

The Bond Market Association
Securities Industry Association

June 30, 2004

Mr. James A. Kaitz
President and CEO
Association for Financial Professionals
7315 Wisconsin Avenue Suite 600 West
Bethesda, MD 20814

Dear Sirs:

The Bond Market Association (“TBMA”)¹ and the Securities Industry Association (“SIA” and, collectively with TBMA, the “Associations”)² are pleased to provide you with these joint comments on the Exposure Draft of the Code of Standard Practices for Participants in the Credit Rating Process (the “Code”) released by the Association for Financial Professionals, the Association of Corporate Treasurers and the Association Francaise des Tresoriers d’Entreprise.

Rating agency reports are analogous to research reports published by the research analysts employed by investment banks. As you may be aware, in 2003, the self-regulatory organizations in the U.S. -- NASD, Inc. and the New York Stock Exchange -- adopted rules governing equity research (the “Equity Research Rules”) that were based on the global settlement between the U.S. Securities and Exchange Commission and 10 major investment banking firms. TBMA has recently published guiding principles for fixed income research prepared by sell-side research analysts (the “Guiding Principles”). See “Guiding Principles to Promote the Integrity of Fixed Income Research, A Global Approach to Managing Potential Conflicts of Interest,” which is available at TBMA’s website.³ Like the Code of Standard Practices for Participants in the Credit Rating Process, the Equity Research Rules and the Guiding Principles aim to restore investor confidence in the global securities markets.

¹ The Bond Market Association represents over 200 firms and banks that underwrite, distribute and trade in fixed income securities, both inside and outside the U.S. Its members include all major dealers in U.S. corporate, municipal and asset-backed securities and money market instruments, as well as all primary dealers in U.S. government and agency securities. More information about TBMA is available on its website at www.bondmarkets.com.

² The Securities Industry Association, established in 1972 through the merger of the Association of Stock Exchange Firms and the Investment Banker’s Association, brings together the shared interests of nearly 600 securities firms to accomplish common goals. SIA member-firms are active in all U.S. and foreign markets and in all phases of corporate and public finance. More information about the SIA is available on its website at www.sia.com.

³ See http://www.bondmarkets.com/Market/Guiding_Principles_for_Research.pdf.

General Thoughts about Rating Agencies

In the Guiding Principles, TBMA acknowledged the importance of credit rating agencies (each a “CRA”) to the fixed income markets:

“Credit rating agencies play an important role in the fixed income markets by providing investors and other market participants with an independent source of information regarding the relative creditworthiness of debt and other fixed income instruments as well as various corporate and other issuers. . . . In cases where an issuer’s credit standing is an important element in determining price, investors routinely factor into the price discovery process the ratings assigned by recognized rating agencies.”

As the introduction to the Code states, during the past two years, CRA’s have been subject to criticism for failing to warn investors of the impending demise of such large companies as Parmalat, Enron and WorldCom.⁴ However, we note that ratings issued by the major rating agencies have generally proved to be a reliable source of information for the fixed income markets. The reputational and commercial interests of the agencies provide a strong motivation to maintain the credibility of their ratings. Historically, a variety of studies have demonstrated a consistent and clear correlation between long-term corporate debt ratings and the probability of default.⁵

The Associations believe that it would be unreasonable for market participants or regulators to expect perfection, i.e. that any rating agency, or ratings system, will act as a perfect evaluator of credit risk or quality. One reason for this is the complexity of evaluating the various objective and subjective factors that affect creditworthiness and reflecting them in a single symbolic rating. More importantly, rating agencies should not and cannot reasonably be charged with uncovering and evaluating all possible undisclosed risks or liabilities that might affect credit quality, or with uncovering fraud or other misconduct by issuers. Rating agencies, like other market participants, must be able to rely on the integrity of the audit process to produce financial information that is accurate and complete.

This is not to say that there is not room for improvement in the rating process. Indeed, the Associations believe that regulators should change their standards for designating approved “nationally recognized statistical rating organizations”, in order to increase the number of recognized CRA’s. We also believe that regulators should promote transparency in the criteria for ratings. However, the Associations are concerned that some of the processes established by your proposed Code would not improve the rating process or promote public confidence in ratings. In particular, the Code’s requirement

⁴ We do not doubt, as you note in the introduction to your report, that “a significant minority of treasury and finance professionals from companies with rated debt believe that their company’s credit ratings are neither accurate nor timely”. We take no position on whether those beliefs are justified or self-interested.

⁵ See generally Credit Ratings and Complementary Sources of Credit Quality Information, Basel Committee on Banking Supervision Working Papers (August 2000).

that CRA's vet their rating reports with the issuer and allow the issuer to appeal a rating it finds objectionable is likely to be viewed by the public and investors as impairing the independence of CRA ratings.

General Principles

Although the Guiding Principles do not by their terms apply to CRA's, the Associations believe that a number of the general principles set forth in the Guiding Principles should also be applied to CRA's. We believe that the single most important factor in ensuring the integrity of credit research, whether performed by analysts at sell-side firms or CRA's, is vigilantly guarding the independence of those analysts from conflicts of interest arising from their personal life (such as personal investments), from their firms' activities (such as interests in investment banking or consulting businesses) or from the interests of third parties (such as issuers).

The principle of independence is evident in a number of the Guiding Principles that we believe should be applied to CRA's. In particular:

- Firms should promote the integrity of fixed income research and the ability of fixed income research analysts to express their own independent views.⁶
- Firms should take measures to prevent inappropriate influence by non-research department personnel and issuers over the content of fixed income research reports and the timing of their publication.⁷ In particular, firms should develop appropriate policies and procedures to control access to, and review of, draft fixed income research reports in order to promote the integrity of fixed income research.
- Firms should not permit issuers to review draft fixed income research reports before publication other than for the purpose of verifying the factual accuracy of information in the reports . . . [I]f a research report contains an investment conclusion, this information should be removed from the draft report that is provided to the issuer.⁸

These general principles lead us to make a number of comments on the Code.

Regulatory Recommendations

The Associations agree with many of the recommendations in this section. For example, we believe that

⁶ Guiding Principle 4.1.

⁷ Guiding Principle 4.3.

⁸ Guiding Principle 4.3.3.

- regulators should eliminate unnecessary regulatory burdens and barriers to entry, and
- regulators should not designate acceptable rating methodologies, or appropriate staffing levels and qualifications.

Most of our reservations regarding this section are not fundamental, but rather differences of degree:

Section 1.1. Section 1.1 of the Code states that regulators should establish simple, stringent but attainable criteria. While we agree that it would be beneficial to increase the number of CRA's recognized by regulators as "nationally recognized statistical rating organizations (NRSROs)", we do not believe the requirement for "attainable" criteria promotes public confidence in the reliability of ratings. If current criteria pose problems, then the Code should recommend their elimination. For example, TBMA, in its comment letter on the SEC's concept release on rating agencies,⁹ proposed elimination of the SEC's current "widely accepted" standard:

"[T]he Association recommends that the Commission revise the current "widely accepted" standard to permit the designation as NRSROs of rating agencies that otherwise satisfy the Commission's criteria but rate securities only in certain market sectors or jurisdictions. For example, an agency that is well established in a foreign jurisdiction may not be widely recognized or accepted in the United States but may still be capable of credibly rating instruments of issuers from that jurisdiction. Rating agencies with expertise in a particular industry sector should also be permitted to be NRSROs for purposes of rating issuers in that sector or jurisdiction."

Section 1.2. This Section of the Code states that the criteria for determining whether a CRA consistently produces credible and reliable ratings may be based solely on market acceptance. While we believe that market acceptance is one possible basis of credibility and reliability, we believe that many of the criteria used by the SEC in designating an NRSRO are also useful, including reviewing (1) its organizational structure; (2) its financial resources (to determine, among other factors, whether it is able to operate independently of economic pressures or control by the companies it rates); (3) the size and experience and training of its staff (to determine if it is capable of thoroughly and competently evaluating an issuer's credit); (4) its independence from the companies it rates; and (5) its rating procedures (to determine whether it has systematic procedures designed to produce credible and accurate ratings).¹⁰

Section 1.9. While we believe that persons with material non-public information should be prohibited from using that information, we do not agree that prohibiting such persons

⁹ See Letter, dated July 28, 2003, to Jonathan G. Katz from John M. Ramsay, Senior Vice President and Regulatory Counsel of The Bond Market Association, available on the SEC's website at <http://www.sec.gov/rules/concept/s71203/bondmarket072803.htm>.

¹⁰ See, e.g., Dominion Bond Rating Service Limited (Feb. 24, 2003).

from working in positions in securities markets or as journalists is an appropriate remedy. The traditional remedy for persons with material inside information who change jobs is the creation of information walls to prohibit the transfer of information and not treating persons with such information as “Typhoid Mary’s” who must be quarantined to ensure adequate protection of society at large.

The Associations support the recommendation that all confidential information gathered by CRA’s during the development of ratings should be protected (behind well documented and robust firewalls) to prevent the disclosure or use of non-public information. However, we believe that there is already adequate protection against such abuses in current U.S. securities rules and regulations.

Rating Agency Code of Standard Practices

Section 2.3. We believe that “widely” publicizing changes in rating methodologies may overstate what is required, although we are aware that rating agencies provide (usually on their websites and to subscribers) rating methodologies for certain industries and for particular types of securities.

Section 2.5. We believe that providing “a guide” to the methodology applicable to a particular company may overstate what is called for. We believe that the CRA should inform both the issuer and users of ratings of the general methodology used for the issuer (which may be that used for other companies in the issuer’s industry). See also IOSCO Statement of Principles Regarding the Activities of Credit Rating Agencies (September 25, 2003) (hereinafter referred to as “IOSCO Statement”)¹¹ at Principle 3.3 (“CRAs should publish sufficient information about their procedures and methodologies so that outside parties can understand how a rating was arrived at by the CRA.”) In addition, we do not believe that a public comment period as to the rating agency’s methodologies should be required before publication of new ratings. We do not believe that either regulatory bodies or members of the public should dictate the CRA’s rating methodologies. Disclosure of such methodologies should be sufficient to ensure that the public understands the methodology.

Section 2.6. We are concerned that publication of the qualifications and experience of the analysts “assigned to a company” is designed to allow the rated company to challenge a rating based on the qualifications of a single analyst. It is our understanding that the ratings process at the NRSRO’s is a collaborative process. Thus, a rating is not the product of a single analyst, but of a committee decision. Consequently, we believe that the “qualifications” of a particular analyst may be misleading. We believe the best way to determine whether ratings are of high quality is through “back-testing”, i.e. determining after-the-fact the accuracy of the ratings. See Section 1.2 (The criteria for recognition should be based on whether the agency can consistently produce credible and reliable ratings over the long-term, not on methodology.) and Section 2.4 (Each CRA

¹¹ Available at www.iosco.org.

should publish the historical default rates of each rating symbol it uses.) If the regulators believe that the ratings produced by a CRA are unreliable, this judgment should affect the CRA's continuing designation as an NRSRO.

Section 5.1, Section 5.2. We agree with the Code that a CRA should disclose whether a rating is solicited or unsolicited, the basis of the rating, i.e. whether it is (1) purely statistical analysis of published information, (2) published information confirmed through conversations with the issuer (but apparently not involving non-public information), or (3) involving published and non-published information gathered in discussions, and the date the rating was last updated.¹² These recommendations are reasonable, promote understanding by users of ratings and would not place a significant burden on the CRA's.

Section 5.3. We agree that CRA's should disclose when they last conducted a full review with the issuer and when the rating was last updated. However, we believe the recommendation that CRA's should conduct a full review of each rated issuer at least annually is problematical. While it may be a desirable goal, it is too prescriptive. Compare IOSCO Statement at Principle 1.2 ("CRAs should monitor on an ongoing basis and regularly update an analysis and rating once a rating is issued whenever new information becomes available that causes the rating agency to revise or terminate its opinion.") It is also inconsistent with Section 1.10 (Regulators should not stipulate a frequency (e.g. annually, semi-annually) with which CRA's must update ratings, but require agencies to disclose the date of the last formal review and when they last updated each rating).

Communication between CRA's and Issuers

Section 6 of the Code gives the issuer substantial access to the reasoning behind the CRA's rating, including the analysis underlying a rating action, and any other information that materially influenced the rating action and that could influence future rating actions. As discussed more fully below, we believe that this access and potential interference undercuts the public perception of the independence of CRA analysts.

Section 6.1. This Section 6.1 would require a CRA to give an issuer an opportunity to review the text of any rating action and to remove any non-public information erroneously included in the text. It is inconsistent with both the Equity Research Rules and the Guiding Principles, which prohibit a research analyst from sharing the conclusions of a report with the issuer. We believe this Section should make clear that the phrase "text of any rating action" does not include the actual rating, and that the issuer is expected only to correct factual inaccuracies and remove any non-public information, but not to challenge the opinions of the rating analyst.

Section 6.5. This Section states that issuers should have an opportunity to provide feedback to the rating committee not only on factual matters but on key assumptions, fundamental analysis and any other information that may have materially influenced the

¹² See IOSCO Statement at Principle 3.5 ("CRAs should disclose if a rating is unsolicited.")

rating action. In our opinion, this would greatly expand the areas in which issuers are allowed to have input on rating actions, and we believe this expanded input gives the appearance that issuers have undue influence on the final product of the rating process.

Section 6.6. This Section states that, when an issuer communicates to a CRA its intention to access the capital markets without requesting a new rating, the CRA should avoid any “unnecessary” rating actions that could hinder the issuer’s ability to complete its capital markets operation. We recognize that there are potential problems with unsolicited ratings – particularly because some issuers believe that they give CRA’s an opportunity to extort solicited ratings. However, we believe there are better ways to ensure that a CRA does not use an unsolicited rating extortionately. Section 6.6, on the other hand, could be interpreted as allowing an issuer to leave potential investors without an independent source of creditworthiness information merely by failing to request a solicited rating.

Section 6.7. This Section allows an issuer to appeal a rating or an outlook to a new group of analysts. This interaction between the issuer and the CRA analyst and appeals process calls into question the independence of the CRA analyst and the CRA rating process. We believe the sponsoring organizations should re-think this interaction. While we appreciate the desire of issuers to understand the CRA’s analysis, we believe the interaction will ultimately undermine the public perception of the independence of the analysts.

We believe the appeals process in Section 6.7 has two problems. First, it allows the issuer to put pressure on the CRA to change a rating to which the issuer objects. Second, it adds time to the rating process – a 5-day waiting period before a CRA can publish a rating and, if the issuer raises an objection, up to 6 additional weeks for the appeal process to work its course. See also Section 6.9. (CRA’s should be expected to respond to issuer concerns about their rating in a timely and serious manner.) We believe there should be a process for issuers to raise with a CRA and with applicable regulators any complaints they may have about the accuracy of ratings. However, we believe such complaints should be used after the fact to judge the accuracy of ratings (when the accuracy of the rating can be demonstrated with the passage of time) and not as a prior restraint to the publication of the rating.

Section 6.8. Although the Code elsewhere states that regulators should not prescribe ratings methodology, Section 6.8 goes a long way toward prescribing such a methodology. For example, it requires that, during each formal review of an issuer, the CRA should confirm whether the information it has on record is still applicable or requires updating. While we agree that rating agencies should not base a rating on outdated information, we think the Code is too prescriptive.

Method of Adoption

The introduction to the Code suggests that “adherence” to the Code could be a recital in rating agency contracts with issuers or a representation to issuers. We believe it undermines public confidence in the independence of ratings for issuers to attempt to bind CRA’s contractually to a set of issuer-developed rules. Rather, we believe the Code should recommend that CRA’s notify the public on their websites the extent to which they adhere to the Code. See Section 3.1 of TBMA’s Guiding Principles, which states that the Guiding Principles are designed to assist TMBA member firms as they establish or modify their individual policies and procedures for the conduct of fixed income research activities. It also notes that TMBA chose to use a principles-based approach rather than detailed rules since firms must apply the principles in light of their particular circumstances.

Miscellaneous

Finally, we have the following drafting recommendation:

1. page 6, Introduction. The second bullet states that debt issuers expect the CRA’s to issue ratings that allow others that deal with the issuer “to improve their assessment of the issuer as a potential trading partner”. The Associations assume that the intention of this statement is to allow persons that deal with the issuer to “make an informed assessment of the issuer as a potential trading partner”. The phrase “improve their assessment” is not consistent with the concept of CRA’s as independent.

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The Associations appreciate the opportunity to comment on the proposed Code.

Please feel free to contact Marjorie E. Gross of TMBA at 646.637-9204 (or mgross@bondmarkets.com) or Frank Fernandez of SIA at 212.618.0517 (or ffernandez@sia.com, with any comments.

Very truly yours,

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