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BEFORE THE CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES SUBCOMMITTEE OF THE HOUSE FINANCIAL SERVICES COMMITTEE

UNITED STATES HOUSE OF REPRESENTATIVES

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Mr. Chairman, Ranking Member Kanjorski, Members of the Committee, good morning. I am Rita M. Bolger, Managing Director, Global Regulatory Affairs and Associate General Counsel for Standard & Poor's ("S&P"), a division of The McGraw-Hill Companies, Inc. On behalf of S&P and S&P Ratings Services, the S&P unit responsible for the preparation and publication of credit ratings, I am pleased that the Committee has granted S&P's request to be permitted to offer our concerns about legislative proposals regarding the credit rating industry and their potential effect not only on S&P, but on the capital markets here and abroad. While my comments are focused primarily on H.R. 2990, the "Credit Rating Agency Duopoly Relief Act of 2005," which has been formally proposed, many of them would likely be relevant to any legislative proposal incorporating the potential legislative framework prepared by staff of the Securities and Exchange Commission ("SEC" or "Commission") at the request of Congressman Kanjorski ("SEC Legislative Framework"), to the extent such a proposal included a licensing scheme for rating agencies and regulation of the manner and method by which they form and disseminate credit ratings.

While S&P has consistently supported increased competition among rating agencies and lower barriers of entry into our industry, we have serious concerns about H.R. 2990 and the disruptive effect its sweeping provisions could well have on the efficient operation of the capital markets. Abolition of the Nationally Recognized Statistical Rating Organization ("NRSRO") designation would be inconsistent with the overwhelming majority of private sector comments received by the Securities and Exchange Commission and is not necessary to achieve pro-competition objectives. Moreover, we believe that H.R. 2990, or a proposal based on certain aspects of the SEC Legislative Framework, could unnecessarily inject the Commission into the substance of the credit ratings process and result in a dilution of the quality and diversity of ratings, thus undermining the benefits of ratings to the market. We have also been advised by independent counsel that licensing and oversight schemes such as those contemplated by H.R. 2990 and the SEC Legislative Framework are facially unconstitutional. The very notion that a *bona fide* publisher — whether it be *BusinessWeek*, *The Wall Street Journal*, or S&P — can be required under the threat of penalty or other retribution to obtain a government license, adhere to government dictates about its policies and procedures, and/or submit to intrusive examinations before being permitted to disseminate its opinions to the public is inconsistent with core First Amendment principles.

In addition to these concerns, we believe that sweeping federal legislation governing the credit rating industry would be inconsistent with oversight initiatives recently approved by international securities authorities that have relied on adherence to codes of conduct, as opposed to rigid government mandates. We also believe that such legislation would be unnecessary in light of recent efforts by the SEC (which we support) to increase competition among rating agencies, as well as the progress that the SEC and the existing NRSROs have made in crafting a more effective regulatory oversight framework that, unlike H.R. 2990, preserves the critical, constitutionally protected independence of rating agencies to publish their opinions without intrusive government mandates.

Background on S&P Ratings Services and the Nature of Credit Ratings

Attached for the Committee's information as Exhibit A to this submission is a short description of S&P's background and an explanation of the process by which our credit ratings are formed and published to the market.

S&P's Concerns About H.R. 2990 and Other Potential Proposals

Abandonment Of The NRSRO Concept And Comprehensive Regulation Of The Credit Rating Process Will Inhibit The Efficient Operation Of The Capital Markets

At the core of H.R. 2990 is the abandonment of the long-standing and generally successful NRSRO concept and the substitution of a new regime that would govern the behavior of all rating agencies (or at least those that have chosen to make their ratings widely available to the public via the Internet), requiring licensing by the government of those agencies and placing the Commission in a new, central role with respect to the expression of opinions by these rating agencies. The NRSRO concept was first utilized by the Commission in 1975 as part of the net capital rule for broker dealers. S&P Ratings Services was designated as an NRSRO in 1976, although it did not affirmatively seek that status. In designating S&P Ratings Services as an NRSRO, the Commission was acknowledging a market reality — that our ratings were and are widely recognized by the market as an effective and credible way to assess the creditworthiness of issuers and issues.

Since the formation of the NRSRO framework, investors and other market participants have come to view the NRSRO designation as a useful means by which to identify those rating agencies that consistently issue independent, objective and credible rating opinions.

Indeed, when the Commission asked market participants in connection with its 2003 Concept Release whether it should retain the NRSRO concept, the vast majority unequivocally said "yes". According to the Commission, these commenters, including investors, trade associations, rating agencies and other market participants, "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 out of 46 commenters supported elimination of the NRSRO concept. While S&P supports lowering barriers to entry and increasing competition in the credit rating industry, we think the sudden, wholesale withdrawal of the NRSRO concept will create a dangerous vacuum, depriving the market of a system of designation that it has looked to for thirty years and which, by almost universal acknowledgment, has served it well.

Second, it is important to recognize that the "new role" for the Commission envisioned by H.R. 2990 and, for that matter, any potential proposal closely based on the SEC Legislative Framework, would require the Commission to engage in comprehensive regulation of the credit rating process. This inherently intrusive regulatory oversight — which, among other things, calls for evaluations by the SEC of the "procedures and methodologies" used by rating agencies in determining ratings — will, we believe, result in ratings of lower, not higher, quality. Because credit ratings are opinions as to which reasonable analysts can and do disagree, there is no one "correct" way to go about forming them. Comprehensive regulation of the manner and method used by rating agencies to determine ratings would thus be impractical and unwise. Such regulation could produce ratings opinions designed to avoid governmental "second-guessing" rather than ratings reflecting the uncompromised view of a committee of analysts. Commission oversight of the ratings process would also encourage rating agencies to standardize their approaches so as to avoid penalties and censure, thus inhibiting the diversity and creative innovation the market has come to expect from NRSROs. The quality of ratings information available to the market would inevitably suffer as a result. In addition, while S&P joins the SEC and the members of this Committee in supporting increased competition in the credit rating industry, the sort of regulation envisioned under H.R. 2990 and the potential SEC Legislative Framework is likely to have the opposite effect, erecting new barriers to entry through burdensome mandates that will inhibit, rather than promote, increased competition. Under these proposals, new entrants in the credit rating industry may be required, for example, to have in place specific policies and practices that are costly to implement and may be required to submit to burdensome, time-consuming government evaluation before they are even allowed to publish their opinions legally. These cost barriers do not exist today.

It is important to consider the effects of these proposals on international markets as well. Indeed, many of these same concerns recently led the Committee of European Securities Regulators ("CESR"), at the request of the European Commission, to recommend oversight of rating agencies based on adherence to codes of conduct and market forces, not comprehensive government mandates like those contemplated by H.R. 2990 and the SEC Legislative Framework. Similarly, the International Organization of Securities Commissions ("IOSCO") determined this past December after months of deliberation and an extensive market comment period that its "Code of Conduct Fundamentals" should be flexible, allowing rating agencies to incorporate its principles into their own respective codes of conduct, but not creating rigid, universally applicable regulations. SEC Commissioner Campos, who also served as Chairman of the IOSCO Task Force, said that IOSCO's flexible approach would be "more effectively enforced" than a "universal code for all credit rating agencies to sign on to." Commissioner Campos explained that a degree of flexibility was appropriate because rating agencies vary considerably in size, business model and rating methods. S&P Ratings Services agrees that IOSCO's flexible approach will better preserve the independence and integrity of the credit rating process around the world. The flexible, adaptable, IOSCO approach is much less likely to chill analysis and innovation or erect new and undesirable barriers to entry than a rigid regulatory scheme.

Abandonment Of The NRSRO Concept And Comprehensive Regulation Of The Credit Rating Process Is Unnecessary

S&P believes that abandonment of the NRSRO designation and sweeping legislation is not only undesirable, but also unnecessary given the success of the NRSRO concept, recent SEC initiatives to increase competition in the credit rating industry, and the ongoing development of a meaningful, effective oversight framework that preserves rating agency independence.

The NRSRO Framework Has Been, And Continues To Be, Successful

First, H.R. 2990 disregards the well-documented and long-standing success of the NRSRO framework in general and individual NRSROs in particular. The Director of the SEC's Division of Market Regulation observed in testimony before this Committee in April 2003 that "in general the credit rating agencies have done remarkably well." Studies on rating trends and performance have repeatedly confirmed the point. These studies show that S&P's ratings, for example, have been highly effective year after year in alerting the market to both deterioration and improvement in credit quality.

The unprecedented wave of corporate fraud that shook the capital markets has led to some persistent criticism of NRSROs, criticism that we believe is unfair and unfounded. There can now be no doubt, based on criminal and civil proceedings related to the scandals arising out of the fraudulent conduct of Enron and Worldcom, that S&P, like many other market participants, was deliberately misled by the parties who committed these frauds. In the Enron case, for example, key Enron personnel have now expressly admitted, and entered into plea agreements based on, their role in deliberately misleading S&P and other rating agencies. It was their intention, they said, to defraud the rating agencies by making false representations and failing to disclose material facts related to Enron's financial position and cash flow. It should also be noted that, contrary to what has been sometimes mischaracterized as a "strong" or "high" rating, S&P rated Enron the lowest investment grade level and had it on "CreditWatch negative," meaning it could be downgraded at any time. This rating was dependent on the outcome of a possible merger with an investment grade company, which ultimately did not occur.

Nevertheless, these scandals have led to constructive responses by market participants and rating agencies alike. S&P, for example, has enhanced its rating process through a number of measures including the addition of specialized accounting expertise, expanded liquidity analysis and recovery assessment, enhanced use of quantitative tools and modeling, increased public commentary, enhanced focus on corporate governance practices, and expanded training programs. In September 2004, S&P Ratings Services published its policies and procedures in a Code of Practices and Procedures, available at our Web site, www.standardandpoors.com, which includes a significant number of policies, procedures and structural safeguards.

Consistent with IOSCO's Code of Conduct Fundamentals, this Code of Practices and Procedures requires, for example, restrictions on securities ownership and trading so as to minimize any conflicts of interest in the conduct of the credit ratings process. The proven success of these safeguards was demonstrated in the SEC's January 2003 "Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets," prepared pursuant to Congress' direction in the Sarbanes-Oxley Act of 2002 and following an extensive review of credit rating agencies. In that Report, the Commission noted that market participants generally believed that any potential conflicts of interest have been "effectively addressed by the credit rating agencies." We believe these existing policies and new initiatives will permit S&P Ratings Services to maintain its long-standing reputation as a widely recognized provider of independent, objective and credible credit ratings.

As a result, we believe it would be precipitous and ill-advised to discard an NRSRO system that has served the capital markets so well for so long and to impose intrusive regulations because companies like Enron and WorldCom set out to deceive deliberately the market and the rating agencies. H.R. 2990, however, would have such a "baby out with the bathwater" effect.

Sweeping Legislation Is Unnecessary In Light Of Recent Initiatives Of The SEC And The Ongoing Development Of A More Effective And Less Intrusive Oversight Framework

We recognize that a primary goal of H.R. 2990 and a concern of this Committee is to increase competition in the credit rating industry. But the radical departure from the proven NRSRO system contemplated by H.R. 2990 is unwarranted to achieve that goal in light of recent initiatives by the Commission. These initiatives, described below, are based on thorough study and analysis of the NRSRO framework by the Commission with a view toward serving the best interests of investors and the marketplace. They represent an approach that attempts to promote competition while at the same time avoid compromising the demonstrated benefits of the NRSRO framework. They should be given time to take effect and be evaluated before any wholesale abandonment of a proven approach is put into place.

The Commission's actions include the recent designation of two new NRSROs and its proposal of a rule designed to provide greater transparency regarding the definition of an NRSRO and guidance to rating agencies on how to meet that definition. While S&P believes the proposed rule has its faults and requires modification (as stated in our comment letter to the SEC), we simply disagree with the "finding" of H.R. 2990 that this proposed rule — which would, among other things, make the NRSRO designation available to credit rating agencies that confine their activities to a limited sector of the debt market or a limited geographic area — will "codify and strengthen" barriers to entry.

The SEC and the existing NRSROs have also been active in taking steps to provide for effective Commission oversight of NRSROs. More particularly, the SEC and the NRSROs have engaged in ongoing, productive negotiations on a proposed regulatory framework that would closely track the IOSCO Code of Conduct Fundamentals, providing, among other things, that all NRSROs adopt and comply with policies and procedures regarding the handling of confidential non-public information and the management of conflicts of interest that may arise in the credit ratings business. In addition, this oversight framework would include a compliance mechanism to provide the SEC with information regarding an NRSRO's fulfillment of its terms. The oversight framework is also being carefully crafted to best preserve the constitutionally protected independence of NRSROs and to avoid the harms resulting from regulatory second-guessing of particular credit ratings decisions in the industry. The SEC staff and existing NRSROs have made real progress on the nature and scope of this regulatory framework. Indeed, almost one month ago the NRSROs provided for the SEC's consideration a final proposal for such a framework. We believe this process should continue and be given time to work prior to the enactment of sweeping legislation that eliminates an approach that the market and the Commission agree has been generally successful.

Mandatory Licensing Of Rating Agencies And Regulation Of The Manner And Method By Which They Form And Disseminate Credit Ratings Would Be Unconstitutional

Finally, we believe that H.R. 2990, as written, is facially unconstitutional. The same would likely be true of any legislation closely based on the SEC Legislative Framework. Rating agencies have been afforded a high level of First Amendment protection by numerous state and federal courts. This is so because, at their core, rating agencies such as S&P perform the journalistic activities of gathering information on matters of public concern, analyzing that information, forming opinions about it and broadly disseminating those opinions to the general public. Indeed, the text of H.R. 2990 itself recognizes that rating agencies are publishers. In decision after decision, courts have held that these journalistic activities entitle S&P and other rating agencies to robust rights under the First Amendment that would, of course, similarly apply to any judicial analysis of the constitutionality of H.R. 2990 or other legislation. Recently, the federal district court in Texas overseeing the various Enron litigations held unequivocally that S&P is protected by the same First Amendment standard that extends to other *bona fide* publishers. We believe that these First Amendment protections, which exist to foster robust debate and to avoid the chilling effect that would inevitably accompany governmental intrusion into the formation and dissemination of opinions about matters of public interest — including the assessment by rating agencies of the likelihood that debt will be repaid — would weigh heavily in the decision-making of any court passing upon the constitutionality of the proposed legislation. Indeed, SEC Chairman William Donaldson recently recognized in testimony before the Senate Banking Committee that congressional action to regulate the rating agencies would raise "a number of important policy considerations that would need to be examined, including First Amendment issues."

In particular, H.R. 2990 or any similar proposal would likely violate the First Amendment rights extended to S&P and other credit rating agencies. By making it illegal for a credit rating agency to publish its opinions without first registering with the government and providing mandatory disclosures about that agency's business activities, H.R. 2990 or similar legislation would place an unconstitutional licensing requirement on First Amendment protected activity. No legislation could constitutionally require the licensing of *BusinessWeek* or *The Wall Street Journal* because they offer their opinions as to the creditworthiness of certain entities. The same is true of S&P and other rating agencies.

Second, intrusive government involvement in the manner and method of generating credit ratings such as that contemplated by the proposed legislation would also strike at the heart of the First Amendment. H.R. 2990 specifically contemplates an evaluation and judgment by the SEC on, among other things, the "procedures and methodologies [a] statistical rating organization uses in determining ratings" before that rating agency would be allowed to publish its opinions legally. Such government mandated policies and procedures for generating and issuing rating opinions would be the equivalent of unconstitutional governmental supervision of publishers from within their own newsrooms. This direct intrusion into the editorial process and the "chilling" effect that such oversight would inevitably have on the ability of S&P and other publishers to disseminate the opinions that they, based on their independent editorial judgment, deem newsworthy, is precisely the type of governmental activity the First Amendment bars.

Indeed, these very issues were before the Supreme Court twenty years ago in the case of *Lowe* v. *SEC*, 472 U.S. 181, 210 (1985), in which the Court unanimously rejected the position of the SEC that a publisher of newsletters of general circulation containing factual information and commentary on market conditions and trends could be deemed an "investment advisor" under the Investment Advisor's Act of 1940 ("IAA") and thereby subjected to Commission regulation. Although the majority opinion sidestepped the constitutional question presented by the case, it observed that there could be "no doubt" that publications containing factual information and commentary on market conditions and trends, were protected by the First Amendment. The concurring opinion of Justice White in *Lowe* (joined by Chief Justice Burger and then-Justice Rehnquist), expressed these constitutional concerns even more sharply, observing that the case involved "a collision between the power of the government to license and regulate those who would pursue a profession or vocation and the rights of freedom of speech and of the press guaranteed by the First Amendment." *Id.* at 228 (White concurring). The concurring Justices made plain their rejection of the proposition that the government could enact a licensing scheme directly affecting speech (including a registration requirement), finding that, "[t]he principle that the government may restrict entry into professions and vocations through licensing schemes has never been extended to encompass the licensing of speech *per se* or of the press." *Id.* at 229. Other federal courts have similarly concluded that the financial press deserves the full protections of the First Amendment and may not be subject to licensing requirements or government inspection.

Our outside counsel, Floyd Abrams of Cahill Gordon & Reindel LLP, is in the process of preparing a more detailed submission that we intend to provide to the Committee on the specific constitutional issues raised by H.R. 2990 and the SEC Legislative Framework. We would also be happy to make Mr. Abrams available to testify before this Committee or to meet with individual Members and staff about the serious First Amendment threats presented by any potential legislation.

Conclusion

While we at S&P Rating Services share the Committee's goals of increasing competition among rating agencies and lowering barriers to entry in our industry, we believe that a legislative scheme such as H.R. 2990 would be undesirable, unnecessary and almost certainly unconstitutional. The proposed legislation overlooks the success of the NRSRO concept and individual NRSROs; rejects the prevailing views of the SEC, regulators around the world and the predominant users of credit ratings; and is unwarranted given recent initiatives by the SEC. We believe that the oversight regime currently being developed by NRSROs and the Commission addresses the concerns of the Committee and would be an effective alternative to H.R. 2990 or an alternative legislative scheme based on the SEC Legislative Framework.

On behalf of S&P Ratings Services, thank you again for the opportunity to participate in these hearings. I'd be happy to answer any questions you may have.

EXHIBIT A

Background on S&P Ratings Services and the Nature of Credit Ratings

S&P Ratings Services began its credit ratings activities almost ninety years ago, in 1916, and today is a global leader in the field of credit ratings and risk analysis, with credit rating opinions outstanding on approximately $30 trillion in debt representing 745,000 securities issued by roughly 42,000 obligors in more than 100 countries. S&P Ratings Services has established a market-tested track record of providing the market with publicly-available, independent, objective and rigorous analytical information in the form of credit rating opinions. A rating from S&P Ratings Services represents our opinion, as of a specific date, of the creditworthiness of either an obligor in general or a particular financial obligation. Unlike equity analysis, a credit rating opinion:

- is not a recommendation to buy, sell, or hold a particular security;
- is not a comment on the suitability of an investment for a particular investor or group of investors;
- is not a personal recommendation to any particular user; and
- is not investment advice.

More detail on the nature of our rating opinions is available on our Web site: www.standardandpoors.com.

Credit ratings are an important component of the global capital markets and over the past century have served investors extremely well by providing an effective and objective tool to evaluate credit risk. Credit ratings provide helpful standards for issuers and investors around the world, facilitating efficient capital raising and the growth of new markets. Indeed, credit rating opinions have supported the development of deeper, broader and more cost effective global debt markets. S&P Ratings Services itself has made significant contributions to this development. We have taken credit research into new markets and new asset classes. Our sovereign ratings have assisted numerous countries in their attempt to access global capital markets they may not have otherwise had access to, hastening capital formation and economic development. S&P has contributed to a greater flow of information in the markets and has enabled the development of a wider array of tools for understanding credit risk and far greater transparency in the marketplace today than ever before.

Critical to a credit rating agency's ability to serve this role in the market is its commitment to, and achievement of, the highest standards of independence, transparency and quality. At S&P Ratings Services, these principles are the cornerstones of our business and have driven our longstanding track record of analytical excellence. Indeed, studies on rating trends have repeatedly shown that our ratings are highly effective in alerting the market to both deterioration and improvement in credit quality. For example, over the past 15 years, less than one percent (1%) of issuers initially rated in the "AAA" category have defaulted while approximately sixty percent (60%) of those initially rated in the "CCC" category have failed to meet their obligations.

The Credit Rating Process

At the heart of this market-tested and accepted track record is a proven process by which S&P Ratings Services arrives at its credit rating opinions. This rating and editorial process begins with the assignment of qualified analysts to a particular issuer. The analysts gather economic, financial and other information directly from the issuer, from public filings and from other sources deemed to be reliable. Because publicly available information about an issuer is an important component of the ratings process, we support the actions taken by

Congress in enacting the Sarbanes-Oxley Act of 2002 to strengthen the process by which financial information is audited and provided to the market. In addition, as part of our rating process, we press issuers to respond to comprehensive questions that help our analysts develop a full picture of the issuer's true credit quality. Our analysts also rely expressly and necessarily on issuers to provide timely and accurate information. We may, depending on the circumstances, decline to issue a rating or may even withdraw an existing rating if an issuer refuses to provide requested information. That said, our analysts are not auditors and are not in a position to perform an audit of information provided by a rated company.

Our rating analysts examine information carefully as it is gathered. When sufficient information to reach a rating conclusion has been received and analyzed, we convene a rating committee comprised of S&P Ratings Services personnel who bring to bear particular credit experience and/or expertise relevant to the rating. A lead analyst makes a presentation to the rating committee that includes an evaluation of the issuing company's strategic and financial management, its business and operating environment, an analysis of financial and accounting factors and the issuer's business and financing plans. Our rating committee meetings involve serious and lengthy discussion that includes frank, and often animated, exchanges.

Once a rating is determined by the rating committee, the issuer is notified and S&P Ratings Services disseminates the rating opinion to the public. Along with the rating, we publish a narrative rationale explaining to the marketplace the key issues considered in the rating. Similarly, when a rating change occurs, our analysts report on the change and the rationale for it. We have a longstanding policy of making our public credit ratings and the basis for those ratings broadly available to the investing public as soon as possible and without cost. Public credit ratings are disseminated via real-time posts on our Web site, and through a wire feed to the news media as well as through our subscription services. Members of the investing public receive credit ratings at the same time as subscribers. This rating and editorial process is fully transparent. We publish our criteria and explain, often in great detail, the rationale for each of our public ratings decisions. We believe that transparency of the ratings process is a critical and indispensable component to our success and to maintaining our reputation, earned over nearly a century, as a global provider of independent, objective and credible credit ratings.

We believe that the independence and integrity of this process would be jeopardized by any regulatory scheme that sought to replace our analysts' judgment with the judgment of regulators or otherwise seeks to intrude upon or control the manner and method by which we form and disseminate credit ratings.