BETTER MARKETS
TRANSPARENCY · ACCOUNTABILITY · OVERSIGHT

August 8, 2011

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Nationally Recognized Statistical Rating Organizations; File No. S7-18-11

Dear Ms. Murphy:

Better Markets, Inc.[1] appreciates the opportunity to comment on the above-captioned proposed rules (the "Proposed Rules") of the Securities and Exchange Commission ("Commission"). The Proposed Rules would impose a wide range of requirements on nationally recognized statistical rating organizations ("NRSROs") relating to internal controls, conflicts of interest, disclosure of ratings, third-party due diligence, training, and enforcement. The Proposed Rules have been promulgated in accordance with Section 932 and other provisions in Subtitle C, Title IX of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").

INTRODUCTION

Due to their privileged legal status, credit rating agencies have been and remain extremely important fixtures in our financial markets. Although they provide useful services for some purposes, they were also major contributors to the financial crisis, giving AAA ratings to toxic mortgage-backed securities in vast quantities, which induced reliance by investors worldwide. The credit rating agencies continue to play the same role in the unfolding crisis in Europe, and the pattern is also fundamentally the same: unjustified AAA ratings that misled investors, followed by downgrades, all with no accountability.

Subsequent investigations, including the Commission's own study of the performance of the three major ratings agencies during the period leading up to the crisis, have revealed serious problems, including egregious conflicts of interest that led ratings agencies to chase profits at the expense of careful analysis, unsound assumptions behind the ratings, and shoddy procedures, including a lack of due diligence with regard to assets underlying the asset-backed securities.

Establishing an effective regulatory regime for credit rating agencies has proven to be a daunting task, one that has not kept pace with the power of credit ratings to

[1] Better Markets, Inc. is a nonprofit organization that promotes the public interest in the capital and commodity markets, including in particular the rulemaking process associated with the Dodd-Frank Act.

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profoundly affect investors, our markets, and the entire economy. The process has been marked by long periods of study and evaluation, followed by Congressional enactments and waves of rulemaking activity.

THE DODD-FRANK ACT

The Dodd-Frank Act represents a Congressional attempt to institute regulatory measures that will finally and effectively address the problems posed by credit rating agencies. The statute includes three fundamentally important reforms. First, it builds on the regulatory requirements that were implemented in the Rating Agency Reform Act of 2006. The Dodd-Frank Act adds new provisions relating to the registration process, corporate governance, compliance examinations, conflicts of interest, and public disclosure of ratings and methodologies.

Second, the Dodd-Frank Act substantially increases the accountability of NRSROs by increasing their exposure not only to enforcement remedies such as monetary fines, but also to liability in private actions.

Finally, the Dodd-Frank Act seeks to reduce reliance upon credit ratings by requiring the Commission and other federal agencies to review their regulations; to remove any references to, or reliance on, credit ratings in those regulations; and to substitute appropriate standards of credit-worthiness in place of credit ratings.

The Proposed Rules focus on implementing the first group of statutory provisions, with a particular emphasis on improving the way NRSROs implement their policies and procedures, manage conflicts of interest, and disclose information in connection with the ratings process. These rules are an extremely important part of the effort to fix the credit rating industry. They represent improvements in the internal workings of NRSROs, and such "changes from within," if successfully implemented, may prove to be among the most effective reforms.

SUMMARY OF COMMENTS

The Commission is to be commended for the Proposed Rules, which implement the statutory directives in the Dodd-Frank Act in a comprehensive manner. In large measure, the Commission has included detailed prescriptions where necessary to fill out the statutory mandate, and it has exercised its authority in appropriate ways to implement pro-investor rules even where not explicitly required under the statute.

Nevertheless, in a number of areas, the Proposed Rules suffer from significant gaps and weaknesses which must be corrected if rating agencies are to serve the public function assigned them, and if the integrity and reliability of their ratings are to be elevated in accordance with the Dodd-Frank Act. Changes necessary to bring the Proposed Rules into compliance with the law include the following:

- The Proposed Rules must prescribe factors to guide the establishment of NRSRO internal control structures, rather than leaving that responsibility in the hands of the NRSROs.

- The Proposed Rules must prohibit sales considerations from actually influencing ratings, rather than merely limiting the involvement of sales personnel in the ratings process, and they should expressly prohibit certain compensation practices that foster conflicts of interest. Further, the exemption for small NRSROs should be narrowed, and the new enforcement remedy should not be weakened by imposing restrictions that are not required under the Dodd-Frank Act.

- The Proposed Rules must prescribe the process governing the review of ratings to determine if a former employee's conflict of interest influenced a rating.

- The Proposed Rules must adopt a single, uniform definition of "default" for purposes of disclosing information about the performance of credit ratings.

- The Proposed Rules must enhance the information provided to investors so they can better understand credit ratings.

- The Proposed Rules must establish a firm deadline for the application of revised surveillance procedures to existing ratings.

- The Proposed Rules must significantly upgrade the standards of training, experience, and competence applicable to NRSROs.

COMMENTS ON THE PROPOSED RULES

The Proposed Rules Must Prescribe Factors to Guide the Establishment of NRSRO Internal Control Structures.

Section 932(a)(2)(B) of the Dodd-Frank Act requires NRSROs to "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, taking into consideration such factors as the Commission may prescribe, by rule." Thus, the statute authorizes the Commission to prescribe factors that rating agencies would have to consider in establishing and maintaining their internal control structures, but it does not require the Commission to do so.

In the Release, the Commission expresses its preliminary belief that "it would be appropriate at this time to defer prescribing factors" that would guide the NRSROs with respect to the establishment and maintenance of their internal control structures.[2] The rationale for this position is that the Commission will have the opportunity, through examinations and review of NRSRO annual reports, to observe how NRSROs have complied with the broad, self-executing statutory requirements in Section 932(a). The Release

[2] Release at 33421.

further notes that it will be able to use the information gathered in that process to inform any future rule-making in this area. [3]

Such a wait and see approach to the implementation of Section 932 is wholly unjustified. The conduct of the NRSROs in the years leading up to the crisis of 2008, their role in the crisis, and their ongoing behavior make clear that delegating internal control responsibilities to the NRSROs is undeserved and misguided. The NRSROs must be immediately subject to clear and concrete standards to ensure that their internal control structures are properly designed, implemented, reviewed, and enforced. By deferring the adoption of those standards indefinitely, the Commission will in effect allow the credit ratings agencies to write their own rules and set their own standards and norms applicable to internal control structures. This is fundamentally wrong: The industry should conform to the Commission's standards, not vice versa. That is the only way to ensure that the internal control structures are sufficiently rigorous to establish and maintain the integrity of credit ratings in accordance with the Dodd-Frank Act.

Establishing guidelines for NRSRO internal control structures is also necessary to achieve other important objectives. The Commission must have concrete standards in place to effectively monitor and enforce compliance with the statutory mandate. A lack of standards will also impair the ability of each NRSRO board or compliance officer to conduct meaningful oversight of internal control structures, and it will undermine uniformity throughout the credit ratings industry.

Prescribing factors or standards that the NRSROs must consider with respect to internal control structures is certainly feasible. It is not inherently difficult, and it does not require the accumulation of further data. In fact, the Commission has already developed an extensive list of factors that would be appropriate to include in the Proposed Rules, and they are described in the Release. They cover a broad range of issues, including—

- Solicitation of feedback from the public and market participants in the development of rating methodologies;
- Review of methodologies by independent personnel within the rating agency;
- Updating methodologies;
- Periodically evaluating the performance of methodologies; and
- Identifying and correcting deficiencies.[4]

The Proposed Rules must incorporate all of these factors and should require NRSROs to consider them as they establish and oversee their internal control structures.

Finally, the immediate adoption of regulatory standards implementing Section 932 does not prevent the Commission from pursuing its stated objective, which is gathering data about industry practices through examinations and annual reports and using that

[3] *Id.*
[4] Release at 33422-23.

information to enhance its rules. In the meantime, the industry must be subject to as much guidance as the Commission is authorized to provide.

The financial crisis should have forever discredited the concept of self-policing by key market participants. The Commission should exercise its regulatory discretion not to revive this failed approach, but to impose reasonable but strong standards that the NRSROs must follow. This is especially important in the area of internal controls, which are core instruments of regulatory reform.

The Proposed Rules Must Prohibit Sales Considerations from Actually Influencing Ratings, Rather than Merely Limiting the Involvement of Sales Personnel in the Ratings Process.

There is no legitimate dispute that conflicts of interest have long plagued the credit rating industry and undermined the accuracy and reliability of credit ratings. Put simply, these conflicts of interest have corrupted the credit rating process. Without addressing the still dominant issuer-pay compensation model, those conflicts will remain intractable. The Dodd-Frank Act includes provisions aimed at limiting conflicts of interest to the extent possible short of major reforms to the credit rating compensation system.

Section 932(a)(4) of the Dodd-Frank Act requires the Commission to "issue rules to prevent the sales and marketing considerations of an NRSRO from influencing the production of ratings by the NRSRO." Section 932(a)(4) also requires that the rules include two additional provisions: (1) exceptions for small NRSROs for which the separation of ratings production from sales and marketing is not appropriate, and (2) an enforcement remedy providing for suspension or revocation of the registration of an NRSRO if it violates the Commission's new rules under Section 932(a)(4) and the violation affects a rating.

The Proposed Rules would implement the mandatory separation of sales and production of ratings by adding a new conflict of interest to the list of absolute prohibitions already contained in the Commission's rules. It would in effect prohibit sales personnel from participating in determining ratings. The proposed language would provide that a conflict of interest exists if—

> The nationally recognized statistical rating organization issues or maintains a credit rating where a person within the nationally recognized statistical rating organization who participates in sales or marketing of a product or service of the nationally recognized statistical rating organization . . . also participates in determining or monitoring the credit rating, or developing or approving procedures or methodologies used for determining the credit rating, including qualitative or quantitative methods.[5]

The Commission's proposal to make this prohibition absolute rather than conditional is necessary and appropriate because the statutory language clearly provides

[5] Proposed Rules § 240.17g-5(c)(8).

no leeway for sales considerations to influence ratings to any degree. The Proposed Rules also appropriately bar sales personnel not only from participating in the actual determination of ratings, but also from participating in the development of the procedures and methodologies used for determining ratings. Insulating the development of methodologies from conflicts of interest is even more critical than protecting individual ratings from such conflicts, since a corrupted methodology can inflict broader harm on the marketplace than a corrupted rating.

However, the Proposed Rules are still too narrow in critically important respects. The scope of the statutory mandate in Section 932(a)(4) is very broad, reflecting a principles-based or results-oriented approach. It requires the Commission to issue rules that will prohibit "sales and marketing considerations . . . from influencing the production of ratings." The Proposed Rules attempt to implement this statutory mandate simply by prohibiting certain types of personnel from participating in certain types of activities, as reflected in the excerpt from the Proposed Rules quoted above. However, this is not sufficient to eradicate the actual **influence** of sales considerations on ratings production as the statute requires.

The Proposed Rules would allow sales considerations to influence ratings production under a number of scenarios. For example, they would not prevent senior management from bringing sales considerations to bear on the production of ratings, since senior management would not likely be deemed "participants" in either sales or ratings activities within the meaning of the Proposed Rules. In addition, even with the Proposed Rules in place, an NRSRO might still allow sales considerations to influence ratings productions through the maintenance of a corporate culture that powerfully but implicitly links sales considerations and ratings production. Finally, the Proposed Rules do nothing to address compensation practices tied to sales considerations that can foster intense conflicts of interest.

To address these concerns, the Proposed Rules must incorporate a number of important changes:

- The Proposed Rules must adopt the same broad mandate that appears in the statute and must prohibit the *influence* of sales considerations on ratings production **through any means whatsoever,** including without limitation, the participation of sales personnel in the ratings process.

- The list of specific restrictions in the Proposed Rules should be expanded to prohibit the management of an NRSRO from using sales considerations to influence ratings production, or from allowing such practices to occur.

- The Proposed Rules should prohibit sales considerations from influencing not only the production of specific ratings, but also the general procedures and methodologies used for determining credit ratings.

- The Proposed Rules should provide that the compensation and promotion of personnel involved in the ratings process must be based on the quality of

> ratings, not sales revenues. Moreover, sales and marketing personnel should not be involved in those compensation decisions, which should be documented to ensure that appropriate performance criteria actually determine the pay for ratings analysts.

Conflicts of interest are among the most serious problems afflicting NRSROs, and to address those problems effectively, the Commission must take greater advantage of the statutory authority at its disposal by adopting the changes highlighted above.

The Exemption for Small NRSROs Should Be Narrowed.

Section 932(a)(4) of the Dodd-Frank Act requires the Commission to provide an exemption from the conflict of interest rule for "small" NRSROs with respect to which "the separation of the production of ratings and sales and marketing activities is not appropriate." This mandate raises a fundamental concern on both logical and practical grounds. Conceptually, and as suggested in the Release, the separation of sales from ratings production within an NRSRO is always appropriate, and the rationale for this prophylactic rule applies with equal force to NRSROs large and small.[6] As a practical matter, subordinating the vitally important prohibition against conflicts of interest to the operational challenges facing small NRSROs creates a real danger that corrupted ratings issued by small, but nevertheless influential, NRSROs will continue to enter the market.

The Proposed Rules include some safeguards against this danger. For example, the Commission rightly rejected the option of creating an automatic exemption for small NRSROs.[7] Instead, the Proposed Rules would require an NRSRO to apply for the exemption, so that the Commission can evaluate each request on a case-by-case basis and determine if in fact, due to its small size, the NRSRO should not be required to completely separate the marketing function from ratings production.[8] This approach will also give the Commission an opportunity to impose conditions on the exemption so that sales and ratings production are separated within the NRSRO to the maximum possible extent.

However, the Proposed Rules must make clear that even small NRSROs that are exempted from the **separation** requirement remain subject to the overarching prohibition against allowing sales and marketing considerations from **influencing** the production of ratings. This clearly was the intent of Congress because the statutory clause providing for exemptions is limited to the separation of sales activities from ratings production, whereas the primary statutory mandate is much broader, prohibiting influence not just separation.

The statute requires all NRSROs to ensure that ratings are not influenced by sales considerations, even if, due to their small size, they are exempted from certain operational requirements regarding the separation of sales and ratings functions. This distinction is appropriate and necessary, because for all NRSROs, ratings should be based strictly on the

6 Release at 33427.
7 *Id.*
8 Propose Rules § 240.17g-5(f).

merits and derived from sound methodologies and accurate data, without regard to economic incentives and the desire to attract or retain clients.

The Commission Should Not Weaken the New Enforcement Remedy by Imposing Restrictions that Are Not Required by the Dodd-Frank Act.

Section 932(a)(4) of the Dodd-Frank Act also provides that the Commission's rules shall permit the suspension or revocation of an NRSRO's registration if the Commission finds that the NRSRO has committed a violation under the subsection regarding conflicts of interest, and the violation affected a credit rating. The Proposed Rules would implement these requirements, but would also impose an additional condition on use of the new registration sanction, by requiring that the revocation or suspension be not only "in the public interest," but also "necessary for the protection of investors."[9]

The inclusion of this additional condition in the Proposed Rules raises obvious questions: Why would the SEC subject itself to requirements that make it more difficult to sanction an NRSRO and why would it provide NRSROs with additional defenses to those sanctions, which will almost certainly lead to more litigation? We see no reason for such an approach.

The Release argues that the additional requirements are justified because this particular enforcement remedy, *unlike* the other registration sanction applicable to NRSROs, does not require a showing of intent and does not limit the duration of the sanction to 12 months.[10] Out of an apparent desire to soften or counterbalance what it regards as an especially potent enforcement weapon, the Commission proposes to require proof that the revocation or suspension is necessary for the protection of investors, as well in the public interest.

Given the undeniable proof of the NRSROs' role in causing historic damage to investors and the public interest during the financial crisis, this approach is unwarranted. The additional restriction on use of the registration sanction must be removed from the Proposed Rules.

The decisive point is that the Dodd-Frank Act does not impose this restriction. Its absence is particularly significant because Congress *did* include such a provision when it originally authorized the Commission to suspend or revoke an NRSRO registration.[11] Thus, Congress intentionally omitted this requirement when it added the new enforcement remedy in the Dodd Frank Act. The inescapable conclusion is that Congress chose to eliminate this prerequisite as part of an overall effort to strengthen enforcement against NRSROs.[12]

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9 Release at 33437-28.
10 Release at 33428.
11 15 U.S.C. § 78o-7(d).
12 In the context of other registration sanctions, Congress has chosen not to require a finding that the sanction is "necessary for the protection of investors." For example, the authority to revoke a broker-dealer's registration

This view is consistent with the other features of the new enforcement provisions in Section 932(a)(4), which do not limit the duration of a registration suspension or impose a willfulness requirement. In light of this Congressional history and the rules of statutory construction, there is no basis for imposing this requirement in the Proposed Rules. Taking this step would conflict with the obvious Congressional intent to increase enforcement remedies against NRSROs.

Moreover, as a practical matter, the new test in the Proposed Rules will actually impede attempts by the Commission to enforce the regulations governing NRSROs. It may be that requiring such sanctions to be "in the public interest" is unobjectionable[13] and common throughout the regulatory scheme governing securities. However, further requiring the Commission to find such sanctions to be "necessary for the protection of investors" will afford the NRSROs an additional defensive weapon without justification. It will inspire a host of arguments along these lines: Sanctions are not "necessary for the protection of investors" since the guilty agency has instituted remedial measures; sanctions are only "necessary" to protect the integrity of the market or mitigate systemic risk, but not to protect investors per se; sanctions are not "necessary" since alternative punishments will protect investors equally well; and so on. None of these arguments should prevent the Commission from applying the new registration sanctions if the statutory tests are met: the violations are found and they affected a credit rating.

Enforcement against NRSROs has been lax for too long, and the Congressional grant of a new enforcement power should not be diluted before it is even on the books. While suspension or revocation of an NRSRO's registration will in fact be necessary for the protection of investors, incorporating this test into the rule will nevertheless afford the NRSROs additional means for fending off sanctions and avoiding accountability.

Finally, the Commission should resist any temptation, as suggested in the Release, to further weaken this enforcement remedy by imposing a time limit on the sanction, or by requiring a finding that the violation not only affected a rating but also "harmed investors." Imposing what is in effect a damages requirement in this context would be unwarranted and completely at odds with the principles normally applicable to government enforcement proceedings.[14]

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hinges only on a finding that it is "in the public interest." 15 U.S.C. § 78o(b)4). This is further evidence that Congress's decision to either include or exclude this test is quite intentional.

13 Unfortunately, the language here can be confusing and misleading. Requiring findings that a sanction is "necessary for the protection of investors and in the public interest" is actually *not* in the public interest because it creates an additional hurdle for the SEC and therefore provides the NRSROs with additional ways to avoid being punished for their misconduct. The public interest is better served if the Proposed Rules do not add to the Commission's burden in enforcement actions, especially where neither the statutory language nor Congressional intent warrant such an approach.

14 Release at 33428.

The Proposed Rules Must Prescribe the Process Governing the Review of Ratings to Determine if a Former Employee's Conflict of Interest Influenced a Rating.

Section 932(a)(4) of the Dodd-Frank Act addresses conflicts of interest through another mechanism known as the "look-back" provision. It requires each NRSRO to establish policies and procedures reasonably designed to ensure that the NRSRO reviews its ratings, and revises them if appropriate, if an employee of the rated entity or an employee of the issuer of a rated security, previously worked for the NRSRO and participated in the rating of the entity during the one-year period preceding the rating.

The statute requires the Commission to prescribe rules governing the actions that an NRSRO must take to **revise** ratings. However, as explained in the Release, the Commission does not interpret the statute as requiring the promulgation of rules governing the initial **review** of ratings to determine if they were influenced by a former employee's conflict of interest.[15]

With respect to ratings **revisions,** the Proposed Rules would require the NRSRO to establish procedures reasonably designed to ensure that whenever an NRSRO determines that a conflict of interest of a former employee influenced a credit rating, the NRSRO takes three steps: (1) immediately place the credit rating on credit watch, to notify users of the credit rating that the rating is undergoing a reevaluation and may be changed; (2) promptly determine whether the credit rating must be revised so it is no longer influenced by a conflict of interest and is solely the product of the NRSRO's procedures and methodologies for determining credit ratings; and (3) promptly publish a revised credit rating, or, if appropriate, an affirmation of the credit rating, to minimize reliance on an erroneous rating.[16]

The Proposed Rules would also require the NRSRO to make certain disclosures, including notification that the rating was influenced by a conflict of interest, and, if the rating is in fact revised, the magnitude or impact of the influence.[17] Finally, the Proposed Rules would require an NRSRO to document its policies and procedures and to retain and produce those documents in accordance with the recordkeeping requirements generally applicable to NRSROs.[18]

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15 Release at 33429.
16 Release at 33429.
17 Release at 33431.
18 Release at 33432.

The Proposed Rules are in large measure an appropriate implementation of the statutory mandate, but they must be strengthened in three respects. First, the Commission must promulgate rules prescribing the specific policies and procedures an NRSRO must apply to determine as a threshold matter whether a former employee's conflict of interest "influenced" a credit rating. The Commission reads Section 932 as requiring a rule-making only as to an NRSRO's revision process, not its review process, based on the language in the statute:

> [T]he nationally recognized statistical rating organization shall—
>
> (i) conduct a review to determine whether any conflicts of interest of the employee influenced the credit rating; and
>
> (ii) take action to revise the rating if appropriate, **in accordance with such rules as the Commission shall prescribe.**[19]

However, as a matter of statutory construction, the rule-making reference can and should be read to apply to subparagraph (i) relating to review as well as to subparagraph (ii) relating to revision. The configuration of the language on the page is not dispositive. More significant is the fact that the statute subjects both sets of policies and procedures—those relating to review as well as those relating to revision—to the same periodic scrutiny by the Commission, as set forth in the subsection immediately following the quoted provision.

Even more important, there is no logical basis for the Commission's narrow interpretation. An NRSRO's initial review to determine if a former employee's conflict of interest influenced a credit rating is **at least as important** as the process for revising a rating to cure any distortions caused by such a conflict of interest. If an NRSRO's policies and procedures are not rigorous and provide for only a cursory review of such potential conflicts of interest, then the remedial provisions requiring the issuance of corrected ratings will never come into play.

Given the equal importance of the process for reviewing ratings and the process for revising them if necessary, there is no reason why Congress would require rulemaking as to one but not the other. Indeed, given Congressional focus on conflicts of interest and their eradication, the interpretation in the Proposed Rules is incompatible with Congressional intent.

Alarmingly, the Proposed Rules would actually incentivize an NRSRO to adopt weak review procedures because the process set forth in the Proposed Rules for correcting a rating entails painful disclosures—admissions, in effect—that the NRSRO issued erroneous ratings caused by a conflict of interest. Therefore, the only way to ensure that the review process is adequate is for the Commission to promulgate rules specifying the minimum

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[19] Dodd-Frank Act § 932(a)(4) (emphasis added).

steps that an NRSRO must follow under its policies and procedures to determine if a former employee's conflict of interest influenced a credit rating.

In addition, the Proposed Rules should require more complete disclosure about the nature of the conflict that has caused a rating to be placed on credit watch or revised. The Proposed Rules currently would require only disclosure of the basic fact that the rating "was influenced by a conflict of interest." More detail should be required, including the fact that the conflict arose because a former NRSRO employee went to work for a rated obligor or issuer, the role of the employee in the rating process, and the impact of the prospective future employment on the rating itself. These details will help investors assess the significance of the rating being placed in watch status and any subsequent revision of the rating.

Finally, the Proposed Rules should require an NRSRO to conduct a de novo analysis of the credit rating using its methodologies and procedures. This step is essential to assess whether the credit rating was in fact influenced by the former employee's conflict of interest, whether the rating warrants revision, and the magnitude of the impact of the conflict of interest on the original rating.

The Proposed Rules Must Adopt a Single, Uniform Definition of "Default" for Purposes of Disclosing Information About the Performance of Credit Ratings.

Section 932(a)(8) of the Dodd-Frank Act requires the Commission to issue rules requiring each NRSRO to publicly disclose information on initial credit ratings and any subsequent changes to those credit ratings. The purpose of this requirement is to enable those who use credit ratings to (1) evaluate their accuracy and (2) compare ratings from different NRSROs. The statute also prescribes in considerable detail the nature of the disclosure that the Commission's rule must require. "At a minimum," the Proposed Rules must require NRSROs to make disclosures that are—

- Comparable among NRSROs;
- Clear and informative for investors having a wide range of sophistication;
- Freely available on an easily accessible portion of the NRSRO website; and
- Appropriate to the business model of the NRSRO.

In addition, under the statute, the Proposed Rules must require each NRSRO to include an attestation affirming that no part of the rating was influenced by any other business activities, that the rating was based solely on the merits of the instruments being rated, and that such rating was an independent evaluation of the risks and merits of the instrument.

These provisions address an insidious problem that has long been pervasive in the credit ratings world as well as the financial services industry in general: The disclosure of information in abundant quantities that is nevertheless useless because it is deliberately presented in confusing ways that prevent real comprehension and meaningful comparison. The Release highlights this problem in the ratings industry, pointing out that, under current rules, NRSROs have used very different techniques to produce performance statistics for ratings, and have also included very different quantities of information, making the presentation of information "widely inconsistent" across NRSROs and difficult for investors to use.[20]

The Proposed Rules implement the statutory mandate by—

- Prescribing the exact formats that must be used for presenting information;
- Creating subclasses of credit ratings for structured products so that the performance history for these types of ratings is more meaningful;
- Limiting the amount of *additional* information that NRSROs may include in the performance histories, so that investors are not needlessly bewildered;
- Establishing uniform definitions for certain terms; and
- Enhancing the amount of information that is available via an "easily accessible" portion of an NRSRO's website.[21]

One of the key provisions in the Proposed Rules is the establishment of a standard definition of "default," which is intended "to make the default rates calculated and disclosed by NRSROs more readily comparable" and therefore more useful for investors.[22] Such a standard definition would also prevent NRSROs from manipulating their reported data to make their ratings look more accurate and reliable than they really are.

Inexplicably, after providing a strong justification for a single, uniform definition, the Release proceeds to explain that the Proposed Rules actually contain two disjunctive definitions for "default."[23] Under the Proposed Rules, the first definition would be standardized, and the second definition would reflect an NRSRO's own customized version.[24] An NRSRO would have to classify an obligor or instrument as having gone into default if the conditions in either or both of the definitions were met.[25]

This approach defeats the aim of promoting uniformity in the performance data for credit ratings. Although adoption of the standard baseline definition would help prevent the manipulation of data to inflate performance statistics, allowing NRSROs to graft their own definition onto the standard definition would undoubtedly undermine the comparability of the performance history.

Moreover, such an approach would defeat or greatly undermine the key statutory goal of making NRSRO information understandable to investors. Given past history, NRSROs should be given no opportunity to present their information in a way that is not immediately and readily understandable and usable by investors. The Proposed Rules fail this fundamental statutory purpose. Therefore, the Proposed Rules must abandon the two-definition approach for categorizing defaults and adhere to a unitary meaning.

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[20] Release at 33435.
[21] Release at 33435-40.
[22] Release at 33441.
[23] *Id.*
[24] *Id.*
[25] *Id.*

<u>The Proposed Rules Must Enhance the Information Provided to Investors So They Can Better Understand Credit Ratings.</u>

Section 932(a)(8) of the Dodd-Frank Act requires NRSROs to disclose an extensive amount of important information at the time a credit rating is published. The required disclosures include—

- Information about the rating itself, including the—
    - Data and assumptions underlying the rating, including its reliability and accuracy;
    - Procedures and methodologies employed;
    - Potential limitations of the rating, including risks excluded from the rating;
    - Potential volatility of the rating, including factors that might lead to a change in the rating; and
    - Conflicts of interest of the NRSRO;
- Information about third-party due diligence services in connection with asset-backed securities, including—
    - A copy of any report provided by the third-party due diligence service provider; and
    - A certification from the third-party due diligence provider to ensure that the provider has conducted a thorough review of the relevant data, documentation, and other information necessary to provide an accurate rating; and
- Information that investors can use to better understand credit ratings.

The statute also specifies the form of the disclosures, requiring them to be "easy to use," comparable across types of securities, and readily available.

Because the requirements in Section 932(a)(8) are relatively detailed and prescriptive, the Proposed Rules largely mirror the statutory language. Where necessary, the Commission has added important requirements to fill some gaps in the statutory scheme. For example, the Proposed Rules correctly provide that the disclosures required under Section 932(a)(8) must be made each time an NRSRO takes a "rating action" with respect to an obligor, security, or money market instrument.[26] The Proposed Rules further define "rating action" expansively to include preliminary credit ratings, initial ratings, upgrades, downgrades, watches or reviews, affirmations, and withdrawals.[27] These provisions will help ensure that the new disclosure regime is broadly applied, not confined just to the issuance of initial ratings.

The Proposed Rules also make a valuable enhancement by applying a strong attestation requirement to the disclosure provisions, even though that requirement is

[26] Release at 33456.
[27] Release at 33456-57.

found in a separate Section of the Dodd-Frank Act and arises in the more limited context of disclosure of performance data. Section 932(a)(8) of the Dodd-Frank Act requires NRSROs to publicly disclose performance information about their credit ratings and it requires each NRSRO to include with its credit ratings an attestation that—

- No part of the rating was influenced by any other business activities;
- The rating was based solely on the merits of the instruments being rated; and
- The rating was an independent evaluation of the risks and merits of the instrument.

The Proposed Rules incorporate this requirement under the general disclosure provisions, and they add a requirement that the attestation must be made by a person who has responsibility for the credit rating.[28] Such attestation requirements are important measures that increase accountability and help induce more meaningful disclosures by market participants. By applying the attestation requirement under the general disclosure rules, the Proposed Rules will help ensure that they apply broadly, not only to initial ratings but also to all "rating actions" as defined under the rule.

Although the Proposed Rules implementing the disclosure requirements are generally strong, they must be enhanced in one important area. They must prescribe in greater detail the disclosures regarding "information that can be used by investors and other users of credit ratings to better understand credit ratings." Section 932(a)(8) of the Dodd-Frank Act requires that this information be disclosed in connection with each rating. However, the Proposed Rules pay scant attention to this requirement, simply requiring that the disclosure form describe the version of the procedure or methodology used to determine the credit rating.[29]

This disclosure requirement is clearly aimed at providing a fundamentally different type of information to investors. The statute and the Proposed Rules already require NRSROs to provide an extensive amount of information to investors about the specific ratings actions that an agency is taking, including the methodologies used in the rating process. Moreover, under the statute and the Proposed Rules, all of this information must be formatted in a way that is "easy to use and helpful."[30]

What investors really require in addition to this large amount of data, and what Congress intended them to receive, is information that would enable them to understand the **significance** of the mandated disclosures. Thus, for example, while it is certainly important that NRSROs disclose the extent to which "data essential to the determination of the credit rating was reliable or limited," the value of this information to investors would be much greater if accompanied by an explanation of how any such limits compare with norms and what those limits ultimately mean in terms of the reliability of the rating itself.

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28 Release at 33464-65.
29 Release at 33459.
30 Dodd-Frank Act § 932(a)(8).

The Proposed Rules should therefore require NRSROs to provide this type of information with respect to each material disclosure required under Section 932(a)(8). This would be a profoundly important step in the direction of genuinely meaningful disclosure.

<u>The Proposed Rules Must Establish a Firm Deadline for the Application of Revised Surveillance Procedures to Existing Ratings.</u>

Section 932(a)(8) of the Dodd-Frank Act also requires the Commission to prescribe rules placing conditions on the procedures and methodologies that NRSROs use to produce credit ratings. Specifically, the statute requires NRSROs to ensure that —

- Procedures and methodologies are approved by the board of the NRSRO and developed in accordance with the policies and procedures of the NRSRO;
- Material changes to the procedures and methodologies are applied consistently, in a timely fashion, and with notice to users and an explanation of the reason for and potential likely impact of the change on existing ratings; and
- Users are notified of significant errors in a procedure or methodology that may result in a credit rating action.

The Proposed Rules implement these requirements largely by incorporating the statutory language, with a number of beneficial enhancements. For example, although the statute does not address documentation, the Proposed Rules would provide that the NRSRO policies and procedures used to implement these restrictions on rating procedures and methodologies would have to be established, maintained, enforced, documented, and subjected to recordkeeping requirements.[31]

In one important respect, however, the Proposed Rules fall short. The statute requires that when material changes are made to credit rating surveillance procedures and methodologies, the changes must be applied to the then-current credit ratings "**within a reasonable time period determined by the Commission.**"[32]

However, contrary to the statutory directive, the Proposed Rules do not specify any deadline for the application of the revised surveillance procedures. Instead, they preserve the "reasonable time period" requirement, but add that the time period will be determined taking into consideration a number of factors, including the number of ratings impacted, the complexity of the procedures and methodologies at issue, and the type of obligor, security, or money market instrument being rated. The Release explains that no specific time period should be set because what is reasonable depends on all the facts and circumstances, and any concrete deadline risks being too short or too generous.[33]

[31] Release at 33456.
[32] Dodd-Frank Action 932(a)(8) (emphasis added).
[33] Release 33454.

This approach is unnecessarily open-ended and inconsistent with the statutory directive. The Proposed Rules should include a specific time period within which the altered surveillance procedures must be applied to then-current ratings. At a minimum, the Proposed Rules should specify that the changes must be applied "as soon as practicable," and should add a "not later than" clause to ensure that all ratings receive the benefit of the revised surveillance procedures within a time certain.

The Proposed Rules Must Significantly Upgrade the Standards of Training, Experience, and Competence Applicable to NRSROs.

Section 936 of the Dodd-Frank Act is a short but important provision simply requiring the Commission to issue rules reasonably designed to ensure that NRSRO employees (1) meet standards of training, experience, and competence necessary to produce accurate ratings, and (2) are tested for knowledge of the credit rating process.

The Proposed Rules would implement Section 936 by incorporating the basic statutory requirement and adding several enhancements. However, the overall result is weak, reflecting a principles-based approach without adequate prescriptive standards. The Proposed Rules would leave it to the NRSROs to "establish, maintain, enforce, and document standards of training, experience, and competence for the individuals it employs to determine credit ratings."[34] The general guidepost would be the requirement that those standards would have to be reasonably designed to achieve the objective that such individuals produce "accurate" credit ratings in the classes and subclasses of ratings for which the NRSRO is registered.[35]

The Proposed Rules stipulate very few required elements that the training and testing standards would have to incorporate. With respect to training, the Proposed Rules would only require an NRSRO to consider four factors when establishing its standards for individual employees:

- Whether the individual uses qualitative analysis;
- Whether the individual uses quantitative analysis;
- The classes and subclasses of ratings in which the individual participates; and
- The complexity of the obligors and securities that the individual rates.[36]

With respect to testing and competence, the Proposed Rules would simply require—

- Periodic testing, with the frequency and manner of testing left to the NRSRO; and
- That a person with at least 3 years of experience participate in determining credit ratings.[37]

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34 Release at 33476.
35 Release at 33477.
36 Release at 33477-78.
37 Release at 33478-79.

Because the Proposed Rules rely almost entirely on the industry to establish virtually all of the standards governing training, experience, competence, and testing, they are inadequate and unacceptable. Moreover, the rationale offered in the Release is unconvincing. It states that a hands-off approach in this area is appropriate because of "the varying procedures and methodologies used by NRSROs to determine credit ratings" and the supposed need to give the NRSROs flexibility to design their own training standards.[38] But there is no reason why establishing strong, minimum standards for training, experience, and competence would necessarily interfere with an NRSRO's need for flexibility in this area. The two goals are not incompatible.

Several changes to the Proposed Rules are necessary to address these weaknesses. First, minimum content for training must be prescribed, and it should cover a number of important topics, including, in addition to substantive material, training related to ethics, conflicts of interest, and the laws and regulations applicable to the credit rating process. In addition, training should focus not only on the correct application of rating methodologies, but also on the proper development of the methodologies themselves.

If industry is allowed to set the **training** standards, then it is imperative that the **testing** regime be independently established and administered by a regulatory body or an independent credentialing organization. Even if the Proposed Rules impose more robust training requirements, the rules still must be more detailed regarding the testing standards and must impose requirements related to the frequency of testing, basic content, consequences of failure, and eligibility for retesting.

The 3-years-of-experience requirement should be strengthened in several respects. Given the enormous complexity of the ratings process, and the importance of ratings in our financial markets, requiring the involvement of a person with only three years of experience in each rating is woefully insufficient. Substantially more seasoning is necessary to ensure that each rating is properly supervised. In addition, the experienced analyst must be required not only to participate in the rating, but to also to certify approval of the rating in writing.

The standards must include a system for periodically reviewing ratings for "accuracy," specifically for the purposed of adjusting the training, experience, or competence requirements as necessary in light of the results of such reviews.

Finally, the documentation requirement should include documentation not only of the standards, but also of the implementation, including records showing that analysts have been tested, that ratings have been reviewed for accuracy to identify weaknesses in the training regime, and that a seasoned analyst has participated in and approved of each credit rating.

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[38] Release at 33476.

CONCLUSION

We hope these comments are helpful in your consideration of the Proposed Rules.

Sincerely,

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