



Consumer Federation of America



August 8, 2011

Elizabeth M. Murphy  
Secretary  
Securities and Exchange Commission  
100 F Street, N.E.  
Washington, D.C. 20549-1090

**Re: File Number 27-18-11  
Nationally Recognized Statistical Rating Organizations**

Dear Secretary Murphy:

We are writing on behalf of the Consumer Federation of America (CFA)<sup>1</sup> and Americans for Financial Reform<sup>2</sup> in response to the Commission's request for comments regarding proposed rule changes relating to credit rating agencies registered with the Commission as nationally recognized statistical rating organizations (NRSROs). The Commission has the opportunity with these rules to significantly improve both the transparency of credit ratings and the operations of rating agencies. While the rule proposal largely delivers on the first promise, it falls well short in other areas, including those most likely to affect the accuracy, integrity, and reliability of credit ratings – internal controls and conflicts of interest. We are writing, therefore, to urge the Commission to strengthen the proposal in order to ensure that the new rules both match the scale of the problem they are intended to address and deliver the full scope of the credit rating agency reforms Congress intended when it adopted the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Even if the recommendations in this letter are adopted, the fundamental conflict of interest embedded in the issuer-pays business model of the NRSROs will make it challenging to effectively police the integrity of ratings. In the long run, it will likely be necessary to challenge the issuer-pays model at a more basic level. However, as currently drafted the proposed rules

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<sup>1</sup> CFA is a non-profit association of approximately 300 national, state and local pro-consumer organizations founded in 1968 to represent the consumer interest through research, education and advocacy.

<sup>2</sup> Americans for Financial Reform is an unprecedented coalition of over 250 national, state and local groups who have come together to reform the financial industry. Members of our coalition include consumer, civil rights, investor, retiree, community, labor, religious and business groups as well as Nobel Prize-winning economists. (Members of AFR are listed at the end of this letter in Appendix A.)

offer little hope of making significant progress on addressing the deep-rooted problems with credit ratings that were revealed by the financial crisis.

## **Introduction**

When the Senate Permanent Subcommittee on Investigations looked at the causes of the financial crisis, it identified many contributing factors. But it concluded that, “the most immediate trigger to the financial crisis” was the July 2007 decision by Moody’s and S&P to downgrade hundreds of residential mortgage-backed securities (RMBS) and collateralized debt obligations (CDOs). “By acknowledging that RMBS and CDO securities containing high risk, poor quality mortgages were not safe investments and were going to incur losses, the credit rating agencies admitted the emperor had no clothes. Investors stopped buying, the value of the MBS and CDO securities fell, and financial institutions around the world were suddenly left with unmarketable securities whose value was plummeting. The financial crisis was on.”<sup>3</sup>

Recognizing the central role credit rating agencies played as enablers of unsound mortgage lending practices that were the root cause of the financial crisis, Congress included a multi-faceted package of credit rating agency reforms in the Dodd-Frank Act. The goal of the legislation was to:

- Improve regulatory oversight of credit rating agencies;
- Enhance internal controls, governance and compliance practices at credit rating agencies;
- Increase transparency with regard to the assumptions behind and data backing credit ratings;
- Increase the legal accountability of rating agencies; and
- Reduce regulatory reliance on ratings and, with it, the financial system’s vulnerability to ratings failures.

CFA and AFR strongly supported these provisions, even as we recognized their limitations. The ability of the SEC to provide effective oversight, for example, is contingent on Congress’s willingness to provide the agency with adequate funding. The success of the bill’s governance reforms will depend on the willingness of the rating agencies to appoint truly independent board members with the technical expertise necessary to provide effective oversight. And, it remains far from clear that courts will be willing to hold rating agencies legally accountable for following sound rating procedures.

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<sup>3</sup> *Wall Street and the Financial Crisis: Anatomy of a Financial Collapse*, Majority and Minority Staff Report, Permanent Subcommittee on Investigations, U.S. Senate, April 13, 2011.

More fundamentally, the legislation fails to mandate a fundamental change in the issuer-pays business model that was the primary cause of the rating agencies' failures.<sup>4</sup> As a result, much is riding on the effectiveness of the Commission's rule proposals to implement the regulatory requirements in Dodd-Frank. In particular, with its provisions on conflicts of interest and internal controls, Dodd-Frank gives the Commission potentially powerful tools to address the effects of that issuer-pays conflict even if Congress chose not to act directly in the near term to address the cause of the conflict. It is absolutely imperative that the Commission make good use of this authority to deliver the sweeping reforms demanded both by the scope of the abuses at the ratings agencies and the severity of their impact on the financial system.

## **The Proposed Rules**

The wide-ranging proposals in the rule release address Dodd-Frank provisions to improve the credit rating disclosures as well as credit rating agency operations. These reflect the statute's twin goals of enhancing the accuracy, reliability, and integrity of the ratings and increasing the ability of market participants to make an informed choice about whether and how to use those ratings. For the most part, the proposed disclosure reforms appear to be generally on the right track, although a better disclosure mechanism is needed for the due diligence disclosures and improvements can and should be made to the content of Form NRSRO disclosures.

Unfortunately, the same cannot be said for the rule proposals related to credit rating agency operations. In some areas, such as methodology and training and testing, the proposals include flaws that can be addressed with relatively minor revisions. On universal ratings, the rule proposal is so vague as to provide no clue regarding how it would be implemented and therefore whether it would have the intended effect. Here, extensive clarification is needed. Most disappointing, however, are the proposals in the key areas of internal controls and conflicts of interest. With these provisions, Congress has given the Commission the tools necessary to help eradicate the abuses that directly contributed to causing the financial crisis. Unfortunately, the proposals in these two most important areas fall well short of both what is authorized under Dodd-Frank and what is needed to bring about meaningful reforms. These provisions demand sweeping revisions.

### **I. The Following Provisions are Badly Off-Track and Need Extensive Revisions**

#### **A. Internal Control Structure**

When Congress adopted the Credit Rating Agency Reform Act of 2006, it made clear that it did not want to put the Commission in the position of regulating credit rating agency methodologies. The credit rating agency reforms in Dodd-Frank retain that basic limitation on agency authority over the *content* of rating agency methodologies, but they also reflect clear congressional intent to go beyond the CRARA reforms by giving the Commission greater authority and responsibility to address abusive practices surrounding *implementation* of those

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<sup>4</sup> Section 939 F of the Dodd-Frank Act requires the Commission to examine a shift to assigned credit ratings, which would remove the issuer-pays conflict of interest, but does not mandate action.

ratings procedures and methodologies. Potentially one the Act's most powerful tools to bring about this improvement is the requirement that NRSROs "establish, maintain, enforce, and document an effective internal control structure governing the implementation of and adherence to policies, procedures, and methodologies for determining credit ratings." Moreover, the Act specifically gives the Commission rule-making authority to prescribe the factors an NRSRO would need to take into consideration when implementing the control structure.

Unaccountably, the Commission proposes to abdicate this standard-setting authority and instead defer entirely to the rating agencies themselves to develop appropriate internal control structures. We cannot stress enough how strongly we oppose this proposed approach, which experience teaches us will be ineffective in reforming credit rating agency practices and will leave the Commission with little if any ability to hold ratings agencies accountable if they adopt weak and ineffective controls. This provision of the rules simply must be fixed if these rules are to have any hope of delivering the reforms promised by Dodd-Frank.

#### The proposed solution is not commensurate with the scale of the problem

One problem with the SEC's proposal to defer to the ratings agencies on internal controls is that it does not match the scale or severity of the problem it is designed to address. The record of the financial crisis is replete with evidence that the control environment at the major credit rating agencies in the years leading up to the crisis was a mess, that this was the direct result of management decisions to prioritize profitability over ratings accuracy, and that the lack of effective controls had a direct and harmful impact on ratings quality and, by extension, on the stability of the financial system. It is going to require a major overhaul of their control structures to resolve those problems, something recent experience suggests ratings agencies cannot be relied upon to do without regulatory pressure.

One of the most comprehensive and damning portraits of rating agency practices can be found in the report on the Financial Crisis by the Senate's Permanent Subcommittee on Investigations.<sup>5</sup> Over the course of the investigation, which focused on Moody's and S&P, the Subcommittee found extensive evidence that "analysts within Moody's and S&P were aware of the increasing risks in the mortgage market ... Yet for years, neither credit rating agency heeded warnings – even their own – about the need to adjust their processes to accurately reflect the increasing credit risk." In other words, the rating agencies were not taken by surprise by risks they had failed to apprehend. Rather, they failed to incorporate those risks into their rating models. Moreover, the report draws a clear cause and effect line between the firms' desire to win market share and increase revenues and their shoddy rating practices. For example, the report cites numerous instances in which exceptions to rating criteria were granted, important improvements to those criteria were delayed, and "troublesome" analysts were barred from participating in rating certain deals, all in an effort to accommodate and appease influential clients.

Other Senate report findings are highly relevant to the Commission decision about the appropriate approach to take regarding internal control requirements. For example, investigators

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<sup>5</sup> *Wall Street and the Financial Crisis: Anatomy of a Financial Collapse*, Majority and Minority Staff Report, Permanent Subcommittee on Investigations, U.S. Senate, April 13, 2011.

found: 1) that “the companies failed to provide their ratings personnel with clear, consistent, and comprehensive criteria to evaluate complex structured finance deals;” 2) that, at times, ratings personnel acted with “a limited understanding of the complex deals they were asked to rate;” 3) that Moody’s and S&P failed to retest outstanding RMBS and CDO securities after improvements were made to their credit rating models; 4) that they regularly failed to perform surveillance activities they were contractually obligated to provide; and 5) that they devoted inadequate resources to the rating process generally and the surveillance process in particular.

The problem was not that the rating agencies didn’t have appropriate policies emphasizing the importance of producing accurate ratings and preventing conflicts from influencing ratings. The problem was that those policies were ignored or overridden in the day-to-day operations of the ratings agencies, where the focus on profits and market share trumped other concerns. The report sums up the problem this way:

“The Subcommittee investigation discovered a cadre of professional RMBS and CDO rating analysts who were rushed, overworked and demoralized. They were asked to evaluate increasing numbers of increasingly complex financial instruments at high speed, using out-of-date rating models and unclear ratings criteria, while acting under pressure from management to increase market share and revenues and pressure from investment banks to ignore credit risk. These analysts were short staffed even as their employers collected record revenues.”

The Senate report builds on an earlier analysis conducted by the staff of the SEC based on examinations of the three major rating agencies.<sup>6</sup> Indeed, the Commission’s 2008 report was among the first to document serious short-comings in ratings agency practices in rating residential mortgage-backed securities (RMBS) and collateralized debt obligations (CDOs). The Commission report provided evidence, for example, that:

- rating agencies were issuing ratings before all issues raised in the analysis had been resolved and despite analyst concerns that ratings did not accurately capture a particular deal’s risks;
- rating agencies frequently made “out of model adjustments,” often without documenting the rationale for the adjustment;
- despite internal policies requiring them to do so (and, after September 2007, a formal record-keeping requirement), ratings agencies routinely failed to document key aspects of the rating process, including rating committee memos and minutes, tallies of rating committee votes, and surveillance activities;
- while each rating agency had policies and procedures restricting analysts from participating in fee discussions with issuers, these policies still allowed key participants in the ratings process to participate in fee discussions; and

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<sup>6</sup> *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, U.S. Securities and Exchange Commission, July 2008.

- rating agencies did not appear to be taking steps to prevent consideration of market share and other business interests from influencing ratings or ratings criteria, and analysts appeared to be aware, when rating issuers, of the agency's business interest in securing the rating of the deal.

Perhaps most relevant to the Commission's decision of whether to defer to rating agencies regarding internal controls are the staff findings with respect to the rating agencies' internal audit processes. Specifically, after reviewing each agency's internal audit programs and activities related to its RMBS and CDO groups for the period from January 2003 to November 2007, the staff concluded that the "internal audit or management response processes" at two of the three examined rating agencies "appeared inadequate." At one firm, the internal audit process was cursory, according to the report, consisting of a one-page checklist covering the completeness of deal files. At another firm, the internal audits appeared to be more robust. Indeed, they "uncovered numerous shortcomings, including non-compliance with document retention policies, lack of adherence to rating committee guidelines and most significantly, the failure of management to formally review/validate derivatives models prior to posting for general use," but the rating agency "did not provide documentation demonstrating management follow-up."

In light of these findings, it is frankly inconceivable to us that the Commission now proposes to defer to the rating agencies in this vital area of developing and administering internal controls over ratings policies, procedures and methodologies.

#### The proposed approach is unlikely to be effective

The Commission has reason to know just how ineffective internal control requirements can be absent an operative enforcement mechanism. After the Foreign Corrupt Practices Act was adopted in 1977, public companies were legally required to maintain effective internal controls over financial reporting. However, that requirement existed in a vacuum, with no enforcement mechanism in place to make sure that companies adopted and enforced appropriate control programs. That shortcoming in regulation surfaced with the numerous corporate scandals of a decade ago, scandals that cost investors hundreds of billions of dollars in losses and sent capital markets into severe decline. When Congress undertook an examination of the causes of those accounting scandals, it found that thousands of these companies did not have adequate internal controls. Time and again they found that internal controls and processes for ensuring reliable financial reporting were ad hoc and inconsistent at best.

It wasn't until the Sarbanes-Oxley Act requirements for an independent assessment of internal controls was implemented that companies began to take their requirements in this area seriously. Even then, however, experience since implementation of SOX has shown the limitations of an approach that relies exclusively on company executives to enforce the requirement. First and foremost, executives have shown themselves all too willing to certify to the effectiveness of controls where serious weaknesses existed. It is only the outside audit of those controls, subject to a clear audit standard, that has disciplined this process.

There is simply no reason to believe that the experience will be different if, as the Commission proposes, credit rating agencies are required to adopt internal control programs with regard to rating policies, procedures and methodologies but given no guidance on what factors those control structures would have to address and no minimum standards to meet with regard to those controls. At best, control systems will be inconsistently applied among the various rating agencies, and necessary controls are more likely to be overlooked or to operate ineffectively.

Moreover, without standards in place governing those control programs, the Commission's examination staff will have no benchmark against which to measure whether or not internal controls are reasonable and whether they are being effectively maintained and enforced. That will inevitably lead to disputes between SEC staff and the credit rating agencies being inspected. But without firm guidelines to point to, the staff is far less likely to be able to enforce its views that controls need to be strengthened. Similarly, without standards in place, credit rating agency boards of directors will find it difficult if not impossible to fulfill their Dodd-Frank mandate to oversee the effectiveness of the internal control system in a way that provides meaningful new protections.

#### The Commission must develop a framework for assessing internal controls

The need for a framework for assessing internal controls was recognized when the Committee of Sponsoring Organization (COSO) undertook to develop the "Internal Control – Integrated Framework" for financial reporting controls in 1992. As COSO stated:

"Internal control means different things to different people. This causes confusion among business people, legislators, regulators and others. Resulting miscommunication and different expectations cause problems within an enterprise. **Problems are compounded when the term, if not clearly defined, is written into law, regulation or rule.**"<sup>7</sup> (Emphasis added.)

To be effective, therefore, and to avoid unnecessary confusion and miscommunication, the SEC must set forth a basic framework against which the credit rating agency control programs will be assessed.

The purpose of that framework would be to link the objectives of the internal control program – in this case production of independent, accurate, and timely ratings in compliance with all relevant laws – with the components of internal controls necessary to achieve those objectives. Toward that end, the SEC should adopt rules laying out:

- a basic definition of internal controls;
- a definition of a "material weakness" in internal controls as a serious deficiency in internal controls that would prevent or in fact did prevent the internal controls from achieving their objective;

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<sup>7</sup> Internal Control – Integrated Framework. Committee of Sponsoring Organizations of the Treadway Commission. September, 1992. Page 1.

- the objectives internal controls are designed to achieve in terms of assurance provided to investors;
- the level of assurance internal controls are expected to provide, which is a reasonable (high) level of assurance;
- the basic components of internal control; and
- the fundamental steps for the management of internal controls.

Such an approach should set basic, enforceable standards but still allow the credit rating agencies more than adequate flexibility to develop an approach to internal controls that matches their size, functions and business model.

#### The agency has ample information and experience on which to base a more rigorous approach

In justifying its proposal to defer any rulemaking, the Commission suggests that, by delaying, the agency could learn more through the NRSRO examination process and NRSRO annual reports about how the ratings agencies are complying. What they learn through that process would then inform any future rulemaking that the agency might initiate in this area. As a practical matter, however, we know it will be more difficult for the Commission to initiate rulemaking in this area the further it gets from the financial crisis, absent another cataclysmic failure.

Moreover, the Commission already has a wealth of information on which to base a control framework. For starters, it has its extensive experience in the area of internal controls over financial reporting to draw on. This includes experience with all aspects of the control process – development, maintenance, enforcement, and documentation – as well as highly relevant experience on how to develop standards that are flexible and scalable. In addition, prior examinations of the credit rating agencies have already identified areas that are critical to promoting ratings accuracy and independence. The 2008 Commission report is full of specific findings that should be addressed by an effective control program. That record has since been expanded by the Senate Permanent Subcommittee report.

Finally, the rule release itself clearly demonstrates that the Commission already has a good grasp of the key considerations rating agencies ought to address in each control area. The criteria on which the Commission seeks comment are precisely the sort of controls that ought to be in place if the system is operating effectively. Thus, while it is perfectly appropriate for the Commission to further refine its proposed approach as it gains additional experience and knowledge from future examinations of rating agencies, there is no reason for it delay initial development of a control framework until that time.

#### COSO offers an appropriate model for internal controls in the credit rating agency context

In developing a control framework for credit rating agencies, the Commission can look to the COSO framework as a guide. While not developed for internal controls over credit ratings, it



is for the most part still applicable and highly relevant. For example, the five components of internal control identified by COSO are all applicable to credit ratings. They include:

1. **The Control Environment.** This includes factors such as incentives, integrity and ethical values, management’s philosophy and operating style, organizational structure, assignment of authority and responsibility, etc. In the context of the issues identified by the Commission and Senate studies discussed above, this would include such factors as how management communicates its priorities with regard to rating accuracy versus gaining market share, how analysts are insulated from sales and marketing influence, the basis on which personnel are evaluated and promoted, and how development of rating criteria is handled to insulate it from marketing concerns.
2. **Risk Assessment.** This entails ensuring that the entity is “aware of and deal[s] with the risks it faces.”<sup>8</sup> In the context of the recent rating failures, this might include risks that ratings for subprime RMBS and CDOs were based on incomplete data and inaccurate models, that the increase in deal volume was outstripping staffing levels in ways that threatened rating accuracy, that investment banks that controlled a considerable volume of business would seek to use that to influence rating decisions, and more.
3. **Control Activities.** This category typically encompasses a wide range of activities in the areas of approvals, authorizations, verifications, reconciliation of data to ensure accuracy and completeness, and proper segregation of duties. Perhaps most importantly, control activities must include a process for ensuring that the risk assessment done in (2) above impacts the design, implementation and operational effectiveness of these activities. This might include everything from ensuring that ratings are based on sufficient data about the underlying assets in an ABS to ensuring that employees with sales and marketing duties are not permitted to influence ratings decisions.
4. **Information and Communication.** The controls in this area are designed to ensure that communication (and data) flows from the top down as well as bottom up in the credit rating agency. They are also designed to ensure timely communication with regulators, users of the credit rating products, and suppliers of data. For example, both the Commission and the Subcommittee studies uncovered serious problems with communication of ratings criteria, both within the rating agencies themselves and externally to issuers seeking ratings and users of those ratings. Control activities in this area would seek to address those communication issues, among others.
5. **Monitoring.** This includes supervisory activities, management of the processes and controls, and board oversight. Monitoring also ensures that deficiencies in internal controls are identified, that they are reported “up the ladder,” and that serious and material weaknesses in internal controls are reported directly to management and to the board. As noted above, the ability of credit rating agency boards to provide effective monitoring of controls will depend on having a clear, well documented control system in

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<sup>8</sup> *Internal Control – Integrated Framework*, Committee of Sponsoring Organizations of the Treadway Commission, September, 1992.

place. The ability of management to certify the effectiveness of controls also depends on effective monitoring of those controls.

If, contrary to our recommendation, the Commission is not prepared to adopt a final internal control standard at this time, it should at least adopt an interim rule requiring the credit rating agencies to implement internal control structures that include each of the components of the COSO framework, or a similar widely accepted framework. In adopting an interim rule, the Commission should make clear that, when the components of the control framework exist and are operating effectively, it is expected that they will result in the type of specific controls set forth by the Commission in its proposing release. As noted above, the factors the SEC has specified are appropriate controls that should exist and operate effectively if credit ratings are to be credible, timely and reliable. Once the interim rule is operational, the Commission could further refine its control requirements in a final rule based on its experience examining the rating agencies and reviewing their annual reports.

#### Internal Controls Should Include Strong Requirements for Consultation and Quantitative Testing

Effective internal controls, such as those following the COSO model, would be a means to enforce professional standards within NRSROs in an objective, professional, and unbiased way. An element that differentiates the discussion of internal controls in the NRSRO context from controls in other areas (such as accounting) is the relative lack of development for professional standards in the area of credit analysis. Although Section 939E of the Dodd-Frank Act mandates a GAO study regarding the creation of a non-profit professional analysts' organization, no such organization exists today. Accepted methodologies for assessing the credit risk of securitized lending were shown to be fundamentally flawed during the financial crisis. In addition, new types of credit instruments are constantly emerging that require new forms of credit assessment.

Without generally accepted professional standards, it becomes even more important that NRSROs consult unbiased sources of external expertise in developing both their methodologies and standards for analysts. For this reason, internal controls in areas like credit rating methodologies, the permissible use of analyst discretion when applying a methodology, and analyst training and testing, should require the NRSRO to solicit external input from unbiased experts. Another means of ensuring such input would be to require significant credit analysis expertise, especially in quantitative methods, for independent members of the NRSRO board of directors. As an additional safeguard, quantitative testing of methodologies prior to implementation should be required. This is especially important when addressing methodologies for rating new types of structured credit instruments. Back-testing requirements for such instruments may require NRSROs to refrain from rating new instruments until there is significant historical experience from which to draw conclusions.

A documentation standard must be adopted without delay

Regardless of what the Commission decides to do in other areas of the rulemaking, one area that must be addressed without delay is improved documentation of internal controls. The experience with internal controls over financial reporting has taught us that, without adequate documentation standards for internal controls, serious material weaknesses in controls are likely to go undetected. Absent that documentation, SEC inspections will at best be difficult to perform, and effective board oversight of controls will be all but impossible. Moreover, without an adequate documentation standard, the Commission is unlikely to gain the increased understanding of control practices necessary to adopt a more effective final control rule, as contemplated in the proposing release.

For these reasons, it is essential that the Commission, as a part of its current rule proposal, establish a minimum standard for internal control documentation. The standard should state that documentation of internal controls should be sufficient so that a “reasonably experienced person” could review the documentation of the internal controls and testing of those controls and reach similar conclusions with respect to:

- the design of the system of internal controls;
- the evidence obtained and conclusions reached during the testing of the operational effectiveness of the internal controls;
- material weaknesses in internal controls that were identified and how they were remediated;
- how the board of directors conducted its oversight;
- significant matters that arose in the design, operation or monitoring of internal controls and how they were resolved; and
- the basis for reports to the SEC on the operational effectiveness of internal controls and the internal control structure.

The standard should be designed so that the extent of documentation may vary with such factors as the size, structure and business model of the entity, the complexity of the products being rated, the information technology in place, and the competence and experience of personnel.

The resulting documentation must be accessible to the SEC examination staff. Moreover, the information must be accessible to the Commission regardless of whether the credit rating is produced in the United States or elsewhere. Foreign rating agencies that choose to register with the SEC as NRSROs must be required to accept U.S. jurisdiction in this area as a condition of registration. We therefore strongly support the Commission recommendation that internal control documentation be subject to recordkeeping requirements, and we further recommend that the Commission specify a retention period for the records, such as 10 years, just as it does for documentation of controls in the financial reporting context.

## Control reporting requirements need to be strengthened

Finally, while we support the general approach to control reporting proposed in the release, we urge the Commission to modify the proposal to be more explicit about the content of the required reports. Specifically, in addition to including a description of the responsibility of managers for establishing and maintaining an effective internal control structure and assessment of the internal control structure, the rule should specify:

1. The period of time to which management's control assessment relates. That is, the assessment should cover the entire year, as credit ratings are issued to and relied upon by investors throughout the year.
2. The benchmark or framework used in making the assessment of whether appropriate controls are in place and operating effectively.
3. A statement that the board of directors is responsible for the oversight of the system of internal controls and a description of how the board conducts that oversight.
4. If a material weakness in controls was detected during the course of the year, a description of that material weakness as well as whether and how it has been remediated at the time of the report.
5. Any noncompliance with applicable laws or regulations that is identified, consistent with the Yellow Book standards of the General Accountability Office.

Given its wide acceptance and use, the SEC should use the COSO framework as a basis for evaluating and inspecting the assessment of internal controls and the control structure on which management of credit ratings will report.

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The Dodd-Frank provisions on internal controls have the potential to significantly improve credit rating agency practices with regard to rating policies, procedures and methodologies. Given the extensive evidence of fundamental control failures at the rating agencies in ways that directly contributed to the cause and severity of the financial crisis, making those improvements should be a top Commission priority. Unfortunately, the approach to internal controls proposed by the Commission will not achieve that desperately needed reform. We therefore urge the Commission to adopt the strengthening amendments recommended above.

### **B. Conflicts of Interest**

The Credit Rating Agency Reform Act of 2006 gave the Commission sweeping authority "to prohibit, or require the management and disclosure of, any conflicts of interest relating to the issuance of credit ratings by a nationally recognized statistical rating organization." The Act specified areas where the Commission was mandated to adopt rules, including compensation

practices and provision of consulting services, but it in no way limited the Commission's authority to these areas. On the contrary, the act specifically authorized the Commission to adopt rules relating to "any other potential conflict of interest, as the Commission deems necessary or appropriate in the public interest or for the protection of investors."<sup>9</sup>

Section 932(a)(4) of Dodd-Frank amends existing provisions by adding a new requirement that the Commission adopt rules to prevent "sales and marketing considerations" from influencing NRSRO ratings. As an indication of just how seriously Congress viewed such conflicts, it added a provision calling for suspension or revocation of registration of an NRSRO where the Commission finds, after notice and opportunity for a hearing, that the NRSRO violated the rule and the violation affected a rating. Finally, it allows an exception for small ratings agencies where the Commission determines that separation of the ratings and sales and marketing activities is "not appropriate."

The Commission proposal represents a useful step to reduce the influence of conflicts of interest. Moreover, there are aspects of the Commission proposal that we strongly support – in particular the proposal to handle the small NRSRO exemption by providing a mechanism for small NRSROs to apply in writing for such an exemption. However, the Commission has chosen to interpret the directive to address sales- and marketing-related conflicts far too narrowly. Unless these provisions are strengthened significantly they are unlikely to have a meaningful impact on conflicts that the record clearly shows were the primary cause of the massive ratings failures that were a major triggering event of the financial crisis.

#### The problem of sales considerations influencing ratings is pervasive and severe

The Senate Permanent Subcommittee on Investigations report provides a damning portrait of the extent to which conflicts of interest at Moody's and S&P were allowed to affect rating quality. In the words of "multiple former Moody's and S&P employees" cited in the report, "in the years leading up to the financial crisis, gaining market share, increasing revenues, and pleasing investment bankers bringing business to the firm assumed a higher priority than issuing accurate RMBS and CDO credit ratings."<sup>10</sup> Former analysts described how they were made to fear for their jobs if they were not viewed as sufficiently flexible and cooperative by the firm's investment banker clients. As one former analyst told the Subcommittee:

"[T]he fear was real, not rare and not at all healthy. You began to hear of analysts, even whole groups of analysts, at Moody's who had lost their jobs because they were doing their jobs, identifying risks and describing them accurately."

The Senate report also provides evidence that concerns about market share had a direct effect on ratings methodologies. One email uncovered in the investigation, for example, shows S&P management discussing changes to its CDO ratings criteria in response to an "ongoing

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<sup>9</sup> See Credit Rating Agency Reform Act of 2006, available on the SEC website at <http://www.sec.gov/divisions/marketreg/ratingagency/cra-reform-act-2006.pdf>.

<sup>10</sup> Similarly, the Commission study found that analysts were well aware of the agency's business interest in securing the rating of particular deals and that rating agencies did not appear to take steps to prevent considerations of market share and other business interests from influencing ratings or ratings criteria.

threat of losing deals.” Another S&P researcher expressed concern in 2005, as S&P was reportedly delaying a revision of its rating criteria because of concerns about the revision’s impact market share, that “Screwing with criteria to ‘get the deal’ is putting the entire S&P franchise at risk – it’s a bad idea.” Far from working to protect the independence of the ratings process, a third S&P executive suggested a more formal role for the agency’s customers in approving ratings criteria. Having expressed concern that changes to criteria could cost the agency deals, she concluded: “I think the criteria process must include appropriate testing and feedback from the marketplace.”

The Senate report also documents what it describes as “blatant pressure exerted by some investment bankers,” pressure that according to the Subcommittee report produced results. The Subcommittee found, for example, that:

Investment bankers who complained about rating methodologies, criteria, or decisions were often able to obtain exceptions or other favorable treatment. In many instances, the decisions made by the credit rating agencies appeared to cross over from the healthy give and take involved in complex analysis to concessions made to prevent the loss of business.

It also documents instances in which ratings analysts who “became unpopular with investment bankers” were barred from participating in rating their deals.

Conflicts of interest became a growing problem as rating structured finance products came to dominate deal volume. University of Columbia law school professor John C. Coffee, Jr. explained it this way in a recent *Harvard Business Law Review* article:

When the CRAs principally rated corporate bonds, no one client accounted for more than 1% of their business (because even large corporations went to the bond market only intermittently). But as structured finance became the CRAs’ principal profit center, the rating agencies faced a limited number of large investment banks that brought deals to them on a continuing basis (and thus could threaten to take a substantial volume of business elsewhere, if dissatisfied).<sup>11</sup>

In the market for MBS, the top six underwriters controlled over 50 percent of the market, and the top dozen accounted for over 80 percent of market share, according to data cited by Coffee. As a result, “they possessed the ability to threaten credibly that they would take their business elsewhere – a threat that the rating agencies had not previously experienced,” Coffee notes.

Moreover, Coffee cites recent research providing empirical support to anecdotal accounts of conflicts’ influence on ratings quality. Perhaps most significant is a 2010 study of over 900 CDOs issued between January 1997 and December 2007. The analysis gave particular attention to rating agency practices with regard to subordination, a key factor in determining what

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<sup>11</sup> “Ratings Reform: The Good, the Bad, and the Ugly,” by John C. Coffee, Jr., *Harvard Business Law Review*, Vol. 1, 2011.

percentage of an issue will be rated AAA.<sup>12</sup> The study found that the credit rating agencies did not follow a consistent policy or valuation model with respect to subordination, but rather regularly made “adjustments” on subjective grounds. Moreover, although these adjustments could be either positive or negative, 84 percent were positive, increasing the size of the top-rated AAA tranche by “an additional 12.1 percent of the AAA at the time of issue.”

Astoundingly, the researchers found that just 1.3 percent of AAA CDOs closed between 1997 and 2007 met the rating agency’s reported AAA default standard. Had the rating agencies followed their stated models, the researchers estimated that the AAA rated CDO tranches would have been rated closer to BBB. Less surprisingly, as Coffee notes, the researchers found that the amount of the adjustment was positively correlated with future downgrades. “In short,” Coffee concludes, “the evidence shows not that the CRAs’ valuation models were wrong, but that they were systematically overridden by discretionary adjustments in a manner that increased the size of AAA tranches.” A larger study by the staff of the New York Federal Reserve Bank similarly concluded that risk-adjusted subordination declined significantly between 2005 and 2007, at the height of the boom when, in the view of the authors, “the reputational costs of error became modest in relation to the expected profits to the rating agency.”<sup>13</sup>

The current proposal represents a useful step in the right direction, but it is not sufficient

Using authority available to it under CRARA, the Commission has taken previous actions to address some of these conflicts. It has, for example, adopted a rule restricting an individual employee of a rating agency who is involved in producing a rating and developing ratings methodologies from also participating in fee negotiations. And, perhaps even more significantly, it has adopted a rule requiring ratings agencies to disclose “out of model” adjustments and the reasons behind those adjustments. In its current rule release, the Commission proposes to expand on these rules by identifying a new prohibition on NRSRO sales or marketing staff participation in determining or monitoring a credit rating or developing or approving procedures or methodologies used for determining the credit rating, including qualitative or quantitative models.

The Commission proposal is good as far as it goes, but it does not deal adequately with the extent of sales and marketing related conflicts or the myriad ways in which those conflicts have been allowed to influence ratings. To be effective, the ban needs to apply not just to sales and marketing staff involvement in the rating process, but more broadly to any action by any rating agency employee that has the intent or effect of allowing sales and marketing considerations, including concern over building market share, to inappropriately influence the rating process or undermine ratings accuracy. Under such a principles-based approach, practices such as basing analysts’ performance evaluations or compensation on their success in building market share would be covered, as would allowing investment bankers to influence the selection

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<sup>12</sup> See John M. Griffin & Dragon Yongjun Tang, *Did Subjectivity Play A Role in CDO Credit Ratings?* 17 (McCombs Research Paper Series, Paper No. FIN-04-10 2010), available at <http://ssrn.com/abstract=1364933>, as cited in Coffee, *The Good, the Bad, and the Ugly*.

<sup>13</sup> See Adam Ashcraft, Paul Goldsmith-Pinkham & James Vickery, FED. RESERVE BANK OF N.Y., STAFF REPORT NO. 449, *MBS RATINGS AND THE MORTGAGE CREDIT BOOM* at 5 (May 2010) as cited in Coffee, *The Good, the Bad, and the Ugly*.

of analysts involved in rating their deals. Delaying revisions to ratings models because of concerns about their impact on market share would also run afoul of such a rule.

The legislative language in Dodd-Frank clearly provides the Commission with the broad authority it needs to adopt such an approach. The Commission's mandate is not just to prevent sales and marketing personnel's involvement in the ratings process, after all, but "to prevent sales and marketing considerations of an NRSRO from influencing the production of credit ratings by the NRSRO." That calls for a broader approach than the narrow mechanistic rule proposed by the Commission. Moreover, if the Commission took that broader approach, ratings agencies that faced suspension or revocation of their NRSRO registration for violations would have a strong incentive to ensure that sales and marketing concerns are not allowed to influence ratings – and the Commission would have the tools it needs to clean up pervasive abuses in rating agency practices.

#### A broad principles-based ban would need to be supplemented with more concrete guidance

The Commission would likely need to provide additional guidance on how to implement such a rule. Its proposed ban on sales and marketing staff involvement in the ratings process would be one component. However, we would encourage the Commission to think more broadly about other practices that should be banned or restricted to achieve this goal of preventing sales and marketing considerations from influencing ratings. For example, it might be appropriate to adopt restrictions to ensure that communication between employees (including management) involved in sales and marketing activities and those involved in producing ratings and developing ratings methodologies is both limited and carefully monitored. In addition, compensation practices would have to be designed to ensure that they did not inappropriately link analyst compensation to business considerations. Some of the reforms included in the equity analyst settlement might provide a useful guide. Ultimately, however, to be effective, the principles-based ban on allowing sales- and marketing-related considerations to influence ratings would have to be enforceable even absent a specific rule violation.

#### The small NRSRO exemption would need to reflect this broader ban

A small NRSRO might find it difficult if not impossible to maintain the strict separation of ratings activities and marketing activities called for under our suggested approach. We nonetheless continue to believe that the Commission's proposed approach to small firm exemptions is an appropriate one, with a few adjustments to reflect the broader reach of our proposed ban. Specifically, we encourage the Commission to maintain its proposed requirement that small NRSROs submit written applications for an exemption from the ban. As part of its exemption application, the NRSRO should be required to discuss what steps it is taking to ensure that sales and marketing considerations are not allowed to inappropriately influence rating decisions. This issue would also have to be addressed as part of the NRSRO's internal control structure, and the NRSRO would need to document compliance with the procedures. In their annual examinations, Commission staff would need to pay close attention to whether these procedures are operating effectively and, where they are not operating effectively, to require alterations to address any short-comings. Indeed, it is even more important that the Commission not adopt an outright exemption for small NRSROs if the rule is cast more broadly, as we



recommend. To do so would be to legitimize practices that allow marketing concerns to influence ratings, something that the Commission cannot in good conscience do. Moreover, while user- or subscriber-pays NRSROs may face less severe conflicts than those inherent in the issuer-pays model, they are not entirely immune from such considerations, which might for example take the form of investor resistance to downgrades of a security they hold. They should therefore not be exempt from requirements in this area. Instead, the steps they take to address those conflicts should be tailored to match their business model.

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Although Dodd-Frank fails to ban the issuer-pays business model out-right, it and the CRARA between them give the Commission broad authority to address conflicts associated with that business model. That authority would also apply to any other conflict that might affect rating quality, including conflicts present in investor- or subscriber-pays business models. So far, however, the Commission has been overly timid in exercising this authority. The rule proposal put forward by the Commission to address conflicts of interest, while useful, does not begin to match the scope or severity of the problem. We urge you to take this opportunity to rectify that regulatory failure by adopting broad new principles-based rules prohibiting sales and marketing considerations from influencing ratings. If effectively enforced, and particularly if combined with strengthened standards for internal controls, such a rule could significantly reduce the risks of another massive rating failure like the one that helped to trigger the financial crisis.

## **II. The Following Flawed Provisions Require More Modest Revisions**

### **A. Methodology**

Section 932(a)(8) of Dodd-Frank gives the Commission new rulemaking authority with regard to credit rating agency methodologies. The provisions respond directly to a number of problems that have been identified with the way in which rating agencies were developing and implementing their rating criteria in the years leading up to the financial crisis. That includes evidence that the ratings assigned did not always conform to rating criteria, that changes in methodology were not always applied in a timely fashion to outstanding ratings, that certain favored clients were given special exemptions from rating criteria, and that the rating process generally was susceptible to outside influence.

In order to clean up such abuses, the legislation directs the Commission to promulgate rules to ensure that all ratings are determined using procedures and methodologies that have been approved by the board of directors and that are in accordance with the rating agency's policies and procedures for the development and modification of rating procedures and methodologies. The legislation further requires the Commission to adopt rules to ensure that: when material changes are made to rating methodologies and procedures, the changes are applied consistently to all credit ratings to which they apply; that any such changes, including changes to surveillance procedures, are applied to all then-current credit ratings within a reasonable time period to be set by the Commission; and that the NRSRO publicly discloses the reason for the change. Finally,

the Commission is directed to adopt rules requiring NRSROs to notify users of credit ratings of the version of the rating methodology used for a particular rating, when a material change is made to the methodology and the likelihood that the change will result in a rating action, and when a significant error is identified in a methodology that may result in a rating action.

We support the general approach proposed by the Commission. This approach consists of: 1) requiring NRSROs to establish, maintain, enforce, and document policies and procedures that are reasonably designed to ensure the objectives identified in this section of the statute are met and 2) supplementing that general requirement with specific objectives that the policies and procedures would need to be reasonably designed to achieve both in design and operation. There are two areas, however, where we believe the rules need to be strengthened.

First and foremost, it is essential that the Commission specify a time period in which changes to rating methodologies would have to be applied to then-current ratings. The Commission suggests in the proposing release that it is reluctant to do so, in part, because “prescribing a timeframe that is too long could create an inadvertent ‘safe harbor’ allowing the NRSRO to act more slowly to apply the changed surveillance procedures and methodologies to the impacted obligors, securities, and money market instruments.” But failing to set any time limit provides precisely the same sort of “safe harbor.” A better approach would be to set a relatively tight deadline, such as 60 days, and then provide a mechanism for rating agencies to apply for an extension in exigent circumstances. This would be consistent with the statutory language, which clearly anticipates that the Commission would designate a time period for the change to be implemented.

We would also suggest that the word “notify” used in the legislation implies a more direct communication than simply updating website-based disclosures. One possible approach would be to permit users of ratings to sign up for alerts regarding rating changes. This is commonly available technology that would significantly improve communication. Improving communication in this area is particularly important with regard to errors that could result in rating actions, but, if the goal is to ensure that users of ratings are well informed about the nature and limitations of those ratings, it also applies to changes generally. Given the technological ease of establishing more robust communications, we would strongly encourage the Commission to require rating agencies to adopt some form of alert system for users of their ratings.

## **B. Analyst Training, Testing and Experience**

Section 936 of Dodd-Frank requires the SEC to issue rules reasonably designed to ensure that any person employed by an NRSRO to perform ratings: 1) meets standards of training, experience, and competence necessary to produce accurate ratings for the categories of issuers whose securities the person rates and 2) is tested for knowledge of the rating process. The Commission proposes to implement this section by requiring each NRSRO to design and administer standards of training, experience, and competence. While deferring to the NRSROs on specifics, the Commission proposes general factors that NRSROs would be required to consider when designing training standards, taking into account the different functions and responsibilities of individual employees as well as the different procedures and methodologies they use to produce ratings. In addition, the Commission proposes to require NRSROs to adopt a

periodic testing requirement for individuals employed to determine ratings on their knowledge of the procedures and methodologies used by the NRSRO to determine credit ratings in the classes or subclasses of credit ratings for which the individual participates. And, to fulfill the experience standard, it proposes to require that at least one individual with three years or more experience in performing credit analysis participates in the determination of a credit rating.

The four factors proposed by the Commission to be taken into account in the design of training programs are appropriate, if somewhat vague. In particular, we would encourage the Commission to adopt an additional explicit requirement that recognizes that new and untested classes or subclasses of securities may require more training (and more specialized expertise) to rate than those in a class with a longer track record. The same is true for customized or highly complex securities, for those where the rating is particularly sensitive to the underlying assumptions, or where qualitative factors are particularly important to the rating decision. While we share the Commission's view that the vast differences among the NRSROs will demand different approaches to training, we are not convinced that rating agencies who have under-invested in the rating process can be relied on to adopt rigorous training programs. Ultimately, some private certification program (along the line of the CFA Institute for equity analysts) may be needed to raise the standards of professionalism in this area.

Where the Commission proposal really goes wrong, however, is in its proposals on testing and experience. The proposal to leave it entirely in the hands of the NRSRO to determine the frequency and manner of testing is completely unacceptable. At the very least, the Commission should establish a minimum testing standard. It should at the very least include a requirement for testing before the employee begins rating a new class or sub-class of ratings and might include additional testing before the employee takes on new responsibilities (e.g., lead analyst role or supervisory role) or when the NRSRO makes significant changes to its procedures and methodologies.

The requirement for three years of generic credit analysis experience is similarly weak. Indeed, we suspect the NRSROs would have adopted stricter standards had the Commission remained silent on the issue. At the very least, the Commission should survey the current NRSROs to establish a baseline of information about experience of analysts, lead analysts, and supervisory personnel currently employed at the agency. We suspect this data will support establishment of a much higher experience standard than that currently proposed. In addition, the Commission should set higher experience standards with regard to rating of complex or customized securities or those without a proven track record. On the other hand, we strongly support the Commission proposal to make training, testing, and experience policies subject to recordkeeping requirements. The Commission should make clear that this includes testing results. A testing requirement is meaningless without accountability for how results are used.

While issues of training, testing, and experience are not central to the issues that led to the financial crisis, they could take on increased importance if more small, less experienced rating agencies register as NRSROs. The Commission should take steps now to ensure that its requirements in this area set an appropriately high bar, particularly in high-risk areas, and lay the foundation for increased professionalism in the rating process.

### **C. Look-Back Reviews**

One aspect of Dodd-Frank's provisions to deal with conflicts of interest is its requirement that NRSROs have policies in place to deal with situations in which an NRSRO employee goes to work for a customer for whom the employee played a role in determining a rating. Specifically, with regard to ratings actions taken within the preceding year, the NRSRO is required to conduct a review to determine whether any conflicts of interest of the employee influenced the rating and to revise the rating as appropriate. The Commission proposes to adopt rules implementing the provision by requiring, at a minimum, that the NRSRO establish, maintain, and enforce policies and procedures that are reasonably designed to ensure that the NRSRO: 1) immediately places the rating on credit watch; 2) promptly determines whether the rating must be revised so that it is solely the product of the NRSRO's documented procedures and methodologies; and 3) promptly publishes a revised rating or reaffirms the rating, as appropriate.

The Commission appropriately proposes to require disclosures that would enable users of ratings to determine the reason the rating was being put on watch. We also support the Commission proposal to require the rating agency to put the affected rating on watch immediately and not wait to act until after they determine the impact of the conflict. Investors have a right to be alerted promptly that there might be a problem. Moreover, this will provide an incentive for the rating agency to act promptly to address any potential problems. (Where the rating agency in question only makes its ratings available to subscribers, the rating agency could satisfy this requirement by providing notice to its subscribers in whatever format it typically uses to convey ratings actions to those subscribers.) Although the Act does not specify that the above policies and procedures would have to be documented, the Commission suggests that documentation would be necessary to carry out the statute's mandate. It further suggests that they should be subject to the record-keeping rules. We strongly agree.

The Commission requests comment on whether this proposal exceeds its authority by regulating rating policies, procedures, and methodologies. Clearly, however, the proposal is simply designed to ensure that the rating agency follows its own methodologies in cases where a specific form of conflict has been identified. As the Commission notes in the proposing release, the rating agency would remain free to apply its own procedures for determining whether the rating would need to be changed. Moreover, we agree with the Commission that these are prudent steps the ratings agency would reasonably be expected to take under the circumstances.

The problem with this proposal is not that it goes too far but that it does nothing to address the more serious situation in which this sort of conflict has influenced the rating agency's rating criteria or other aspects of its rating methodology. The Commission could rectify this shortcoming without straying into the area of dictating the substance of ratings methodologies by requiring the rating agency to conduct a review of whether the conflict in question influenced those methodologies and procedures and take corrective action if they find that to be the case. This would arguably only be required in the limited number of circumstances in which the former employee had been directly involved in determining the firm's rating methodology. However, failing to require this added review in these circumstances would leave unaddressed the systemic effects of conflicts revealed in the recent crisis. Indeed, using the

standard of ensuring the rating was performed according to the documented methodology and procedures could do more harm than good if the procedures and methodologies themselves are compromised.

#### **D. Third-Party Due Diligence Reviews**

Consistent with its goal of improving the quality of due diligence used in developing asset-backed securities (ABS) and determining ratings, Section 932(a)(8) of the Dodd-Frank Act adds new requirements with regard to third-party due diligence reports for these securities. The first paragraph of the provision requires the issuer or underwriter of any Exchange Act-ABS to make publicly available the findings and conclusions of any third-party due diligence report obtained by the issuer or underwriter. In addition, when an issuer, underwriter or NRSRO employs a third-party due diligence service, the entity that employs the due diligence service is required to provide to any NRSRO that produces a rating to which the service relates written certification, in a form determined by the Commission, to ensure that the providers of the due diligence services have conducted a thorough review of data, documentation, and other relevant information necessary for an NRSRO to provide an accurate rating. Finally, when an NRSRO produces a rating that utilizes the report of the third-party due diligence service, the NRSRO must disclose the certification in a manner that allows the public to determine the adequacy and level of due diligence services provided by the third party.

In general, we believe the Commission has done a good job of defining due diligence reports covered by the rule as well as the content of the required certifications. In particular, the Commission has done a good job of spelling out the information the certification would have to contain with regard to the scope and manner of the review in a way that should ensure that the disclosures provide meaningful information rather than boilerplate. We do not believe the Commission should be more detailed in describing the procedures a due diligence service would have to follow to carry out the review. We share the view, cited by the Commission, that the variation for reviews of different types of offerings is likely to be significant and that this area therefore is better served by principles-based standards than by prescriptive rules. (As it goes forward, the Commission should continue to evaluate whether existing standards are sufficient.)

The Commission appears to have struggled, however, to come up with an appropriate disclosure approach for the certifications. The legislation is admittedly convoluted in its approach to establishing this due diligence disclosure regime. In particular, it raises the question of how the Commission is to read the statute's dual requirements for disclosure by issuers and underwriters on the one hand and by NRSROs on the other. When the Commission released its rule proposal implementing Section 945 of Dodd-Frank last October, it proposed to require issuers and underwriters of any registered Exchange Act ABS to disclose the findings and conclusions of any third party engaged to perform a due diligence review in the prospectus. For unregistered transactions, the issuer would have been required to file a form containing the same information with the Commission on EDGAR five business days prior to the first sale of the offering. Unfortunately, at the urging of industry, the Commission now proposes to withdraw that approach, which would have ensured easy access to the information for any investor in the offering. The revised disclosure regime proposed by the Commission is unnecessarily complex and should be simplified.

The most logical approach is for the Commission to create a website database where the findings and conclusions of the third-party due diligence services would be centralized and made available to any NRSRO that is producing a rating for the offering in question. Under this approach, the reports would also be available to any other investor or market participant interested in obtaining that information. Indeed, investors who are performing their own risk analysis and not relying on ratings may have even greater need than other investors of the information in the due diligence reports. By adopting a disclosure mechanism that is not primarily dependent on the rating agencies, the Commission would promote ease of access to the information for these investors as well as for the users of credit ratings, an appropriate goal in light of congressional intent to reduce reliance on ratings.

The information would have to be made available on the database in a way that makes it easy for NRSROs and other users of the information to identify the offering to which it relates. It might also be appropriate to include a notification system that would allow users of the database to receive alerts when due diligence reports for particular types of offerings are entered into the database. Particularly if such a notification method were built into the database, it would be appropriate to deem submission of the certification as constructive receipt of the certification by an NRSRO. A less attractive but still acceptable alternative would be to design the database to be easily searchable so that an NRSRO could readily identify those reports that relate to offerings on which it is producing a rating.

Because the findings would be made publicly available through the database, this approach could also eliminate the convoluted system proposed by the Commission that would require the issuer or underwriter to get a representation from each credit rating agency engaged in producing a rating that the rating agency in question will publicly disclose the findings of the due-diligence reports five days before the first sale of the offering. Instead, the issuer or underwriter could verify that the information was publicly available through the Commission website five days before the sale. (Ideally, the issuer or underwriter would also be required to provide a link to that disclosure with the pre-sale information about the offering.) The rating agencies would then be solely responsible for their own disclosures, not for fulfilling the issuer or underwriter's five-day pre-sale disclosure requirement.

There may be other disclosure approaches that would achieve the same results. We would support any approach that provides a simple straightforward mechanism to ensure that third-party due diligence reports are made readily available both to any NRSRO producing a rating on the offering in question and to the investing public more generally. The current approach proposed by the Commission does not meet this test for ease of use.

## **E. Universal Ratings**

Section 938(a) of Dodd-Frank requires the Commission to issue rules requiring NRSROs to establish, maintain, and enforce written policies and procedures that: 1) assess the probability that the issuer of a security or money market instrument will default, fail to make timely payments, or otherwise not make payments to investors in accordance with the terms of the security or money market instrument; 2) clearly define and disclose the meaning of any symbol

used by the NRSRO to denote a credit rating; and 3) apply any such symbol in a manner that is consistent for all types of securities and money market instruments for which the symbol is used. Section 938(b) makes clear that rating agencies are free to use “distinct sets of symbols to denote credit ratings for different types of securities or money market instruments.” The Commission is proposing that the rule text mirror the statutory language, but with the addition of a requirement that the NRSRO document its policies. This added documentation requirement is essential to ensure the Commission’s ability to examine for compliance, as well as for the NRSRO’s own internal controls and compliance effectiveness.

Unfortunately, although the proposed rule mirrors the statutory language, the proposing release provides so little discussion of what is intended by this rule that it leaves completely ambiguous whether it will be applied in a way that achieves the goal of promoting universal ratings. The Report of the Committee on Banking, Housing and Urban Affairs leaves no doubt as to what Congress intended to achieve with this requirement when it states: “The Committee believes that an NRSRO’s credit rating symbol should have the same meaning about creditworthiness when it is applied to any issuer – the same symbol should not have different meaning depending on the issuer.”<sup>14</sup>

Of particular concern to Congress in adopting the provision is the higher costs state and local governments pay because of the more conservative standards applied to these ratings, but the provision is also directly relevant to problems with inflated ratings for structured finance products. As the Senate Permanent Subcommittee report points out, AAA rated investments have traditionally had “a less than 1% probability of incurring defaults.” For subprime RMBS originated in 2006 and 2007, however, over 90% of the AAA ratings were later downgraded to junk status, according to the report. As noted above, research looking at CDO ratings over a 10-year period found that only 1.3% of AAA-rated CDOs actually met the rating agency default standards for a triple-A rating. Had the rating agencies actually applied their rating criteria consistently, these CDOs would have carried ratings roughly equivalent to a BBB, according to the research, and a lot of damage to our financial markets might have been avoided.

Moreover, the disparity in default rates was already evident well before the housing bubble burst. Examining Moody’s system, for example, one analyst found that just 2.2 percent of corporate bonds rated Baa (Moody’s lowest investment-grade rating) defaulted during each five-year period from 1983 to 2005. For CDOs with the same rating, the average five-year default rate from 1993 to 2005 was 24 percent. For municipal bonds with the same rating, the five-year default rate was less than one-tenth of one percent.<sup>15</sup>

In its limited discussion of this provision, the Commission fails to make clear how it will enforce the requirement that ratings be based on an assessment of the likelihood of default and applied consistently across different ratings categories. What standards will the Commission use to determine whether ratings are being applied consistently across categories of ratings? The

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<sup>14</sup> Committee Report, U.S. Senate Committee on Banking, Housing and Urban Affairs, Report No. 111-176, The Restoring American Financial Stability Act of 2010, April 30, 2010, available at: <http://banking.senate.gov/public/ files/RAFSAPostedCommitteeReport.pdf>.

<sup>15</sup> Mendales, Richard E., “Collateralized Explosive Devices: Why Securities Regulation Failed to Prevent the CDO Meltdown, and How to Fix It,” University of Illinois Law Review.

performance disclosures required in a separate section of the rule proposal could be used to provide a basis for enforcement, since ratings agencies will be required to report aggregated numbers showing how ratings in each asset class have performed in terms of transitions and defaults. But what steps will the rating agencies be required to take if their performance numbers reveal discrepancies in the performance of ratings across different rating categories?

It appears from the release that the Commission has given little if any thought to these questions, which are central to the provision's effectiveness. We urge the Commission to provide additional guidance on these issues before it finalizes the rule in order to ensure that the rule has the effect intended by Congress.

### **III. The Following Provisions Appear to be Generally on the Right Track**

#### **A. Performance Disclosures**

Following passage of the Credit Rating Agency Reform Act of 2006, the Commission adopted rules requiring rating agencies to disclose performance statistics for their ratings. The purpose of the disclosures is both to enable users of ratings to assess the relative accuracy and reliability of the various rating agencies and to make the rating agencies more accountable for producing reliable ratings. In September, the Government Accountability Office (GAO) issued a report that analyzed the performance disclosures.<sup>16</sup> The report found serious short-comings in the performance disclosures, most notably that, "because SEC did not specify how NRSROs should calculate these statistics, the NRSROs used varied methodologies, limiting their comparability." In addition, GAO concluded that, "the ratings history data sets do not contain enough information to construct comparable performance statistics and are not representative of the population of credit ratings at each NRSRO. Without better disclosures, the information being provided will not serve its intended purpose of increasing transparency."

Section 932(a)(8) of Dodd Frank requires the Commission to take steps to improve the quality of performance disclosures. The Act specifies that the Commission's rules must, at a minimum, require disclosures: 1) that are comparable among NRSROs; 2) are clear and informative for investors with a wide range of sophistication; 3) include performance information over a range of years and for a variety of types of credit ratings (including withdrawn ratings); and 4) are appropriate to the business model of the NRSRO. It further requires that the disclosures be published and made freely available by the NRSRO on an easily accessible portion of the NRSRO website (and in writing, when requested). Finally, it requires that the NRSRO include an attestation with each rating issued that it was not influenced by any other business activities and was based solely on the merits of the instrument being rated and was an independent evaluation of the risks and merits of the instrument.

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<sup>16</sup> *SECURITIES AND EXCHANGE COMMISSION: Action Needed to Improve Rating Agency Registration Program and Performance-Related Disclosures*, Government Accountability Office, September 2010 (GAO-10-782) available at: <http://www.gao.gov/new.items/d10782.pdf>.



The Commission proposes to implement this requirement primarily by enhancing the current requirements to publish performance statistics and ratings histories. Specifically, it proposes to:

- prescribe a methodology an NRSRO must use to calculate and present the performance measurement statistics;
- limit the information the NRSRO can include in the Exhibit to default and transition rates, plus certain limited supplemental information; and
- standardize the presentation of the default and transition rates.

Each of these proposals is directly responsive both to the statutory mandate to improve comparability of performance disclosures and to the GAO recommendations for achieving that goal. We strongly support all three changes. Indeed, we do not believe the Commission could satisfy the mandate for enhanced comparability without adopting these changes. In addition, we support specific aspects of the Commission proposal, including its proposal to add new sub-classes of ABS, to use a standardized definition of default for the performance tables, and to include withdrawn ratings in the data.

The Commission proposes to require transition and default rates based on the single cohort approach. In its analysis, GAO described benefits of both the single cohort and the average cohort approach. The single cohort approach “is useful for describing the historical experience of a particular group of ratings under a particular set of circumstances. Single cohort transition matrixes are thus useful as predictors of the performance of ratings in future time periods under similar circumstances, but they are less useful as predictors of the performance of ratings in future time periods under different economic and other conditions.” In contrast, the average cohort approach “describes the NRSRO’s performance during an average 1-, 3-, or 10-year time period. As such, average cohort transition rates are useful indicators of expected transition rates in the future, given that future economic and other conditions are unknown.”

While we think the Commission decision to require the single cohort approach satisfies the Dodd-Frank mandate of promoting comparability, we encourage the Commission to consider whether users of ratings wouldn’t be better served by requiring NRSROs to produce separate tables using each approach. That way, investors and other users of ratings could decide for themselves which provides the most relevant information. Assuming this would not impose an undue burden on NRSROs, we believe the benefits could be significant.

Transition and Default Matrix: Overall, we find the proposed transition and default matrix to be clear and usable. Still, we believe less sophisticated investors might benefit from a few minor adjustments.<sup>17</sup> Specifically, we do not believe less sophisticated investors will automatically understand what is meant by the term “transition.” This could be addressed by adding a new heading: “Status of those ratings at the end of the time period.” In addition, it

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<sup>17</sup> We are not convinced that unsophisticated investors are likely to make extensive use of these disclosures. However, given the statutory mandate that the disclosures be useful for investors of varying degrees of sophistication, these suggested changes might be appropriate.

might be useful to highlight (for example with gray shading) the box on the chart that corresponds with the rating's being the same at the end of the period as it was at the beginning.

Enhancement to Disclosures of Rating Histories: We support the Commission proposal to enhance disclosure of rating histories by eliminating the current “10% rule” and improving the existing “100% rule.” Specifically, we strongly support the proposal to expand the rule to cover all outstanding credit ratings in each class and subclass of credit ratings for which the NRSRO is registered and to cover all ratings regardless of the rating agency business model. The Commission has done a good job of identifying the information that should have to be disclosed. In order to make the disclosures more useful to less sophisticated users of ratings, the Commission should require the NRSRO to include the definition it gives to the particular notch on the rating scale along with the rating being disclosed.

### **B. Form and Certifications to Accompany Credit Ratings**

One reason rating agencies were able to play fast and loose with their own rating methodologies is that the ratings were a sort of “black box,” with little information made available to the users of those ratings about the assumptions that lay behind them or the data on which they were based. Dodd-Frank includes provisions to address this problem by requiring new disclosures to accompany the publication of a rating. The legislation specifies that these disclosures should include information relating to the assumptions underlying the credit rating procedures and methodologies, the data that was relied on to determine the credit rating, and, if applicable, how the NRSRO used servicer or remittance reports, and with what frequency, to conduct surveillance of the credit rating. It also requires disclosure of information that can be used by investors and other users of credit ratings to better understand credit ratings in each class of credit rating issued by the NRSRO. It requires that the information be made readily available to users of credit ratings, in electronic or paper form, as the Commission by rule determines. Finally, it requires disclosure of any certifications from providers of third-party due diligence services in a manner that allows the public to determine the adequacy and level of due diligence services provided by that third party.<sup>18</sup>

To comply with this requirement, the Commission proposes to require NRSROs to publish a form containing information about the rating action each time it takes a rating action. Importantly, the Commission proposes to include preliminary ratings among the actions that would trigger the required disclosures. We strongly support this approach, which is essential to ensure that investors in ABS get the information at time when it is likely to be most useful to them in making an investment decision. Moreover, to promote informed investment decision-making, we believe it would be appropriate for the Commission to require that these disclosures be made at least five days before the first sale of the offering.

The Commission requests comment on whether the information included in the form is relevant for actions other than preliminary or initial ratings. We believe that it is. For example, if the user of a rating is notified of a downgrade or default on a particular rating, seeing information about the assumptions and data underlying the rating might help that user to anticipate problems with other ratings based on similar assumptions and data. Since this

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<sup>18</sup> See above for a discussion of the required due diligence disclosures.

information will be delivered primarily through electronic means, the costs of making it available in these situations should be minimal and should be greatly outweighed by the benefits.

We believe the usefulness of the disclosures could be improved if the Commission were to prescribe the form of the disclosures, or at least provide greater guidance in this area. Without providing greater guidance or specificity, the Commission risks having these disclosures diverge significantly in clarity of presentation. “Easy to use” and “helpful” are highly subjective terms. Absent clearer guidance, we fear the Commission could find it difficult to challenge sub-standard disclosures on this basis. At the very least, we encourage the Commission to require a table of contents and standard headings for the required disclosures. In addition, specifying the order in which the required topics would have to be presented would promote ease of use. Such an approach would promote comparability while still leaving flexibility for the rating agencies to customize their disclosures. If the Commission chooses not to provide greater guidance at this time, it will need to closely monitor the quality of disclosures to determine whether additional rule-making is required.

Improvements Needed to Content: There are several areas where improvements or refinements are needed to the content of the disclosures.

- The proposed rule requires the NRSRO to provide “information” in each of the prescribed areas. That should be revised to clarify that the disclosures must be sufficiently detailed to enable a knowledgeable user of the ratings to assess the topic (e.g., assumptions underlying the rating) and draw their own conclusions with regard to that topic.
- The Commission should specify that under disclosure regarding either limitations on the rating or the uncertainty of the rating, the rating agency would have to address the heightened uncertainty associated with ratings of offerings that do not have an extensive track record, customized or complex securities, or areas where the rating agency has limited data on which to base a rating.
- The Commission should make clear that the required disclosures on potential limitations should do more than list the risks that are not assessed as part of the rating.
- With regard to disclosures of the sensitivity to assumptions, the Commission should require the NRSROs to be specific about the events (and the magnitude of those events) that would cause the rating to be in error (e.g., a 5% drop in housing prices).
- With regard to disclosures about conflicts of interest, the three areas identified by the Commission for disclosure are all appropriate, but they do not encompass the full range of conflicts or the even the most important of those conflicts. For example, at least for issuer-paid ratings of ABS, the biggest source of the conflict is likely to be the volume of business a particular investment bank controls and the degree to which the rating agency’s profitability depends on that business. The Commission should therefore require the NRSRO to disclose the revenue the NRSRO received from that particular

issuer in the previous year (or other appropriate time period) both as an absolute amount and as a percentage of the NRSRO's revenues for that particular product category.

Finally, once the disclosure requirements become operational, the Commission will need to take steps to ensure that they provide useful information and do not devolve into meaningless boilerplate. In this regard, we are concerned by the Commission's request for comment with regard to disclosure of proprietary information. It is clear that Congress intended robust disclosure in such areas as underlying assumptions and data, so that ratings would no longer be opaque and therefore immune to analysis by the users of those ratings. Rating agencies must not be allowed to use arguments about proprietary information to evade these requirements or to succeed in making the disclosures so vague as to be meaningless.

\* \* \*

The disclosure requirements included in Dodd-Frank have to the potential to assist investors and other market participants to be more educated users of ratings. Perhaps even more significantly, they create an incentive for rating agencies to follow more rigorous and independent rating procedures. It is commonly said that, "You manage what you measure." The same can be said for disclosures. Rating agencies that have to disclose their data analysis practices, for example, are likely to adopt more robust data analysis procedures. If they have to disclose the assumptions behind their ratings methodologies, they may similarly be more likely to adhere closely to those methodologies. And, if they have to make clear disclosure of conflicts, they may take more meaningful steps to appropriately manage those conflicts. It is therefore essential that the Commission adopt a strong set of disclosure rules. With the amendments recommended above, we believe the Commission proposal would meet that standard and thus would deliver significant benefits to users of ratings.

## **Conclusion**

Despite congressional attempts to reduce regulatory reliance on ratings, it is all but certain that they will continue to serve as an important source of credit information for investors and other market participants. Flawed as the rating agencies have shown themselves to be, it simply is not realistic to expect that every investor – or for that matter, every community bank – will start from scratch in making an independent assessment of the credit risks of the securities in which they invest. Congress recognized that fact when it included, in addition to the provisions to reduce regulatory reliance on ratings, additional provisions to improve the reliability of ratings. Whether the provisions deliver the promised reforms in rating agency practices will depend in large part on the effectiveness of the rule proposals addressed in the current rule release. It is absolutely imperative, therefore, that the Commission remedy the fatal weaknesses in its proposals on internal controls and conflicts of interest. Once a good rule is in place, the Commission must follow up with tough enforcement and a willingness to impose penalties in any case where an NRSRO is improperly influenced by customer pressure to compromise ratings assessments. With the country still suffering the ill effects of the last ratings failure, we can ill afford another missed opportunity to eradicate the influence of conflicts of interest on rating quality and to clean up the deeply flawed rating practices that result.

Respectfully submitted,

Barbara Roper  
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Consumer Federation of America

Marcus Stanley  
Policy Director  
Americans for Financial Reform

Cc: Chairman Mary Schapiro  
Commissioner Luis Aguilar  
Commissioner Kathleen Casey  
Commissioner Troy Paredes  
Commissioner Elisse Walter

## Appendix A:

### **Following are the partners of Americans for Financial Reform.**

*All the organizations support the overall principles of AFR and are working for an accountable, fair and secure financial system. Not all of these organizations work on all of the issues covered by the coalition or have signed on to every statement.*

- A New Way Forward
- AARP
- AFL-CIO
- AFSCME
- Alliance For Justice
- Americans for Democratic Action, Inc
- American Income Life Insurance
- Americans United for Change
- Campaign for America's Future
- Campaign Money
- Center for Digital Democracy
- Center for Economic and Policy Research
- Center for Economic Progress
- Center for Media and Democracy
- Center for Responsible Lending
- Center for Justice and Democracy
- Center of Concern
- Change to Win
- Clean Yield Asset Management
- Coastal Enterprises Inc.
- Color of Change
- Common Cause
- Communications Workers of America
- Community Development Transportation Lending Services
- Consumer Action
- Consumer Association Council
- Consumers for Auto Safety and Reliability
- Consumer Federation of America
- Consumer Watchdog
- Consumers Union
- Corporation for Enterprise Development
- CREDO Mobile
- CTW Investment Group
- Demos
- Economic Affairs Bureau/Dollars & Sense
- Economic Policy Institute
- Essential Action
- Greenlining Institute
- Good Business International
- HNMA Funding Company
- Home Actions
- Housing Counseling Services
- Information Press

- Institute for Global Communications
- Institute for Policy Studies: Global Economy Project
- International Brotherhood of Teamsters
- Institute of Women’s Policy Research
- Krull & Company
- Laborers’ International Union of North America
- Lake Research Partners
- Lawyers' Committee for Civil Rights Under Law
- Move On
- NASCAT
- National Association of Consumer Advocates
- National Association of Neighborhoods
- National Community Reinvestment Coalition
- National Consumer Law Center (on behalf of its low-income clients)
- National Consumers League
- National Council of La Raza
- National Fair Housing Alliance
- National Federation of Community Development Credit Unions
- National Housing Trust
- National Housing Trust Community Development Fund
- National NeighborWorks Association
- National People’s Action
- National Council of Women’s Organizations
- Next Step
- OMB Watch
- OpenTheGovernment.org
- Opportunity Finance Network
- Partners for the Common Good
- PICO
- Progress Now Action
- Progressive States Network
- Poverty and Race Research Action Council
- Public Citizen
- Sargent Shriver Center on Poverty Law
- SEIU
- State Voices
- Taxpayer’s for Common Sense
- The Association for Housing and Neighborhood Development
- The Fuel Savers Club
- The Institute for College Access & Success
- The Leadership Conference on Civil and Human Rights
- The Seminal
- TICAS
- U.S. Public Interest Research Group (PIRG)
- UNITE HERE
- United Food and Commercial Workers
- United States Student Association
- USAction
- Veris Wealth Partners
- Western States Center
- We the People Now
- Woodstock Institute
- World Privacy Forum

- UNET
- Union Plus
- Unitarian Universalist for a Just Economic Community

*Partial list of State and Local Signers*

- Alaska PIRG
- Arizona PIRG
- Arizona Advocacy Network
- Arizonans For Responsible Lending
- Association for Neighborhood and Housing Development NY
- Audubon Partnership for Economic Development LDC, New York NY
- BAC Funding Consortium Inc., Miami FL
- Beech Capital Venture Corporation, Philadelphia PA
- California PIRG
- California Reinvestment Coalition
- Century Housing Corporation, Culver City CA
- CHANGER NY
- Chautauqua Home Rehabilitation and Improvement Corporation (NY)
- Chicago Community Loan Fund, Chicago IL
- Chicago Community Ventures, Chicago IL
- Chicago Consumer Coalition
- Citizen Potawatomi CDC, Shawnee OK
- Colorado PIRG
- Coalition on Homeless Housing in Ohio
- Community Capital Fund, Bridgeport CT
- Community Capital of Maryland, Baltimore MD
- Community Development Financial Institution of the Tohono O'odham Nation, Sells AZ
- Community Redevelopment Loan and Investment Fund, Atlanta GA
- Community Reinvestment Association of North Carolina
- Community Resource Group, Fayetteville A
- Connecticut PIRG
- Consumer Assistance Council
- Cooper Square Committee (NYC)
- Cooperative Fund of New England, Wilmington NC
- Corporacion de Desarrollo Economico de Ceiba, Ceiba PR
- Delta Foundation, Inc., Greenville MS
- Economic Opportunity Fund (EOF), Philadelphia PA
- Empire Justice Center NY
- Enterprises, Inc., Berea KY
- Fair Housing Contact Service OH
- Federation of Appalachian Housing
- Fitness and Praise Youth Development, Inc., Baton Rouge LA
- Florida Consumer Action Network
- Florida PIRG
- Funding Partners for Housing Solutions, Ft. Collins CO
- Georgia PIRG
- Grow Iowa Foundation, Greenfield IA
- Homewise, Inc., Santa Fe NM
- Idaho Nevada CDFI, Pocatello ID
- Idaho Chapter, National Association of Social Workers



- Illinois PIRG
- Impact Capital, Seattle WA
- Indiana PIRG
- Iowa PIRG
- Iowa Citizens for Community Improvement
- JobStart Chautauqua, Inc., Mayville NY
- La Casa Federal Credit Union, Newark NJ
- Low Income Investment Fund, San Francisco CA
- Long Island Housing Services NY
- MaineStream Finance, Bangor ME
- Maryland PIRG
- Massachusetts Consumers' Coalition
- MASSPIRG
- Massachusetts Fair Housing Center
- Michigan PIRG
- Midland Community Development Corporation, Midland TX
- Midwest Minnesota Community Development Corporation, Detroit Lakes MN
- Mile High Community Loan Fund, Denver CO
- Missouri PIRG
- Mortgage Recovery Service Center of L.A.
- Montana Community Development Corporation, Missoula MT
- Montana PIRG
- Neighborhood Economic Development Advocacy Project
- New Hampshire PIRG
- New Jersey Community Capital, Trenton NJ
- New Jersey Citizen Action
- New Jersey PIRG
- New Mexico PIRG
- New York PIRG
- New York City Aids Housing Network
- NOAH Community Development Fund, Inc., Boston MA
- Nonprofit Finance Fund, New York NY
- Nonprofits Assistance Fund, Minneapolis M
- North Carolina PIRG
- Northside Community Development Fund, Pittsburgh PA
- Ohio Capital Corporation for Housing, Columbus OH
- Ohio PIRG
- OligarchyUSA
- Oregon State PIRG
- Our Oregon
- PennPIRG
- Piedmont Housing Alliance, Charlottesville VA
- Michigan PIRG
- Rocky Mountain Peace and Justice Center, CO
- Rhode Island PIRG
- Rural Community Assistance Corporation, West Sacramento CA
- Rural Organizing Project OR
- San Francisco Municipal Transportation Authority
- Seattle Economic Development Fund
- Community Capital Development
- TexPIRG
- The Fair Housing Council of Central New York
- The Leadership Conference on Civil and Human Rights

- The Loan Fund, Albuquerque NM
- Third Reconstruction Institute NC
- TICAS
- Vermont PIRG
- Village Capital Corporation, Cleveland OH
- Virginia Citizens Consumer Council
- Virginia Poverty Law Center
- War on Poverty - Florida
- WashPIRG
- Westchester Residential Opportunities Inc.
- Wigamig Owners Loan Fund, Inc., Lac du Flambeau WI
- WISPIRG