase" their dependence to the issuer/underwriter/arranger as they can be "forced" to respond to the willingness of the latter in order to be paid and conserve/gain market share;

- it reinforces rating shopping practices as the issuer/underwriter/arranger can look for the best rating.

[8] *In* U.S. Securities and Exchange Commission, 2003a, "Concept Release: Rating Agencies and the Use of Credit Ratings under the Federal Securities Laws", U.S. Securities and Exchange Commission, June 2003, Release n°33-8236, 34-47972; File n°S7-12-03. See also Cantor and Packer (1995a) and Covitz and Harrison (2003).

[9] *In* U.S. Securities and Exchange Commission (2008a), see footnote 5.

[10] *In* U.S. Securities and Exchange Commission, 2008b, "Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies", by the Staff of the Office of Compliance Inspections and Examinations Division of Trading and Markets and Office of Economic Analysis, July.

[11] "Typically, the rating agency is paid only if the credit rating is issued, though sometimes it receives a breakup fee for the analytic work undertaken even if the credit rating is not issued." *In* U.S. Securities and Exchange Commission (2008b).

This issue is not new! This kind of problems has already been raised in previous consultations. Raingeard (2003, 2004, 2005a) pointed out that preliminary corporate ratings[12] used by certain rating agencies increase this potential conflict of interest and submitted the idea to prohibit this practice.

Rule 17g-5 Prohibition on Conflict of Interested Related to Rating an Obligor or Debt Security where Obligor or Issuer Received Ratings Recommendations from the NRSRO or Person Associated with the NRSRO

This proposition is more or less linked to the issues related to ancillary services raised in 2002. The lack of thinking on ancillary services - as far as I know, regulatory authorities do not identify the different advisory/ancillary services proposed by rating agencies and their affiliates; IOSCO (2008) only proposes to "force" credit rating agencies to disclose "what it considers, and does not consider, to be an ancillary business and why"[13] - has probably contributed to this result. For instance, concerning structured finance, some practices raise concerns. Is it "efficient" (for the rating industry) that rating analysts make proposals regarding the design of structured finance products? Is it efficient that rating agencies develop services related to price transactions on the secondary market[14]? In order to ensure that the rating industry keeps its credibility, the Commission has to deal with these points.

Rule 17g-5 Prohibition on Conflict of Interest Related to the Participation of Certain Personnel in Fee Discussions

It is well-known by market participants and regulatory authorities that, in order to reduce the potential issuer's influence and increase transparency, rating agencies should ensure the independence of people involved in the rating process through policies and procedures; in order to ensure the credibility of the rating's system, direct or indirect capital link with issuer should be prohibited; and the disclosure to regulatory authorities and/or to

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[12] After the initial contact between the agency and the issuer and the communication of the appropriate information, few rating agencies (NRSROs and non-NRSROs) provide a preliminary rating, which can be comprised within a range (*e.g.* a preliminary rating A+/A; in certain cases, a probability of realisation is indicated). If the issuer accepts this preliminary rating, the rating procedure is engaged; otherwise, he can drop the process.

[13] *In* IOSCO, 2008, "The role of credit rating agencies in structured finance markets", Technical Committee of the International Organization of Securities Commission, March.

[14] See Aguesse P., 2007, "La notation est-elle une réponse efficace aux défis du marché des financements structurés", Autorité des Marchés Financiers, Direction de la Régulation et des Affaires Internationales, Risques et tendances n°2, mars.

market participants when issuers exceed a certain percentage of the revenues should be required. This kind of issues has been analysed since 2002.

Despite of this knowledge and rules concerning some of those conflicts of interest, the Staff of the Office of Compliance Inspections and Examinations (2008) notices that “while each rating agency has policies and procedures restricting analysts from participating in fee discussions with issuers, these policies still allowed key participants in the rating process to participate in fee discussion.”[15] Consequently, the Commission has to deal with this problem.

2 - Amendments to the Instructions for Form NRSRO

The Commission is proposing to enhance ratings performance measurement statistics on Form NRSRO and the disclosure of rating methodologies. Those issues are related to rating agencies’ transparency and market perceptions.

The Commission seems to have operated a major shift since 2007. Indeed, until its new rule in 2007, it appeared to primarily rely on the reliability and credibility of rating agencies. For instance, the SEC (1997) claimed that the “single most important criterion is that the rating organization is nationally recognized, which means the rating organization is recognized in the United States as an issuer of credible and reliable ratings by the predominant users of securities ratings”[16]. Its new rule (2007) drops the concepts of reliability and credibility of ratings and only requires “that an application for registration as an NRSRO contain credit rating performance measurement statistics”[17].

This shift is difficult to understand: does the Commission drop the concept of reliability and credibility in order not to give investors the “illusion” of reliability and accuracy of rating? Does the Commission drop them in order not to give investors the “illusion” that the Commission guarantees the reliability and credibility of NRSROs?[18] If so, it would have been

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[15] *In* U.S. Securities and Exchange Commission (2008b), see footnote 10.

[16] *In* U.S. Securities and Exchange Commission, 1997, “Capital Requirements for Brokers or Dealers Under the Securities and Exchange Act of 1934”, “Proposed Rule”, Release n°34-39457; File n°S7-33-97, December 17.

[17] “The Commission intends to continue to consider this issue to determine the feasibility, as well as the potential benefits and limitations, of devising measurements that would allow reliable comparisons of performance between NRSROs.” *In* U.S. Securities and Exchange Commission, 2007, “Final Rule: Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations”, Release n°34-55857; File n°S7-04-07, June 5.

[18] Does the Commission make this shift in order not to give investors the “illusion” of the equivalence of reliability and credibility between rating agencies? This concern has been already raised by some rating agencies since 1994! For example, Moody’s (1994) claimed that “the SEC appears to have created in the capital markets merely the *illusion* of equivalence among the various agencies, their ratings and their rating standards. This illusion, Moody’s believes, creates the opportunity for rating shopping (…). In addition, because of the manner in which the SEC uses NRSRO ratings in its regulations, investors may be led - fallaciously - to conclude that all NRSRO ratings of a certain level express opinions denoting equivalent levels of risk”. Numerous researches demonstrate that differences between rating agencies exist. For instance, Packer and Reynolds (1997) find

more efficient to abandon the use of rating for regulatory purposes. In any cases, I guess that this shift has led the Commission to avoid considering the different measures of rating performance.

3 - The specific question of competition

Looking at the consultation of IOSCO (2008) or the proposed rule of the Commission, it appears that the question of competition is, again[19], raised. Even though regulatory authorities are mindful of the difficulties in increasing competition - "as the CRA report notes, some observers believe the nature of the CRA "market" may make it difficult for new CRA entrants to succeed"[20] -, there is still the will, particularly of the SEC, to "foster competition"[21].

One may wonder if those regulatory authorities are aware of their own role and of the potential negative effects they can produce on the rating industry. Indeed, surprisingly IOSCO (2008) notices that "CRA Report noted in 2003 that CRAs were not extensively regulated in most IOSCO jurisdictions and those regulations that did exist are not onerous for new entrants". Has not the SEC regulated the rating market - the main market for the rating industry - with its NRSRO qualification since 1975? In order to address the question of competition in the rating industry, theoretical conditions - homogeneity, transparency and free access to the market - have to be analysed.

Is there any homogeneity on the rating market? The rating is not necessarily "a homogeneous product". Differences of reliability and credibility exist between rating agencies[22].

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significant differences between the ratings of Standard & Poor's and Moody's and those of Japanese rating agencies, *i.e.* Rating and Investment Information and Japan Credit Rating: "Japanese investors are unlikely to assume that the Japanese agencies' particular grade ratings correspond to the same absolute level of default risk as the ratings of Moody's and Standard & Poor's. More likely, Japanese investors will consider the information provided by Japanese agency ratings about the rank ordering of default risk." Based on a sample constructed in 2003, Raingeard (2005b) finds similar results. Does it mean that Japanese agencies' rating is not reliable information? Not necessarily as Packer and Reynolds (1997) and Packer (1999) affirm that credit spreads are correlated to R&I ratings.

[19] Market participants called for more competition in the rating industry, as it is shown - for instance - by the AFP Survey (2002) which stated that "[T]reasury and finance professionals support additional competition in the market for credit ratings".

[20] *In* IOSCO (2008), see footnote 13.

[21] *In* U.S. Securities and Exchange Commission (2008a), see footnote 5.

[22] See footnote 18. For further details, see Raingeard (2005b) demonstrating that differences of reliability between rating agencies exist. It also appears that differences of rating agencies' credibility can be observed [*e.g.* Cantor, Packer and Cole (1997), Raingeard (2005b) find that Standard & Poor's and Moody's have the same

Is there any transparency on the rating market? If the "fee models" are disclosed, rating's prices are not necessarily transparent, *e.g.* the NRSROs, as far as I know, do not publicly disclose them. Besides, the SEC (2007) believes that its final rule on the oversight of credit rating agencies registered as Nationally Recognized Statistical Rating Organizations "should elicit more information about fees so that the information will be disclosed to users of credit ratings. This will improve price transparency, which may lead to greater competition."[23]

Is the market free to access? Natural barriers to entry linked to credibility, reliability and time and resources necessary to set them up exist. Nevertheless, one could consider that there are exogenous barriers related to the role of regulatory authorities.

The lack of transparency/accuracy of the NRSRO status has probably dissuaded potential competitors. Indeed, the SEC did not disclose applications for NRSRO recognition and did not define a planning for its decision. For example, Lace Financial Corporation (2002) criticised the NRSRO status: "I would hope that this time the SEC would process our appeal for NRSRO status on a more timely process (the last application took eight years). It would also be helpful if the Division of Market Regulation could be more forthright with us and tell us in writing what part of the SEC criteria we do not meet."[24] Moreover, even though the SEC (1997) stated that "the single most important criterion is that the rating agency is widely accepted in the U.S. as an issuer of credible and reliable ratings by the predominant users of securities ratings"[25], several criteria of its recognition were not necessarily objective or accurate[26].

The conditions for competition were not "secured". The fact that Moody's and Standard & Poor's rate, in the United States, all public corporate debt issues has probably hindered the development of competitors. As an example, Standard & Poor's admits that it rates "99,2% of the debt obligations and preferred stock issues publicly traded in the United States"[27]. Therefore, in the United States, corporate issuers have *de facto* two ratings, with or without request, contributing to hinder rating agencies' development. This has probably led Fitch to

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credibility; contrary to Jewell and Livingston (1999), it seems that Fitch has a specific credibility (Raingeard, 2005b)].

[23] *In* U.S. Securities and Exchange Commission (2007), see footnote 17.

[24] *In* Lace Financial Corporation's Letter to the SEC, 2002, "Appeal for Lace Financial Corporation to receive Nationally Recognized Statistical Rating Organization status", September 26. Nonetheless, the Commission has addressed this weakness since 2007.

[25] *In* U.S. Securities and Exchange Commission (1997), see footnote 16.

[26] See, for example, Rating and Investment Information's comments on the SEC's Concept Release (2003). Rating and Investment Information, 2003, "Comments of Rating and Investment Information on S7-12-34", Securities and Exchange Commission Concept Release: "Rating Agencies and the Use of Credit Ratings under the Federal Securities Laws", July 28.

[27] *In* Standard & Poor's, 2003, "Corporate Rating Criteria".

develop its activities by acquisitions of some NRSROs[28]. As a result, the SEC - despite some recognitions - has not necessarily secured the conditions for competition as it does not regulate this systematic rating policy.

The use of ratings for regulatory purpose has probably contributed to this result too. Indeed, regulatory authorities, by recognising/qualifying rating agencies and using their ratings for regulatory purposes, encourage issuers to request a "recognised/qualified rating" because of credibility recognition, notoriety effect, and regulatory concerns[29]. This influence is well-described in the last IOSCO consultation: "to the extent that regulatory recognition is based on reliance by market, and market reliance is influenced by regulatory recognition, the cycle of discrimination is perpetual."[30]

Last, I have some difficulties in understanding the methodology of the Commission: it seems that credit rating agencies "have more chances" to obtain the NRSRO's qualification each time that regulatory processes are ongoing!

Decision of the Commission	Date	NRSRO Qualification Granted	Date
Concept Release Proposed Rules	January 1994 December 1997		
Special study	January 2003	DBRS	February 24, 2003
Concept Release	June 2003		
Proposed Rules	April 2005	A.M. Best	March 3, 2005
Proposed Rules	February 2007		
Final Rules	June 2007	Japan Credit Rating Rating and Investment Information Egan Jones Lace Financial	September 24, 2007 September 24, 2007 Decembre 21, 2007 February 11, 2008
Proposed Rules	July 2008	Real Point	June 23, 2008

If the recognitions of Japan Credit Rating and Rating and Investment Information seem logical as they are the results of the application of new rules, other qualifications do not seem to be the result of a consistent process. Indeed, in 2003, whereas the Commission studied the role of rating agencies, it recognised DBRS. One month before the Commission issued a proposed rule in 2005, the latter recognised A.M. Best. Less than one month before the current proposed rules, the Commission qualified Real Point. Whereas the role of rating agencies in the current market turmoil were studied and call for regulation were expressed[31], the Commission recognised Egan Jones and Lace Financial.

[28] Ficth Ratings is the result of several merger/acquisition with other NRSROs.

[29] U.S. authorities use ratings in their regulations in order to "secure their financial system". For further details, see for example Cantor and Packer (1995a) and the U.S. Securities and Exchange Commission (1997).

[30] *In* IOSCO (2008), see footnote 13.

[31] See for example: Financial Times, 2007, "Regulators to probe rating agencies", November 9; Financial Times, 2008, "EU leaders take credit rating agencies to task", January 30.

Part II-Specific issues raised by structured finance product were already identified in 2005

Most of the reports consider rating agencies as a key actor of the current market turmoil[32]. Nonetheless, in 2005, it seems that "[I]nvestors do not appear to be overly reliant on ratings in making structured finance investment decision. In fact, Working Group's interviews with investors and other market participants suggest that, in general, investors are aware of the risk of basing their investment decisions solely on ratings. In other words, investors view ratings as just one part of an informed investment decision."[33]

Looking at the usefulness of rating, the Committee on the Global Financial System (2005) states that "deal origination implicitly involves obtaining structure advice by the rating agencies" and that "it is generally more difficult for investors to obtain information about the performance of structured finance pools"[34].

More interestingly, the report emphasizes possible issues arising for structured finance markets linked to model risk and rating agency conflicts of interest. The Committee warns that "model-based risk assessments can be a long way from "true" values and, to the extent that investors rely on ratings for their structured finance investments, the model risk linked to the agencies' rating methodologies will be among the principal risks these investors are exposed to."[35]

Concerning conflicts of interest, even though the Committee claims that "the fact that the agencies may have expressed an "ex ante opinion" regarding deal structure suggests that they are providing structuring advice"[36], it believes "that the complexity of managing potential conflicts of interest has not been altered by the agencies' involvement in rating structured finance instruments"[37]. Nevertheless, it stresses that "the potential for advisory fee-related conflicts of interest would arise in the future and could meaningfully affect the complexity of managing these conflicts going forward."[38]

The Committee concludes that "unexpected losses on structured finance investments could thus become an issue going forward, particularly once the current environment of low

[32] See for example the report of the President's Working Group on Financial Markets *in* footnote 6.
[33] *In* Bank for International Settlement (2005), see footnote 7.
[34] *In* Bank for International Settlement (2005), see footnote 7.
[35] *In* Bank for International Settlement (2005), see footnote 7.
[36] *In* Bank for International Settlement (2005), see footnote 7.
[37] *In* Bank for International Settlement (2005), see footnote 7.
[38] *In* Bank for International Settlement (2005), see footnote 7.

default rates and tight credit spreads comes to an end (…) The occurrence of worst case scenarios on the basis of mispriced or mismanaged exposures might thus lead to situations in which extreme market events could have unanticipated systemic consequences."[39] Consequently, it seems that regulatory authorities were mindful of the potential risks. Nonetheless, as far as I know, the report had no consequence on the rating industry. Does it makes sense to identify the potential conflicts of interest and the limits of rating in structured finance and to deal with them, three years latter, once problems and limits arise?

Part III-Comments/proposals on the proposed rules of the Commission and discussion on key issues

1-Comments/proposals on the proposed rules of the Commission

Amendments to Rule 17g-5

Addressing the particular conflict arising from rating structured finance products by enhancing the disclosure of information used in the rating process

This proposal may increase the transparency of the rating process and as such makes it more apparent when an NRSRO may be allowing business considerations to impair its objectivity.

Nonetheless, this proposal is not sufficient to deal with conflicts of interest. I urge the Commission to take into account the fact that rating agencies do not charge a break-up fee and give preliminary ratings clearly reinforces the potential conflict of interest generated by the "issuer/underwriter pay model"[40]. Consequently, "preliminary rating" should be prohibited. Rating agencies may argue that such a rule would affect their rating methodologies and deteriorate their rating process. Nonetheless, from my point of view, the practice of preliminary rating is more a commercial tool rather than a part of the rating methodology.

Furthermore, I have some doubts about the fact that the amendment could enhance competition. Indeed small NRSROs have not necessarily the means to issue unsolicited ratings related to structured finance products. More generally, the Commission must ensure

[39] *In* Bank for International Settlement (2005), see footnote 7.
[40] As stated above, see Part I page 5.

the conditions for competition[41]. For example, on the one hand, it could be useful to monitor the development of unsolicited ratings in order to prevent main rating agencies to use it so as to reduce competition. On the other hand unsolicited ratings could help new entrants to gain market share/reputation… Consequently, in order to conciliate these two approaches, unsolicited ratings could be regulated by a simple set of rules[42]:

- rating agencies broadly explain that unsolicited ratings are requested by investors. In order to legitimate this action, formalised requests from a significant threshold of investors would be required for the "Main Three";
- as stated by rating agencies, issuers are an important source of input. Unsolicited ratings, although reliable, have not necessarily the same value as solicited ones. Consequently, unsolicited ratings should be clearly identified (with a "signal" pi for public information for example)[43];
- unsolicited ratings should not be used for regulatory purposes.

The Commission can also deal with transparency by requiring rating agencies to improve the documentation of their rating scheme, *e.g.* what are the determinants of the rating's price? To what extent rating's prices could be subject to negotiation? Do credit rating agencies use an annual subscription fee that can be used as a credit against future debt issuance?…

Rule 17g-5 Prohibition on conflict of interest related to rating an obligor or debt security where obligor or issuer received ratings recommendations from the NRSRO or person associated with the NRSRO

In 2003, I considered that "the Commission has to deal with the definition of ancillary services. Are they assessment services that estimate the impact of an issuer's action (merger, acquisition, debt restructuring...) or large management services which propose management, strategic, process risk...? In other words, what are the ancillary services proposed by the rating agencies? Those questions need clear answers"[44]. I proposed few alternatives for rating assessments services. Concerning ancillary services like management, strategic risk... I stated that "rating agencies should not develop them in order to ensure that the rating industry keeps its credibility. Could strict "Chinese walls" guarantee business units' independence? Recent

[41] For more details, see Part I.
[42] Nevertheless, it is doubtful that market participants, and more particularly rating agencies, share this point of view. This set of rules could have difficulties in overcoming the First Amendment in the United States.
[43] A time period - issuer could not request a rating and rating agency could not assign solicited rating - could be imposed after an unsolicited rating. This set of rules could have difficulties to overcome the First Amendment in the United States.
[44] *In* Raingeard O., 2003, "Comments of Olivier Raingeard on S7-12-30", Securities and Exchange Commission Concept Release: "Rating Agencies and the Use of Credit Ratings under the Federal Securities Laws", July 27.

events concerning other market "watchdogs" have showed that potential conflicts of interest can be difficult to manage. Should those ancillary services, despite "Chinese Walls" and independence, use a similar denomination? How could the Commission ensure that rating agencies do not sell ancillary services?"[45]

I do not change my point of view. The Commission has to identify the ancillary services proposed by rating agencies and deal with them:

- for rating assessment services, a simple set of rules should be implemented: a formalised issuer's request should be required; an explicit statement indicating that the rating assessment does not mean that the effective rating will correspond to the estimated one; the "prohibition" of a rating assessment when the rating agency carries out a rating action; possibly, the disclosure of the rating assessment by the rating agency or the issuer to investors[46];
- consulting services through "independent affiliates" (which, for example, deal with management, strategic risks…) should be at least regulated by a non-overlapping benefits rule (despite implementation difficulties) or prohibited;
- concerning structured finance, the proposal of the Commission could address this concern.

Rule 17g-5 Prohibition on conflict of interest related to the participation of certain personnel in fee discussions

In 2003, I claimed that the organizational structure must "ensure the independence of analysts", meaning that "a separation of the analyst from the business relationship (payment, prices, issuers solicitation...)"[47] was necessary. Furthermore, I added that it "seems that few NRSROs have implemented such procedures. Nevertheless, prohibiting employees involved in the rating process from participating in the solicitation of new business and from fee negotiations could be a criterion of NRSRO recognition. Moreover, it appears essential that rating agencies and the Securities and Exchange Commission define, together, a code of Ethics that specifies minimum and explicit standards. The acceptance of the rules of this code should be a criterion of NRSRO recognition."[48]

[45] *In* Raingeard (2003), see footnote 44.
[46] Such disclosure could lead to an infringement of confidentiality requirements.
[47] *In* Raingeard (2003), see footnote 44.
[48] *In* Raingeard (2003), see footnote 44.

My point of view remains the same. It is necessary to require the separation within the NRSRO of persons involved in fee discussions from persons in the credit rating analytical process, whatever the size of the rating agencies is.

Rule 17g-5 Prohibition of conflicts of interest related to receipt of gifts

I do not think that it is efficient to add this new paragraph. I think that a code of ethic, procedures, policies… implemented by rating agencies may deal with this conflict of interest. For example, employees of rating agencies should have to declare to their compliance any gifts received from issuer, underwriter…

Amendments to Rule 17g-2
A Record of Rating Actions and the Requirement that they be made Publicly Available

The requirement to make and retain a record showing all rating actions could be useful so as to compare the performance of rating agencies. The proposed six-month time lag in order to accommodate NRSROs that operate using the "subscriber-pay" model seems reasonable as comparison of rating performances need a long timeframe (at least one year).

Amendments to the Instructions for Form NRSRO
Enhanced Ratings Performance Measurement Statistics on Form NRSRO

Broadly, rating is a relative measure of credit risk which is relatively stable. Furthermore, the performance of ratings can be estimated from an absolute point of view. In economic sciences, credibility is used to assess central bank policy. Consequently, numerous ratings performance measurement statistics can be imagined:

- the *relative performance of the rating agencies* [the relation rating-default rate (annual and cumulative) so as to "appreciate" agency's rating scale[49], the agency's "power curve" in order to appreciate how the agency distinguishes defaulters and non-defaulters, the agency's transition matrices in order to "appreciate" rating's scale and stability];
- *the stability of rating* (the examination of rating actions : the frequency of rating's upgrades and downgrades ; rating changes : the rating variation and rating reversals);

[49] "Mortality rate" could also be analysed [see Altman (1989) for a definition].

- *an analysis of the rating's absolute performance* (it would consist in an analysis of annual default rates for investment and speculative grade issuers relative to their historical mean and determinants[50], an analysis of average rating prior to default in order to appreciate the agency's capacity to anticipate default, possibly a comparison between rating and absolute measures of credit risk).

Different methodologies to assess the performance of rating agencies exist. But do regulatory authorities have to require specific measures?

Compared to the different methodologies to assess the reliability of rating listed above, the current requirement of the Commission does not seem sufficient. Nonetheless, as the Commission does not assess the reliability and the credibility of rating and if the amendment requiring a record of rating actions (publicly available) is adopted, this current requirement would be sufficient. Furthermore, it is not necessary to require the disclosure of statistics broken out over 1,3 and 10 years periods as the "Main Three" performed this and competitors are broadly much smaller and probably suffer from insufficient data sets in order to produce relevant statistics. Last, it is not necessary to require NRSROs to disclose how its credit ratings performed relative to metrics such as credit spreads, as it generated difficulties linked to consistent pricing information, biased results due to small sample for smaller rating agencies... However, it may be efficient to require the disclosure of separate sets of default and transition statistics for each asset class of credit rating in order to improve the quality of information.

Amendments to Rule 17g-3 (Report of Credit Rating Actions)

The proposition to require an additional annual report of the number of credit rating actions during the fiscal year in each class of security for which the NRSRO is registered is not necessary because of the requirement of performance statistics.

[50] According Jónsson and Fridson (1996), Jónsson, Fridson and Zhong (1996), Helwege and Kleiman (1996), Fridson, Garman and Wu (1997), Raingeard (2005b), explanatory variables of speculative grade default rates are the economic and monetary environment, the sample's distribution, the lag between the issue and the default event…

Proposed new rule 17g-7 (Special reporting or use of symbols to differentiate credit ratings for structured finance products)

I think that investors are now mindful of the fact that "there are different rating methodologies and risk characteristics associated with structured finance products"[51]! Admittedly the "differentiated symbol would alert investors that a structured product was being rated and, therefore, raise the questions of how it differs from other types of debt instruments"[52]. However I expect that investors look for understanding constantly the types of debt they buy! Consequently, this proposed rule is not necessary. However, rating agencies have to clearly indicate the differences of criteria, of default behaviour… between the debts they rate, as it did not seem to be the case according to the Staff of the Office of Compliance Inspections and Examinations[53].

2-Discussion on key issues

Could reputational risk generate a potential conflict of interest?

In 2005, the Committee on the Global Financial System studied the potential conflict of interest arising "when the ratings of some structured credits are contingent on the agency's own rating of a monoline insurer that provides credit enhancement to the most senior tranche(s) of these structures."[54] Rating agencies considered that those "circularities issues in rating monolines were not different from, for example, rating sovereigns"[55]. It implied "that the agencies' problem with regard to managing potential conflicts of interest is not a new one."[56] This assumption is not sure.

First of all, if it is well-known by market participants that the "situation" (from economic, monetary, political… points of view) of the country in which firms have their business is a criterion of their ratings, it is not sure that a downgrade of the ratings of a country has necessarily some consequences on corporate ratings whereas "a downgrade of a large monoline from its high rating, usually AAA or AA level, could severely undermine its

[51] *In* U.S. Securities and Exchange Commission (2008a), see footnote page 5.
[52] *In* U.S. Securities and Exchange Commission (2008a), see footnote page 5.
[53] "Relevant ratings criteria were not disclosed. Documents reviewed by the Staff indicate the use of unpublished ratings criteria." *In* U.S. Securities and Exchange Commission (2008b), see footnote page 10.
[54] *In* Bank for International Settlements (2005), see footnote 7.
[55] *In* Bank for International Settlements (2005), see footnote 7.
[56] *In* Bank for International Settlements (2005), see footnote 7.

business, perhaps affecting confidence in the financial guarantor sector more widely."[57] Secondly, the Staff of the Office of Compliance Inspections and Examinations (2008) reveals that "members of the committee, all analysts or analytical managers, considered the rating agency's reputational interest in not making its error public, according to the rating agency."[58] Consequently, the following question should be arisen: could rating agencies be "reluctant" to review ratings because of the consequences they could have in order to keep their credibility? The fact that rating agencies' involvements are numerous creates multiple circularities that generate potential conflict of interest. Consequently, it may be efficient to require rating agencies to disclose/communicate those circularities to market participants.

Could a supervisory body be useful in order to monitor/oversee the rating industry rather than imposing strict rules?

Rather than imposing strict rules on the rating industry that may hinder innovation, an oversight of the rating industry should take place. This solution has two advantages: it may ensure innovation in the rating industry and it may help to prevent the development of practices that could generate adverse effect on the rating industry. For instance, the development of new rating products could create/increase potential conflicts of interest. The supervisory authority could monitor them thanks to a permanent dialogue with rating agencies and market participants. Possibly, one could also imagine that market participants turn to the supervisory authority in order to warn about unfair practices linked to credit rating agencies influence, unwilling cooperation or payment for a rating, third-party analyst complaints…

In other words, rather than identifying problems and dealing with them only once they materialize, it will be more efficient to monitor/supervise their development. In order to perform this task, an international cooperation would be far more efficient! But, despite numerous calls for international cooperation[59], I have some doubts about the fact that one day it will effectively be put in place.

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[57] *In* Bank for International Settlements (2005), see footnote 7.

[58] *In* U.S. Securities and Exchange Commission (2008b), see footnote page 10.

[59] For instance, "[I]nternationally, the PWG is working with foreign regulators, finance ministries, and central banks through the Financial Stability Forum (FSF) on a report to the G-7 Finance Ministers and Governors that will provide a diagnosis of the causes of global financial turmoil and an agreed-upon set of recommendations for addressing identified weaknesses in global markets and institutions." *In* The President's Working Group on Financial Markets (2008).

For which reasons, despite calls for international cooperation, it is possible to have doubts about the fact that one day it will be put in place?

The lack of international cooperation could be analysed through two angles. It appears that the IOSCO Code of Conduct (2008) is far from being sufficient as the Securities and Exchange Commission is considering proposed rules that do not really take it into account and as the European Commission seems to have the will to supervise rating agencies at a European level. Furthermore, since Basel II, European securities regulators apply the guidelines defined by the Committee of European Banking Supervisors (CEBS)[60] that are quite different than the rules of the Commission (2007).

Rating agencies' policy seems to rely, in the United States, on the First Amendment - rating is an opinion - and the so-called "journalist's privilege"[61]. According to the European Parliament report (2004) and the "Call to CESR for Technical Advice"[62] (2004), European authorities have an other view. For instance, Katiforis stated that "this analogy [rating agencies "act in a journalist capacity"] does not hold much water from the moment that ratings become part of the regulatory mechanism of financial markets, even against the better judgement of rating agencies."[63] Furthermore, it is doubtful to consider that there are no few political concerns as Katiforis noticed "that the predominantly American character of the agencies and of their supervisors (SEC, US Congress) creates a vast de facto imbalance towards the American side."[64] Despite of the conclusion of CESR (2005) "not to regulate the Credit Rating Agencies industry at an EU level for the time being, and instead proposed that a pragmatic approach should be adopted to keep under review how CRAs would implement the standards set out in the IOSCO Code of Conduct"[65], the subject is not closed as the European Commission seems, currently, to have the will to oversee the rating industry.

Furthermore, currently, regulatory authorities adopt different methodologies to "regulate" rating agencies. On the one hand, as stated earlier, the SEC has dropped the concept of reliability and credibility since 2007. On the other hand, European securities

[60] Committee of European Banking Supervisors, 2006, "Guidelines on the recognition of External Credit Assessment Institutions", January.
[61] But, is it still the case?
[62] Committee of European Securities Regulators, 2004, "CESR's technical advice to the European Commission on possible measures concerning credit rating agencies", November.
[63] *In* European Parliament, 2004, "Report on role and methods of rating agencies", Committee on Economic and Monetary Affairs, A5-0040/2004, January.
[64] *In* European Parliament (2004). See footnote 62.
[65] *In* Committee of European Securities Regulators, 2008, "The role of credit rating agencies in structured finance", Consultation Paper, February.

regulators are recognising rating agencies whose rating can be used for regulatory purposes, *i.e.* the recognition of External Credit Assessment Institution defined by Basel II. The "Guidelines on the recognition of External Credit Assessment Institutions" defined by the CEBS (2006) affirm that the "recognition criteria is to identify ECAI that produce external credit assessments of sufficiently high quality, consistency and robustness to be used by institutions for regulatory capital purposes under the Standardized approach"[66]. Furthermore, the terms robust - "competent authority will take into consideration the ability of the ECAI to produce robust credit assessments"[67] -, accurate -"the demonstration should (…) be supported by statistical evidence that the methodology has produced accurate credit assessments in the past"[68] - are used.

Are those developments efficient for the rating industry and market participants? I do not think so as it means that regulatory authorities do not have a clear and common understanding of the rating system.

Is it efficient to use rating for regulatory purposes?

I do not have a definitive answer to this question. One the hand, I guess that the use of ratings for regulatory purposes could be useful as rating reduces informational asymmetry, contributes to improve market efficiency… as far as it is reliable and credible. On the other hand, as mentioned above, the use of rating for regulatory purposes can give the "illusion" to investors that rating is a "perfect" assessment of credit risk. The SEC (2003) called for comment on the alternatives to the NRSRO designation, trying to "identify alternatives capable of achieving the regulatory objectives currently served by use of the NRSRO designation in certain Commission rules"[69]. "Most of the 46 commenters responding to the 2003 Concept Release supported retention of the NRSRO concept. They generally represented that, among other things, eliminating the NRSRO concept would be disruptive to the capital markets, and would be costly and complicated to replace. Only four commenters supported elimination of the concept, and there was limited discussion of regulatory alternatives."[70]

[66] *In* Committee of European Banking Supervisors (2006), see footnote 60.
[67] *In* Committee of European Banking Supervisors (2006), see footnote 60.
[68] *In* Committee of European Banking Supervisors (2006), see footnote 60.
[69] *In* U.S. Securities and Exchange Commission (2003a), see footnote 8.
[70] *In* U.S. Securities and Exchange Commission, 2005, "Proposed Rule: definition of Nationally Recognized Statistical Rating Organization"; Release n°33-8570; 34-51572; File n°S7-04-05.

Regulatory authorities must keep on analysing the pros and cons. If they want to keep on using ratings in regulation, the criteria of reliability and credibility must be used in order to qualify rating agencies. Furthermore, regulatory authorities should oversee the credit rating industry in order to prevent anti-competitive or unfair practices and the development of potential conflicts of interest that are inadequately addressed. However I think that the Commission and more broadly regulatory authorities, by not distinguishing rating agencies issuing "public goods" to those issuing "private goods", generate adverse effects on market participants. For instance, by recognising NRSROs issuing "private goods", does not the Commission discriminate between investors[71]?

[71] *i.e.* the discrimination between investors who have/have not the means to buy those "private goods".

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