Report to Congress on Assigned Credit Ratings

As Required by Section 939F of the Dodd-Frank Wall Street Reform and Consumer Protection Act

This is a study by the Staff of the Division of Trading and Markets of the U.S. Securities and Exchange Commission. The Commission has expressed no view regarding the analysis, findings or conclusions contained herein.

December 2012

Table of Contents

I. INTRODUCTION 1

II. NRSRO REGISTRATION AND OVERSIGHT 4

III. THE CREDIT RATING PROCESS FOR STRUCTURED FINANCE PRODUCTS AND THE CONFLICTS OF INTEREST ASSOCIATED WITH THE ISSUER-PAY AND THE SUBSCRIBER-PAY MODELS 6

A. Overview of the Market for Structured Finance Products 6

B. The Credit Rating Process 9

C. Conflicts of Interest 12
1. Issuer-Pay Model 12
a. Overview 12
b. Comments on the Issuer-Pay Model 13
2. Subscriber-Pay Model 16
a. Overview 16
b. Comments on the Subscriber-Pay Model 16

D. Measures to Mitigate Conflicts of Interest 17
1. Statutes and Commission Rules 17
a. Overview of Requirements Designed to Address NRSRO Conflicts 17
b. Comments on Requirements Designed to Address NRSRO Conflicts 20
c. Other Structured Finance Initiatives 21
2. Reducing Reliance on Credit Ratings 23
a. Overview 23
b. Comments on Reducing Reliance on Credit Ratings 25
3. Reputational Risk 25
a. Overview 25
b. Comments on Reputational Risk 26
4. Internal Controls 27

E. Benefits of the Current Rating System 27

IV. FEASIBILITY OF ESTABLISHING AN ASSIGNMENT SYSTEM FOR CREDIT RATINGS 28

A. Mechanics of the Section 15E(w) System 28

B. Statutory Factors 30
1. Fee Determination 30
2. Method of Payment 31
3. Moral Hazard 31
4. Constitutional and Other Issues Concerning the Establishment of the Section 15E(w) System 33
a. Operational Feasibility 33
b. Legal Feasibility 34

C. GAO Framework 35
1. Independence 35
2. Accountability 39
3. Competition 41
4. Transparency 44
5. Feasibility 45

6. Market Acceptance and Choice 48
7. Oversight 51

V. METRICS FOR DETERMINING THE ACCURACY OF CREDIT RATINGS 52

VI. ALTERNATIVE MEANS FOR COMPENSATING NRSROS 53

A. Rule 17g-5 Program 54
1. Mechanics of the Rule 17g-5 Program 54
2. Comparing the Rule 17g-5 Program to the Section 15E(w) System 55
3. Use of the Rule 17g-5 Program 57
4. Potential Modifications to the Rule 17g-5 Program 59

B. Investor-Owned Credit Rating Agency Model 62
1. Mechanics of the IOCRA Model 62
2. Commenters' Reactions to the IOCRA Model 63

C. Stand-Alone Model 64
1. Mechanics of the Stand-Alone Model 64
2. Commenters' Reactions to the Stand-Alone Model 64

D. Designation Model 66
1. Mechanics of the Designation Model 66
2. Commenters' Reactions to the Designation Model 66

E. User-Pay Model 68
1. Mechanics of the User-Pay Model 68
2. Commenters' Reactions to the User-Pay Model 68

F. Other Alternative Models 69
1. Issuer and Investor-Pays Model 69
2. Alternative User-Pays Model 70
3. Investor Owned Rating Agency Model 71
4. Additional Suggestions From Commenters 72

VII. FINDINGS 72

A. Section 15E(w) System 73
1. Potential Benefits 73
2. Potential Concerns 74
3. Potential Considerations 77

B. Rule 17g-5 Program 77
1. Potential Benefits 77
2. Potential Concerns 78
3. Potential Considerations 79

C. Other Alternative Compensation Models 79
1. Potential Benefits 80
2. Potential Concerns 81
3. Potential Considerations 82

APPENDIX 83

I. INTRODUCTION

On July 21, 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") into law.[1] Title IX, Subtitle C of the Dodd-Frank Act ("Title IX, Subtitle C"), "Improvements to the Regulation of Credit Rating Agencies," among other things, established new self-executing requirements applicable to nationally recognized statistical rating organizations ("NRSROs"), required certain studies, and required that the Commission adopt rules applicable to NRSROs in a number of areas.[2] Under section 939F of Title IX, Subtitle C ("section 939F"), the U.S. Securities and Exchange Commission ("Commission") must submit to the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Financial Services of the House of Representatives, not later than 24 months after the date of enactment of the Dodd-Frank Act, a report containing: (1) the findings of a study on matters related to assigning credit ratings for structured finance products; and (2) any recommendations for regulatory or statutory changes that the Commission determines should be made to implement the findings of the study.[3] In particular, section 939F provides that the Commission shall carry out a study of the following:

> (1) The credit rating process for structured finance products and the conflicts of interest associated with the issuer-pay and the subscriber-pay models;[4]
>
> (2) The feasibility of establishing a system in which a public or private utility or a self-regulatory organization ("SRO") assigns NRSROs to determine the credit ratings for structured finance products, including:
>
> > (a) An assessment of potential mechanisms for determining fees for NRSROs for rating structured finance products;
> >
> > (b) Appropriate methods for paying fees to NRSROs to rate structured finance products;
> >
> > (c) The extent to which the creation of such a system would be viewed as the creation of moral hazard by the Federal Government; and

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1 Pub. L. No. 111-203, 124 Stat. 1376 (2010).

2 See Pub. L. No. 111-203 §§ 939, 939D - 939F.

3 See Pub. L. No. 111-203 § 939F. Section 939F(a) provides that, for purposes of section 939F, the term "structured finance product" means an "asset-backed security," as defined in section 3(a)(77) of the Exchange Act, as added by section 941 of the Dodd-Frank Act (15 U.S.C. § 78c(a)(77)), and any structured product based on an asset-backed security, as determined by the Commission, by rule. See Pub. L. No. 111-203 § 939F(a). For the purposes of this study, the term "structured finance product" means an "asset-backed security" as defined in section 3(a)(77) of the Exchange Act and, to the extent not included in that definition, any security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction. See, e.g., 17 CFR 240.17g-2(a)(2)(iii), (a)(7), and (b)(9); 17 CFR 240.17g-3(a)(6); 17 CFR 240.17g-5(a)(3) and (b)(9); 17 CFR 240.17g-6(a)(4). See also Amendments to Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 61050 (Nov. 23, 2009), 74 Federal Register ("FR") 63832, n. 3 (Dec. 4, 2009).

4 See Pub. L. No. 111-203 § 939F(b)(1).

(d) Any constitutional or other issues concerning the establishment of such a system;[5]

(3) The range of metrics that could be used to determine the accuracy of credit ratings for structured finance products;[6] and

(4) Alternative means for compensating NRSROs that would create incentives for accurate credit ratings for structured finance products.[7]

Section 939F also provides that, after submission of the report to Congress containing the findings of the study, the Commission shall, by rule, as the Commission determines is necessary or appropriate in the public interest or for the protection of investors, establish a system for the assignment of NRSROs to determine the initial credit ratings of structured finance products, in a manner that prevents the issuer, sponsor, or underwriter of the structured finance product from selecting the NRSRO that will determine the initial credit ratings and monitor such credit ratings.[8] In issuing any rule pursuant to section 939F, the Commission is directed to give thorough consideration to the provisions of section 15E(w) of the Exchange Act, as that provision would have been added by section 939D of H.R. 4173 (111th Congress), as passed by the Senate on May 20, 2010 (the "Section 15E(w) Provisions"), and shall implement the system described in section 939D of H.R. 4173 (the "Section 15E(w) System") unless the Commission determines that an alternative system would better serve the public interest and the protection of investors.[9]

The Commission requested public comment to assist the staff in carrying out this study.[10] The Commission received thirty-two comment letters in response to its solicitation for comment. Six of the comment letters were submitted by NRSROs.[11] The remaining twenty-six comment letters were submitted by other interested parties, including organizations representing investors, trade organizations, non-profit organizations, brokerage and financial services firms, academics

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5 See Pub. L. No. 111-203 §§ 939F(b)(2)(A) through (B).

6 See Pub. L. No. 111-203 § 939F(b)(3).

7 See Pub. L. No. 111-203 § 939F(b)(4).

8 See Pub. L. No. 111-203 § 939F(d).

9 See Pub. L. No. 111-203 § 939F(d). Section 939D of H.R. 4173 (111th Congress) was passed by the Senate on May 20, 2010. However, this amendment was not included in the final version of the Dodd-Frank Act. The text of the amendment is attached as an appendix to this study.

10 See Solicitation of Comment to Assist in Study on Assigned Credit Ratings, Exchange Act Release No. 64456 (May 10, 2011), 76 FR 28265 (May 16, 2011).

11 See letter from Daniel Curry, DBRS Limited, dated Sep. 13, 2011 ("DBRS Letter"); letter from Charles D. Brown, Fitch Ratings, dated Sep. 9, 2011 ("Fitch Letter"); letter from James Nadler, Kroll Bond Rating Agency, Inc., dated Sep. 13, 2011 ("Kroll Letter"); letter from Michel Madelain, Moody's Investor Service, dated Sep. 13, 2011 ("Moody's Letter"); letter from Robert Dobilas, Morningstar Credit Ratings, LLC, dated Sep. 13, 2011 ("Morningstar Letter"); and letter from Patrick Milano, Standard and Poor's Ratings Services, dated Sep. 13, 2011 ("S&P Letter").

and individuals.[12] The staff reviewed each comment letter. The comment letters helped to inform the staff and raise complex issues for consideration. The staff also gathered information about the credit rating process for structured finance products, conflicts of interest in the issuer-pay and subscriber-pay systems and alternative models for compensating NRSROs through: (1) a review of certain studies, articles, and testimony;[13] (2) meetings with proponents of alternative models; and (3) meetings with NRSROs.[14]

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[12] See letter from Gerald W. McEntee, American Federation of State, County and Municipal Employees, dated Sep. 12, 2011 ("AFSCME Letter"); letter from Tom Deutsch, American Securitization Forum, dated Sep. 12, 2011 ("ASF"); letter from Americans for Financial Reform dated Sep. 13, 2011 ("AFR Letter"); letter from Richard Hopkin, Association for Financial Markets in Europe, dated Sep. 13, 2011 ("AFME Letter"); letter from Dennis Kelleher, Wallace C. Turbeville, and Stephen W. Hall, Better Markets, Inc., dated Sep. 13, 2011 ("Better Markets Letter"); letter from Adrian Burridge, CanadianInvestors.com, dated May 10, 2011 ("CI.com Letter"); letter from Laurel Leitner, Council of Institutional Investors, dated Sep. 13, 2011 ("CII Letter"); letter from Stephen M. Renna, CRE Finance Council, dated Sep. 13, 2011 ("CRE Letter"); letter from William Michael Cunningham, Creative Investment Research, Inc., dated Jul. 4, 2011 ("CIR"); letter from Richard M. Whiting, The Financial Services Roundtable, dated Sep. 13, 2011 ("FSR Letter"); letter from the Honorable Al Franken, U.S. Senate, dated Nov. 17, 2011 ("Franken Letter"); letter from the Honorable Al Franken and the Honorable Roger F. Wicker, U.S. Senate, dated Sep. 14, 2011 ("Franken/Wicker Letter"); letter from Jeffrey Manns, George Washington University Law School, dated Sep. 13, 2011 ("Manns Letter"); letter from Donald C. Huffaker dated May 10, 2011("Huffaker Letter"); letter from Karrie McMillan, Investment Company Institute, dated Sep. 13, 2011 ("ICI Letter"); letter from Valerie Kay, Morgan Stanley & Co. LLC, dated Sep. 13, 2011 ("MS Letter"); letter from David H. Stevens, Mortgage Bankers Association, dated Sep. 13, 2011 ("MBA Letter"), letter from Jason Parsont dated Sep. 13, 2011 ("Parsont Letter"); second letter from Jason Parsont dated Jun. 20, 2011 ("Parsont Letter II, with attached article, NRSRO Nullification: Why Ratings Reform may be in Peril, 77 BROOK. L. REV. 3, 1015 (Spring 2012) ("Parsont Article"); letter from Karen Polege dated May 11, 2011 ("Polege Letter"); letter from Anthony Randazzo, Reason Foundation, date Sep. 13, 2011 ("Reason Letter"); letter from Martin S. Hughes, Redwood Trust, Inc., dated Jun. 11, 2012 ("Redwood Letter"); letter from Richard A. Dorfman and Christopher B. Killian, Securities Industry and Financial Markets Association, dated Sep. 13, 2011 ("SIFMA Letter"); letter from Ja Sto dated May 10, 2011 ("Sto Letter"); letter from Claire A. Hill, University of Minnesota Law School, dated Sep. 13, 2011 ("Hill Letter"); and letter from Robert Grunzinger, Wheelhouse Securities Corp., dated May 12, 2011 ("Wheelhouse Letter"). These comment letters are available on the Commission's Internet website at the following address: http://www.sec.gov/comments/4-629/4-629.shtml. See also letter from the Honorable Carl Levin, U.S. Senate, dated Aug. 8, 2011 ("Levin Letter") (commenting on Proposed Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 64514 (May 18, 2011), 76 FR 33420 (Jun. 8, 2011) and section 939F of the Dodd-Frank Act).

[13] See Nan S. Ellis, Lisa M. Fairchild, & Frank D'Souza, Rating the Regulation of Rating Agencies: Credit Rating Agency Reform in the Aftermath of the Global Financial Crisis (2011), available at http://works.bepress.com/nan_ellis/2; Professor John C. Coffee, Jr., Turmoil in the U.S. Credit Markets: The Role of the Credit Rating Agencies, testimony before the U.S. Senate Committee on Banking, Housing and Urban Affairs (April 22, 2008), available at http://banking.senate.gov/public/_files/OpgStmtCoffeeSenateTestimonyTurmoilintheUSCreditMarkets.pdf; John C. Coffee, Jr., Understanding Enron: It's About the Gatekeepers, Stupid (Jul. 2002), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=325240; Jess Cornaggia, Kimberly Rodgers Cornaggia, & John Hund, Credit Ratings Across Asset Classes: A = A?, Working Paper Series (2011), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1909091; Sulette Lombard, Credit Rating Agencies as Gatekeepers: What Went Wrong (2009), available at http://www.clta.edu.au/professional/papers/conference2009/LombardCLTA09.pdf; Frank Partnoy, How and Why Credit Rating Agencies Are Not Like Other Gatekeepers (2006), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=900257; Bo Becker & Todd Milbourn, How Did Increased Competition Affect Credit Ratings? Journal of Financial Economics, Elsevier, vol. 101(3), pages 493-514; Efraim Benmelech & Jennifer Dlugosz, The Credit Rating Crisis, the National Bureau of

The staff's study focused on the Section 15E(w) System and potential alternatives to that system, including an existing rule (Rule 17g-5) under the Exchange Act that is designed to mitigate the issuer-pay conflict with respect to structured finance products.[15] This report – which was prepared by Commission staff and approved for release by the Commission – is being submitted to Congress pursuant to section 939F. The views expressed in this report are those of the Commission staff and do not necessarily reflect the views of the Commission or the individual Commissioners. The report identifies potential benefits and concerns with respect to the Section 15E(w) System and potential alternatives to that system. The report also identifies potential regulatory or statutory changes the Commission could consider if the Commission determined to implement the Section 15E(w) System or one or more of the potential alternatives.

II. NRSRO REGISTRATION AND OVERSIGHT

The Credit Rating Agency Reform Act of 2006 (the "Rating Agency Act of 2006") established a registration and oversight program for credit rating agencies registered with the Commission as NRSROs through self-executing provisions added to the Exchange Act and implementing rules adopted by the Commission under the Exchange Act as amended by the Rating Agency Act of 2006.[16] The Rating Agency Act of 2006, among other things: (1) amended section 3 of the Exchange Act to add definitions; (2) added section 15E to the Exchange Act to establish self-executing requirements on NRSROs and provide the Commission with the authority to implement a registration and oversight program for NRSROs; (3) amended section 17 of the Exchange Act to provide the Commission with recordkeeping, reporting, and examination authority over NRSROs; and (4) amended section 21B(a) of the Exchange Act to

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Economic Research (2010), available at http://www.economics.harvard.edu/faculty/benmelech/files/MacroAnnual.pdf; Patrick Bolton, Xavier Freixas, & Joel Shapiro, The Credit Ratings Game, Journal of Finance, Volume 67, Issue 1, pages 85-112; Jerome Mathis, James McAndrews, & Jean-Charles Rochet, Rating the Raters: Are Reputation Concerns Powerful Enough to Discipline Rating Agencies?, 56(5) J. Monetary Econ. 657 (2009); Parsont Article; Amadou N.R. Sy, The Systemic Regulation of Credit Rating Agencies and Rated Markets, International Monetary Fund, Working Paper No. WP/09/029 (2009), available at http://www.imf.org/external/pubs/ft/wp/2009/wp09129.pdf; See Jie (Jack) He, Jun 'QJ' Qian & Philip E. Strahan, Are All Ratings Created Equal? The Impact of Issuer Size on the Pricing of Mortgage-Backed Securities, Journal of Finance (forthcoming); Vasiliki Skreta & Laura Veldkamp, Ratings Shopping and Asset Complexity: A Theory of Ratings Inflation, Journal of Monetary Economics (2009); and Heski Bar-Isaac & Joel Shapiro, Ratings Quality over the Business Cycle, Journal of Financial Economics (forthcoming 2012).

[14] Documentation of the staff's meetings with proponents of the alternative models and the NRSROs is available on the Commission's Internet website at the following address: http://www.sec.gov/comments/4-629/4-629.shtml.

[15] See 17 CFR 240.17g-5.

[16] See Pub. L. No. 109-291 (2006). The following ten credit rating agencies currently are registered with the Commission as NRSROs: A.M. Best Company, Inc. ("A.M. Best"), DBRS, Inc. ("DBRS"), Egan-Jones Ratings Co. ("EJR"), Fitch, Inc. ("Fitch"), Japan Credit Rating Agency, Ltd. ("JCR"), HR Ratings de México, S.A. de C.V. ("HR"), Kroll Bond Rating Agency, Inc. ("KBRA"), Moody's Investors Service, Inc. ("Moody's"), Morningstar Credit Ratings, LLC ("Morningstar"), and Standard & Poor's Ratings Services ("S&P").

provide the Commission with the authority to assess penalties in administrative proceedings instituted under section 15E of the Exchange Act.[17]

The Commission adopted rules to implement a registration and oversight program for NRSROs in June 2007.[18] The implementing rules adopted in 2007 were Form NRSRO, Rule 17g-1, Rule 17g-2, Rule 17g-3, Rule 17g-4, Rule 17g-5, and Rule 17g-6.[19] Among other things, the rules require NRSROs to publish information about their activities, make and maintain certain records, file annual reports with the Commission, establish and enforce procedures to protect material nonpublic information, and establish and enforce procedures to manage conflicts of interest. The rules also prohibit NRSROs from having certain conflicts of interest and from engaging in unfair, coercive, and abusive practices. The Commission twice has adopted amendments to certain of these rules.[20]

The Dodd-Frank Act, among other things, established new self-executing requirements applicable to NRSROs and requires that the Commission adopt rules applicable to NRSROs in a number of areas.[21] The Commission has adopted one new rule and proposed other new rules and amendments to existing rules in accordance with the Dodd-Frank Act.[22] The Dodd-Frank Act also amended the Exchange Act to require the Commission staff to examine each NRSRO annually.[23] Further, the Commission is required to make available to the public, in an easily understandable format, an annual report summarizing: (1) the essential findings of the examinations as deemed appropriate by the Commission; (2) the responses by the NRSROs to any material regulatory deficiencies identified by the Commission in those findings; and (3) whether the NRSROs have appropriately addressed the recommendations of the Commission contained in previous reports.[24] The Commission published the first annual report in September 2011[25] and a second annual report in November 2012.[26]

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17 See Pub. L. No. 109-291 §§ 3 and 4; see also 15 U.S.C. 78c, 78o-7, 78q, and 78u-2.

18 See Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 55857 (Jun. 5, 2007), 72 FR 33564 (Jun. 18, 2007).

19 Id. See also 17 CFR 240.17g-1 ("Rule 17g-1"), 17 CFR 240.17g-2 ("Rule 17g-2"), 17 CFR 240.17g-3 ("Rule 17g-3"), 17 CFR 240.17g-5 ("Rule 17g-5"), 17 CFR 240.17g-6 ("Rule 17g-6"), and 17 CFR 249b.300 ("Form NRSRO").

20 See Amendments to Rules for Nationally Recognized Statistical Rating Organizations, 74 FR 6456; see also Amendments to Rules for Nationally Recognized Statistical Rating Organizations, 74 FR 63832.

21 See Pub. L. No. 111-203 §§ 931-939H and § 943.

22 See Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Securities Act of 1933 ("Securities Act") Release No. 9175 (Jan. 20, 2011), 76 FR 4489 (Jan. 26, 2011) (adopting Rule 17g-7 (17 CFR 240.17g-7)) and Nationally Recognized Statistical Rating Organizations, 76 FR 33420.

23 See Pub. L. No. 111-203 §932 and 15 U.S.C. 78o-7(p)(3).

24 See 15 U.S.C. 78o-7(p)(3)(C).

25 See 2011 Summary Report of Commission Staff's Examinations of Each Nationally Recognized Statistical Rating Organization, Commission staff (Sep. 2011), available at http://www.sec.gov/news/studies/2011/2011_nrsro_section15e_examinations_summary_report.pdf.

III. THE CREDIT RATING PROCESS FOR STRUCTURED FINANCE PRODUCTS AND THE CONFLICTS OF INTEREST ASSOCIATED WITH THE ISSUER-PAY AND THE SUBSCRIBER-PAY MODELS

Section 939F(b)(1) provides that the Commission shall carry out a study of the credit rating process for structured finance products and the conflicts of interest associated with the issuer-pay and the subscriber-pay models.[27] The Commission's solicitation of comment for the section 939F study asked about these matters.[28] The discussion below provides an overview of the credit rating process for structured finance products and a description of the conflicts of interest associated with the issuer-pay and the subscriber-pay models.

A. Overview of the Market for Structured Finance Products

The term "structured finance product" as used throughout this study refers broadly to any security or money market instrument backed by an asset pool or as part of any asset-backed or mortgage-backed securities transaction. This broad category of financial instruments includes, but is not limited to: (1) asset-backed securities ("ABS") backed by pools of student loans, credit card receivables, consumer loans and leases, auto loans and leases, auto floor plans, and/or equipment loans and leases; (2) residential mortgage-backed securities ("RMBS"); (3) commercial mortgage-backed securities ("CMBS"); (4) collateralized loan obligations ("CLOs"); and (5) other types of structured debt instruments such as collateralized debt obligations ("CDOs"), including synthetic and hybrid CDOs.

The number of structured finance products sold in the U.S. market has fluctuated greatly in recent years. For example, one source estimates (as reflected in Figure 1) that issuance of certain types of structured finance products peaked in 2006 at $906.6 billion, representing a 228% increase from 2000, and then dropped off sharply in 2007 and 2008 and that issuance has remained low since that time.[29]

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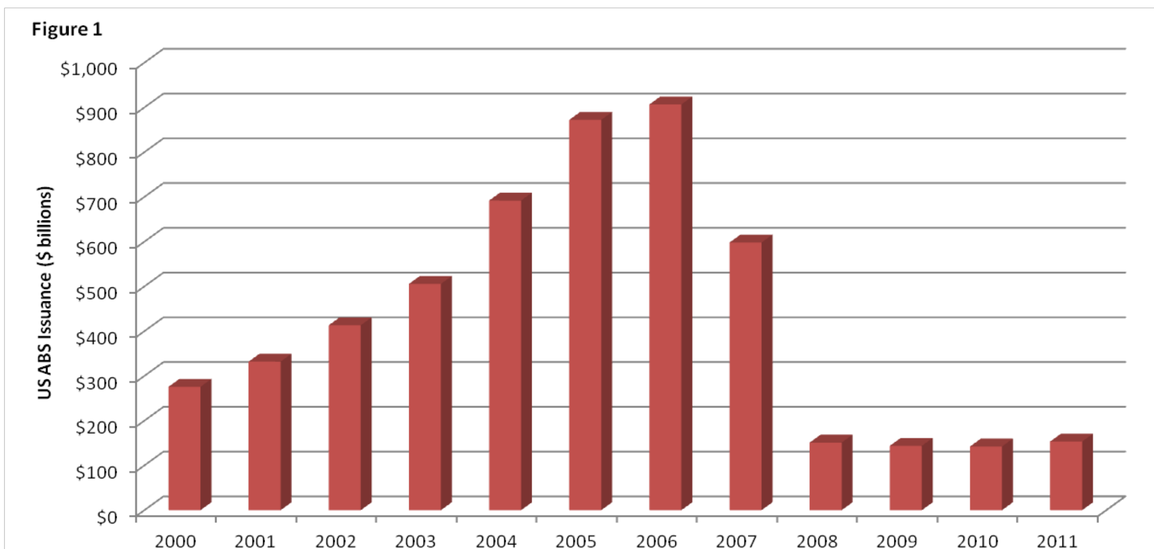
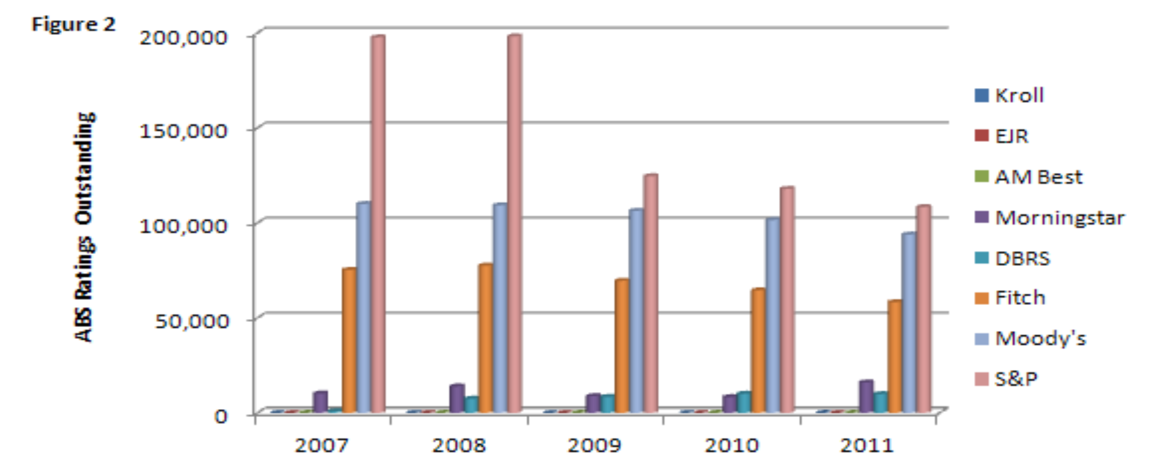
26 See 2012 Summary Report of Commission Staff's Examinations of Each Nationally Recognized Statistical Rating Organization, Commission staff (Nov. 2012), available at http://www.sec.gov/news/studies/2012/nrsro-summary-report-2012.pdf

27 See Pub. L. No. 111-203 § 939F(b)(1). Under the issuer-pay model, the NRSRO receives compensation from issuers and obligors for rating the securities of the issuer or the obligor as an entity. NRSROs operating under this business model generally make their credit ratings publicly available for free. Under the subscriber-pay model, subscribers (e.g., investors) pay the NRSRO for access to the NRSRO's ratings. NRSROs operating under this business model charge subscribers a fee for access to their credit ratings.

28 See Solicitation of Comment to Assist in Study on Assigned Credit Ratings, 76 FR at 28268-70.

29 Source: Asset-Backed Alert (http://www.abalert.com). The types of structured finance products reflected in the statistics in Figure 1 are rated by at least one major rating agency, under the control of a trustee, and collateralized by assets of some kind. Synthetic collateralized debt obligations and catastrophe bonds are also included. The statistics do not include CMBS, Federal National Mortgage Association and Federal Home Loan Mortgage Corporation issuances, municipal issuances, tax-exempt issuances, issuances that are fully retained by an affiliate of the deal sponsor or sold to a commercial-paper conduit operated by an affiliate of the sponsor, and commercial paper and other continuously offered securities such as medium-term notes.





Eight of the ten NRSROs are registered in the class of credit rating for structured finance products.[30] Based on information disclosed by these eight NRSROs in their most recently filed Forms NRSRO for the year ended December 31, 2011, the number of outstanding credit ratings in this class has similarly declined in recent years (see Figure 2).[31]

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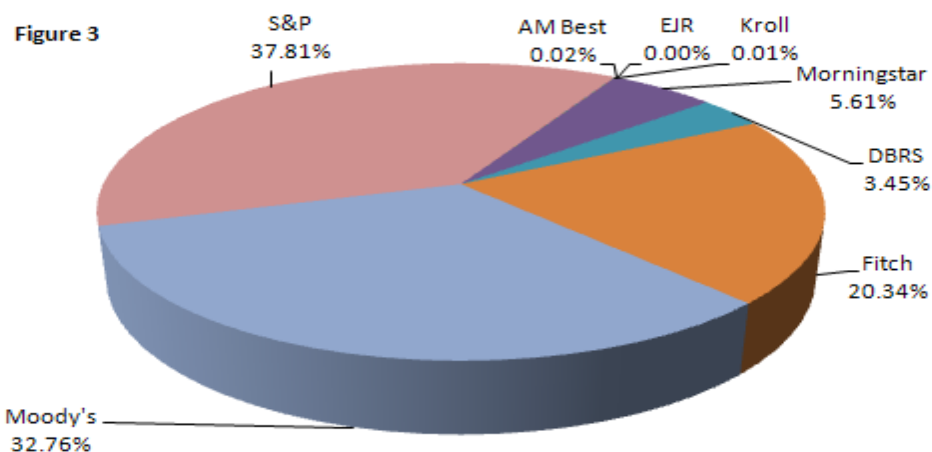
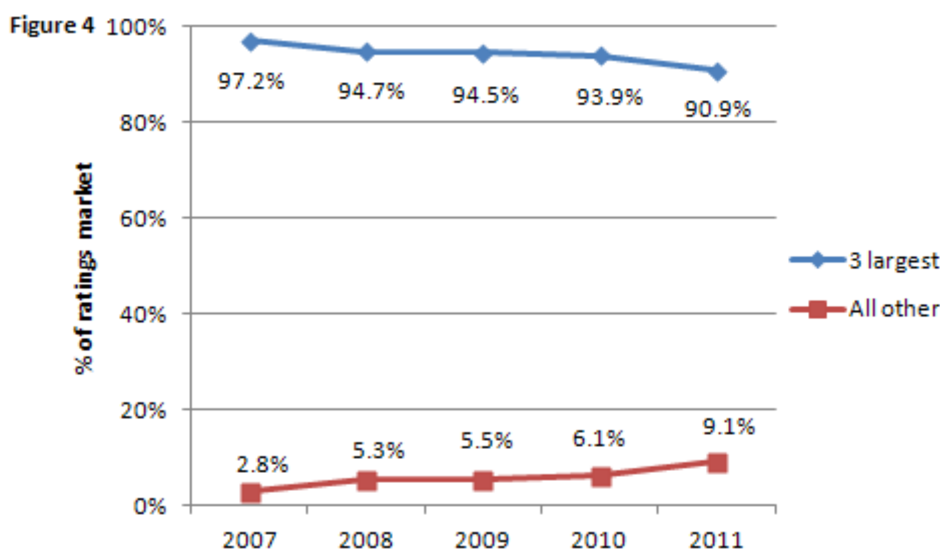
30 JCR and HR are the only NRSROs not registered in the asset-backed securities class. The classes of credit ratings for which an NRSRO can be registered are enumerated in the definition of "nationally recognized statistical rating organization" in section 3(a)(62) of the Exchange Act: (1) financial institutions, brokers, or dealers; (2) insurance companies; (3) corporate issuers; (4) issuers of asset-backed securities (as that term is defined in section 1101(c) of Part 229 of Title 17, Code of Federal Regulations, as in effect on the date of enactment of section 3(a)(62) of the Exchange Act); and (5) issuers of government securities, municipal securities, or securities issued by a foreign government. 15 U.S.C. 78c(a)(62).

31 Rule 17g-1 prescribes, among other things, how an NRSRO must apply to be registered with the Commission, keep its registration up-to-date, and comply with a statutory requirement to furnish the Commission with an annual certification. See 17 CFR 240.17g-1. Specifically, all of these actions must be accomplished by filing a Form NRSRO with the Commission. An NRSRO is required to make its current Form NRSRO and information and documents in Exhibits 1 through 9 publicly available. See 17 CFR

The staff estimates that, as of December 31, 2011, approximately 91% of the outstanding credit ratings for structured finance products were determined by the three largest NRSROs (Fitch, Moody's and S&P) (see Figure 3). This difference in the market share between the largest three and the remaining NRSROs, however, has been declining since the Commission began collecting this data in 2007 (see Figure 4).



240.17g-1(i). Items 6 and 7 of Form NRSRO require an NRSRO to provide the approximate number of credit ratings outstanding in each class of credit rating for which the NRSRO is registered.



B. The Credit Rating Process

The credit rating process for structured finance products used by NRSROs generally is similar, at least with respect to the more common types of products such as RMBS. The following summarizes the general process for rating a non-synthetic structured finance product.[32]

The issuer of the securities to be rated is a bankruptcy remote entity (typically a trust or a limited liability company) that is created solely to hold a pool of assets that generates cash flows, which are used to pay principal and interest on securities issued by the issuing entity. The securities typically are issued in "tranches" that are assigned priorities in terms of receiving interest and principal payments from the cash flows generated by the asset pool and incurring losses resulting from the failure of the assets in the pool to perform (e.g., because of defaults). The tranche that is the last to incur losses has the highest level of "credit enhancement." This tranche receives the highest credit rating and, generally, the arranger of the transaction seeks to obtain a credit rating that is in the highest category of credit rating the NRSRO issues (e.g., "AAA").[33] Usually, the arranger seeks to design a capital structure for the issuer that will result in securities at given tranches receiving specific credit ratings that are demanded by the potential investors in the securities (e.g., the arranger will seek to design a capital structure that results in a "AAA" rating for securities in the most senior tranche). The investors may require specific

[32] See Proposed Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 57967 (Jun. 16, 2008), 73 FR 36212, 36213-16 (Jun. 25, 2008) (describing the process for creating and rating certain structured finance products). See also Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies, at 6-10; The Role of Credit Rating Agencies in Structured Finance Markets, International Organization of Securities Commission (May 2008) at 3-7.

[33] Frequently, the arranger will not obtain credit ratings for all the tranches, particularly the lowest tranches.

credit ratings to obtain benefits or relief under statutes and regulations using the term NRSRO.[34] They also may require specific credit ratings to meet investment guidelines or contractual requirements.

The arranger initiates the rating process by sending the NRSRO data on the assets to be held by the issuing entity (e.g., mortgages, student loans, credit card receivables or, in the case of CDOs and CLOs, the underlying RBMS or ABS), the proposed capital structure of the trust, and the proposed level of credit enhancement for each tranche of security to be issued by the issuing entity. The NRSRO assigns a lead analyst, who is responsible for analyzing the information and, ultimately, for formulating a ratings recommendation that will be submitted to a rating committee.[35]

The lead analyst uses quantitative expected loss models and qualitative analysis to develop predictions as to how the assets in the pool held by the issuing entity likely will perform under market stresses of varying severity. These predictions include assumptions regarding the amount of principal likely to be recovered in the event of default when the asset is secured by collateral. The analyst typically reviews different characteristics of each asset in the pool. For example, in the case of an RMBS (which holds a pool of residential mortgages), the analyst reviews the value of the property relative to the amount of the loan, the amount of equity the borrower has in the property, the geographic location of the property, the credit score of the borrower, the income and net worth of the borrower, and the amount of documentation provided by the borrower to verify the borrower's financial condition. The analyst also may consider other factors, such as the quality of the loan servicer or the actual performance of similar pools of assets. The purpose of this loss analysis is to determine how much credit enhancement a given tranche would need for a security in that tranche to receive a particular category of credit rating (e.g., a "AAA" rating).

The analyst next evaluates the proposed capital structure of the issuer. Generally, the arranger proposes a capital structure with credit enhancement levels to obtain desired credit ratings for securities in each tranche. The analyst reviews the proposed credit enhancement levels against the predictions as to how the assets in the pool will perform to determine whether the amount of credit enhancement at each tranche is sufficient to support the desired credit rating. If the analyst concludes that the capital structure of the issuer will not support the desired rating for a security in a particular tranche, the analyst typically conveys this preliminary conclusion to the arranger. The arranger requests this preliminary view from the analyst because – as noted above – the potential investors who will purchase the securities generally demand specific credit ratings. Consequently, if the securities will not receive the credit rating sought by the potential investors, the arranger may not be able to sell them. In the case where the analyst's preliminary view differs from the expectation of the arranger, the arranger can accept the lower credit ratings or take steps to obtain the desired credit ratings. These steps can include changing

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[34] See Stocktaking on the use of credit ratings, Joint Forum (June 2009), available at http://www.bis.org/publ/joint22.pdf?noframes=1 (describing how various jurisdictions use credit ratings in laws and regulations).

[35] See the S&P Letter.

the composition of the asset pool so that it yields better expected loss measures or adjusting the capital structure of the issuer to increase the level of credit enhancement at a given tranche.

The next step in the process is to perform a cash flow analysis on the interest and principal expected to be received by the issuing entity from the asset pool to determine whether these cash flows will be sufficient to pay the interest and principal due on each security, as well as to cover the administrative expenses of the issuing entity. The analyst uses a quantitative model often developed by the NRSRO that analyzes the amount of principal and interest payments from the assets over the terms of the securities under various stress scenarios. The outputs of this model are compared against the required payments on the securities specified in the transaction's legal documents.

In addition to the expected loss and cash flow analysis, the analyst reviews the legal documentation of the issuing entity to evaluate whether it is bankruptcy remote (i.e., isolated from the effects of any potential bankruptcy or insolvency of the arranger). The analyst also reviews operational and administrative risk associated with the issuing entity, using the results of periodic examinations of the principal parties involved in the issuance of the security, including the asset originators, the servicer of the assets, and the trustee. In assessing the servicer, for example, an NRSRO might review its past performance with respect to loan collections, billing, recordkeeping, and the treatment of delinquent loans.

Following these steps, the analyst develops a rating recommendation for the securities in each tranche. The recommendation is presented to a rating committee, which may be comprised of a lead analyst, a senior analyst, and a chairperson, among others.[36] An analyst is not allowed to participate on a committee if he or she has a conflict of interest. Potential conflicts of interest may be monitored throughout the rating process. Conflicts of interest also are controlled by internal procedures, such as requiring credit ratings to be determined by a committee rather than individual analysts, requiring rating committees to act by majority vote, and physically or substantively segregating rating committees from business functions.

Generally, the rating committee votes on the rating for the securities in each tranche and usually notifies the issuer privately of the rating decision. An issuer may be able to appeal a rating decision, although the appeal is not always granted, and, if granted, may not necessarily result in any change in the rating decision. In those cases where appeals are granted, the issuer may be entitled to a decision by a second rating committee, but the standards for changing a rating are generally very stringent (e.g., missing or materially misinterpreting critical information). Final rating decisions are published and subsequently monitored and maintained through surveillance processes.[37]

Generally, the analyst who monitors the rating after it is issued is different than the analyst who performed the initial rating. The surveillance process generally includes a periodic review of the performance of the assets in the pool, including delinquency and loss trends. If it is

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[36] Generally, the arranger does not know the identities of the members of the rating committee.

[37] An issuer may disregard the final rating outcome and withdraw its rating request for a rating. Following this, an NRSRO may choose not to issue and publish the ratings on the securities.

determined that the asset pool is performing differently than predicted, the surveillance analyst may recommend taking a rating action by presenting the recommendation to a rating committee.

An NRSRO that operates under an issuer-pay model typically is paid only if the credit rating is issued, though sometimes it receives a partial fee for the analytic work undertaken if the credit rating is not issued. The issuer will pay an initial rating fee to the NRSRO when the transaction is sold. A surveillance fee for maintaining the rating also may be paid at closing or over the life of the securities.

C. Conflicts of Interest

1. Issuer-Pay Model

a. Overview

Under the issuer-pay model, the NRSRO is paid by the arranger to rate a proposed structured finance product. As discussed above, investors may not purchase a structured finance product if it is not rated at a specific level because, for example, they are subject to laws or regulations that provide benefits or relief based on credit ratings. Investors also may be subject to investment guidelines that require the instruments they hold to be rated at or above a certain category in a rating scale (e.g., the four highest categories). Arrangers also desire higher credit ratings to lower financing costs of the products they structure as lower ratings generally result in higher interest rates. For these reasons, this payment model presents an inherent conflict of interest because the arranger has an economic interest in obtaining credit ratings that are demanded by investors and that lower the issuer's financing costs and the NRSRO has an economic interest in having the arranger hire it in the future.[38] This creates the potential that the NRSRO will be influenced to issue the credit ratings desired by the arranger.

There are several aspects of the credit rating process for structured finance products that may heighten the effects of the conflicts of interest inherent in the issuer-pay model. For example, an arranger may have multiple NRSROs analyze a proposed structured finance product and select the one or two NRSROs that provide the desired credit ratings (i.e., engage in "rating shopping"). When this occurs, the arranger provides information about a proposed structured finance product (e.g., a CMBS) to multiple NRSROs that rate the type of product being offered. The NRSROs will provide preliminary estimations of the credit enhancement levels necessary to support a credit rating in the highest credit rating category. The arranger then selects the NRSRO or NRSROs that provide it with the preliminary credit enhancement level it desires. This creates an incentive for the NRSRO or NRSROs to provide preliminary estimations desired by the arranger in order to be hired to produce a final credit rating for the transaction.

In addition to the "rating shopping" dynamic, the issuer-pay conflict may be more acute for structured finance products (as compared to other types of debt instruments) because certain

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38 See Proposed Rules for Nationally Recognized Statistical Rating Organizations, 73 FR 36218.

arrangers of these products bring substantial ratings business to the NRSROs.[39] As sources of repeat business, arrangers of structured finance products may exert greater undue influence on an NRSRO than personnel involved in obtaining credit ratings for other types of issuers.[40] Furthermore, in the case of certain structured finance products, there are only a few major investment banks that assemble and sell these products.[41] Losing the business of one of these banks could have a substantial impact on an NRSRO's revenues.[42] Conversely, an arranger potentially could bring repeat rating business to a credit rating agency because the arranger's own credit rating was determined by the credit rating agency and, therefore, wants to curry favor with that credit rating agency.

b. Comments on the Issuer-Pay Model

Several commenters stated that the issuer-pay model is flawed because issuers, who benefit from higher ratings and delays in downgrades, provide the credit rating agencies' revenues, while the purchasers of structured finance products, who use credit ratings as indicators of risk, neither play a role in the ratings process nor have a way of holding credit rating agencies accountable for inaccuracies.[43] One commenter cites a working paper testing whether credit ratings contain the same information across asset classes.[44] One finding in that working paper is that – compared to traditional corporate bonds – structured finance products receive more generous ratings, and "ratings standards are inversely correlated with revenue generation among the asset classes" (i.e., the more revenue a product brings in, the lower the ratings standards are for that product).[45] The authors of this working paper attribute this finding to the conflicts of interest in the issuer-pay model.[46]

Several commenters note that another aspect of structured finance products that exacerbates the conflicts of interest associated with the issuer-pay model is the complexity of the models used to rate structured finance products as compared to other products.[47] One commenter argues that this complexity heightens the risk that the rating process will be corrupted.[48] Another commenter suggests that since the process is more opaque to outside

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[39] See Amendments to Rules for Nationally Recognized Statistical Rating Organizations, 74 FR at 63844; Proposed Rules for Nationally Recognized Statistical Rating Organizations, 73 FR at 36219. See also Ellis, Fairchild, & D'Souza at 42 ("[P]ressures to 'over-rate' the issue are more intense in the case of structured products."); Coffee, Turmoil in the U.S. Credit Markets: The Role of the Credit Rating Agencies at 7 ("No individual corporate issuer accounts for a significant share of the revenues of any rating agency.").

[40] See He, Qian & Strahan.

[41] See Ellis, Fairchild, & D'Souza at 42.

[42] Id.

[43] See, e.g., the Franken/Wicker Letter and the Manns Letter.

[44] See the Franken Letter (citing Cornaggia, Cornaggia, & Hund).

[45] See Cornaggia, Cornaggia, & Hund.

[46] Id.

[47] See the AFR Letter and the Franken/Wicker Letter.

[48] See the AFR Letter.

observers, it is easier for credit rating agencies to conceal illegitimate adjustments to the ratings.[49] One study suggests that the more complex a product is, the greater the chance that different credit rating agencies may determine different credit ratings for the product, which increases the opportunity for the issuer to engage in "rating shopping."[50]

Comparing the issuer-pay model to the subscriber-pay model, one NRSRO – which historically has operated mainly under the subscriber-pay model but initiated an issuer-pay ratings service in 2010 – argues that the issuer-pay model is more susceptible to undue influence and manipulation.[51] This NRSRO estimates that revenues from a one-year surveillance subscription are between 1%-20% of the revenues an NRSRO receives for issuing an initial rating for a structured finance product (initial ratings primarily are produced under the issuer-pay model).[52] Additionally, the commenter states that there are significantly fewer arrangers than there are potential subscribers.[53] The NRSRO concludes that NRSROs are more susceptible to the undue influence of a single arranger under the issuer-pay model than they are to the influence of a single subscriber under the subscriber-pay model because a single arranger can have a much greater effect on the NRSRO's revenues than any single subscriber.[54]

The Commission requested empirical data, studies, or other information that would indicate conflicts of interest associated with the issuer-pay model influenced credit ratings.[55] Several commenters cited sources for the proposition that the conflict of interest inherent in the issuer-pay model leads to inflated credit ratings for structured finance products.[56] For example, two commenters cite a study that indicates that the downgrades of structured finance products during the 2007-2008 credit crisis were much more severe than downgrades of corporate bonds during the 2001-2002 recession.[57] The authors of this study state:

> Our regression analysis shows that tranches with one rater only were more likely to be downgraded—a finding consistent with issuers shopping for the highest ratings available from the rating agencies. Consistent with claims made in the news media, we find evidence that Standard & Poor's (S&P's) ratings were somewhat inflated. Our regressions show that tranches rated by S&P only were more likely than tranches rated by either Moody's or Fitch to be downgraded subsequently. While some "rating shopping" probably took place, more than 80% of all tranches were rated by either two or three

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[49] See the Franken/Wicker Letter.

[50] See Skreta & Veldkamp.

[51] See the Morningstar Letter.

[52] Id.

[53] Id.

[54] Id.

[55] See Solicitation of Comment to Assist in Study on Assigned Credit Ratings, 76 FR at 28269.

[56] See the AFR Letter, the AFSCME Letter, and the Franken/Wicker Letter.

[57] See the Franken/Wicker Letter (citing Benmelech & Dlugosz).

> agencies and were less prone to rating shopping. We also provide anecdotal evidence that one of the main causes of the credit rating disaster was overreliance on statistical models that failed to account for default correlation at a macroeconomic level.[58]

Several commenters also cite an investigation by the Permanent Subcommittee on Investigations of the U.S. Senate.[59] The report resulting from this investigation concluded that "a host of factors [were] responsible for the inaccurate credit ratings issued by Moody's and S&P" in the lead up to the 2008 financial crisis, but that "one significant cause was the inherent conflict of interest arising from the system used to pay for credit ratings."[60] Additional factors responsible for the inaccurate ratings cited in the report include rating models that failed to include relevant mortgage performance data, unclear and subjective criteria used to produce ratings, a failure to apply updated rating models to existing rated transactions, and a failure to provide adequate staffing to perform rating and surveillance services, despite record revenues.[61]

A commenter also cites a paper that indicates that competition from a new entrant in the credit rating industry results in lower quality credit ratings from incumbents.[62] This paper, however, also concluded that it "appears unlikely that ratings shopping or growth in overall market share can explain these patterns."[63]

One NRSRO cited a 2003 paper that found that reputation-related incentives, not issuer-pays conflicts, influenced rating decisions.[64] The same NRSRO also cites a December 2003 paper studying whether issuer-pay conflicts influenced ratings decisions, noting that its findings are consistent with the paper.[65] The authors of the paper used a data set of about 2,000 credit rating migrations and found that reputation-related incentives – not issuer-pay conflicts – influenced rating decisions.[66] Specifically, the authors did not find any evidence consistent with rating agencies acting in the interests of issuers due to a conflict of interest but instead, found

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58 See Benmelech and Dlugosz at 162.

59 See the AFR Letter, the AFSCME Letter, and the Franken/Wicker Letter (citing Wall Street and the Financial Crisis: Anatomy of a Financial Collapse, Permanent Subcommittee on Investigations, U.S. Senate (Apr. 13, 2011)).

60 See Wall Street and the Financial Crisis: Anatomy of a Financial Collapse, U.S. Senate at 7.

61 Id.

62 See the AFR Letter (citing Becker & Milbourn).

63 See Becker & Milbourn at 30.

64 See the Moody's Letter (citing Measuring the Performance of Corporate Bond Ratings, Moody's (Apr. 2003)). Moody's states that internal "research demonstrates that the issuer-pay era is actually associated with higher accuracy ratios, lower investment-grade loss rates, and higher downgrade rates."

65 See the Moody's Letter (citing Daniel M. Covitz & Paul Harrison, Testing Conflicts of Interest at Bond Ratings Agencies with Market Anticipation: Evidence that Reputation Incentives Dominate, Board of Governors of the Federal Reserve System (2003), available at http://www.federalreserve.gov/pubs/feds/2003/200368/200368pap.pdf).

66 See Covitz & Harrison.

evidence suggesting that rating agencies are relatively responsive to reputation concerns.[67] Another NRSRO reports that it has conducted similar studies and states that it "has been utilizing an issuer-pays model for over 30 years and default and transition studies have clearly demonstrated strong correlations between ratings levels and the likelihood of default."[68]

2. Subscriber-Pay Model

a. Overview

As with the issuer-pay model, the subscriber-pay model also presents certain conflicts of interest. These conflicts result because subscribers – the source of the NRSRO's revenues – could have an interest in specific credit ratings and, consequently, could exert pressure on the NRSRO to determine or maintain credit ratings that will result in outcomes that favor the subscriber.[69] For instance, subscribers may use the credit ratings of the NRSRO to comply with, and obtain benefits or relief under, statutes and regulations using the term "NRSRO," or subscribers may own investments or have entered into transactions that could be favorably or adversely impacted by a credit rating issued by the NRSRO. In other words, a subscriber (like an issuer) may have an interest in the NRSRO determining or maintaining a particular credit rating. In cases where the interests of a substantial number of subscribers are aligned, this potential conflict may be heightened.

b. Comments on the Subscriber-Pay Model

The Commission requested comments regarding the conflicts of interest inherent in the subscriber-pay model.[70] Several commenters note that subscribers have their own interests in credit ratings.[71] One NRSRO states that a subscriber that is an investor seeking a higher risk premium might prefer a lower credit rating, while a subscriber that is a broker-dealer subject to net capital rules or a money market fund subject to investment quality requirements might prefer a higher credit rating.[72] Additionally, the NRSRO highlights that the subscriber-pay model generally does not allow for broad market scrutiny of credit ratings because – unlike the issuer-pay model – the credit ratings are not widely disseminated to the public.[73] The NRSRO argues that widespread public dissemination of issuer-paid credit ratings provides quality control.[74]

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67 See id.

68 See the S&P Letter (citing S&P's Global Structured Finance Default Study – 1978-2010, S&P (Mar. 28, 2011)).

69 See 2011 Summary Report of Commission Staff's Examinations of Each Nationally Recognized Statistical Rating Organization, Commission staff.

70 See Solicitation of Comment to Assist in Study on Assigned Credit Ratings, 76 FR at 28269.

71 See the AFR Letter, the AFSCME Letter, and the CRE Letter.

72 See the S&P Letter.

73 Id.

74 Id.

Commenters did not provide empirical data, studies, or other information that the conflicts of interest associated with the subscriber-pay model influenced credit ratings. This may be because of the relatively small number of structured finance products that have been rated by NRSROs using the subscriber-pay model.

D. Measures to Mitigate Conflicts of Interest

The sections below discuss measures that help to mitigate the conflicts of interests inherent in the credit rating industry.

1. Statutes and Commission Rules

a. Overview of Requirements Designed to Address NRSRO Conflicts

As discussed above in section I.C, the Rating Agency Act of 2006 and the Commission's rules thereunder established a registration and oversight program for NRSROs. Under this program, NRSROs are subject to a number of requirements designed to address conflicts of interest. For example, NRSROs are required to publicly disclose certain information in Form NRSRO.[75] This information includes: (1) a list describing, in general terms, the types of conflicts of interest that arise from the NRSRO's business activities;[76] and (2) a copy of the written policies and procedures the NRSRO establishes, maintains, and enforces to address and manage conflicts of interest.[77] Section 15E(h)(1) of the Exchange Act requires an NRSRO to establish, maintain, and enforce policies and procedures reasonably designed, taking into consideration the nature of its business, to address and manage conflicts of interest.[78]

Section 15E(h)(2) of the Exchange Act requires the Commission to adopt rules to prohibit or require the management and disclosure of conflicts of interest relating to the issuance of credit ratings.[79] The statute also identifies certain types of conflicts relating to the issuance of credit ratings that the Commission may address in its rules.[80] Furthermore, it contains a catchall provision for any other potential conflict of interest that the Commission deems is necessary or appropriate in the public interest or for the protection of investors to address in its rules.[81] The Commission implemented these statutory provisions through the adoption of Rule 17g-5 under the Exchange Act.[82] This rule prohibits certain types of conflicts if the NRSRO has not

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75 See Form NRSRO and the instructions to Form NRSRO (17 CFR 240.249b.300).

76 See Form NRSRO, Exhibit 6.

77 See Form NRSRO, Exhibit 7.

78 15 U.S.C. 78o-7(h)(1).

79 15 U.S.C. 78o-7(h)(2).

80 See 15 U.S.C. 78o-7(h)(2)(A) through (D).

81 See 15 U.S.C. 78o-7(h)(2)(E).

82 See 17 CFR 240.17g-5.

disclosed the conflicts and established policies and procedures to manage the conflicts.[83] The rule also prohibits certain types of conflicts outright.[84] Consequently, an NRSRO would violate

83 See 17 CFR 240.17g-5(a) and (b). Paragraph (a) of Rule 17g-5 prohibits a person within an NRSRO from having a conflict of interest relating to the issuance of a credit rating that is identified in paragraph (b) of the rule unless the NRSRO has disclosed the type of conflict of interest in Exhibit 6 to Form NRSRO and has implemented policies and procedures to address and manage the type of conflict of interest in accordance with Section 15E(h)(1) of the Exchange Act. The following conflicts are identified in paragraph (b) of Rule 17g-5 and, therefore, subject to the provisions of paragraph (a):

Being paid by issuers or underwriters to determine credit ratings with respect to securities or money market instruments they issue or underwrite;

Being paid by obligors to determine credit ratings with respect to the obligors;

Being paid for services in addition to determining credit ratings by issuers, underwriters, or obligors that have paid the NRSRO to determine a credit rating;

Being paid by persons for subscriptions to receive or access the credit ratings of the NRSRO and/or for other services offered by the NRSRO where such persons may use the credit ratings of the NRSRO to comply with, and obtain benefits or relief under, statutes and regulations using the term "NRSRO;"

Being paid by persons for subscriptions to receive or access the credit ratings of the NRSRO and/or for other services offered by the NRSRO where such persons also may own investments or have entered into transactions that could be favorably or adversely impacted by a credit rating issued by the NRSRO;

Allowing persons within the NRSRO to directly own securities or money market instruments of, or having other direct ownership interests in, issuers or obligors subject to a credit rating determined by the NRSRO;

Allowing persons within the NRSRO to have a business relationship that is more than an arms length ordinary course of business relationship with issuers or obligors subject to a credit rating determined by the NRSRO;

Having a person associated with the NRSRO that is a broker or dealer engaged in the business of underwriting securities or money market instruments;

Issuing or maintaining a credit rating for a security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction that was paid for by the issuer, sponsor, or underwriter of the security or money market instrument; and

Any other type of conflict of interest relating to the issuance of credit ratings by the NRSRO that is material to the NRSRO and that is identified by the NRSRO in Exhibit 6 to Form NRSRO.

84 See 17 CFR 240.17g-5(c). Paragraph (c) of Rule 17g-5 specifically prohibits outright the following seven types of conflicts of interest:

The NRSRO issues or maintains a credit rating solicited by a person that, in the most recently ended fiscal year, provided the NRSRO with net revenue (as reported under Rule 17g-3) equalling or exceeding 10% of the total net revenue of the NRSRO for the fiscal year;

The NRSRO issues or maintains a credit rating with respect to a person (excluding a sovereign nation or an agency of a sovereign nation) where the NRSRO, a credit analyst that participated in determining the credit rating, or a person responsible for approving the credit rating, directly owns securities of, or has any other direct ownership interest in, the person that is subject to the credit rating;

The NRSRO issues or maintains a credit rating with respect to a person associated with the NRSRO;

The NRSRO issues or maintains a credit rating where a credit analyst who participated in determining the credit rating, or a person responsible for approving the credit rating, is an officer or director of the person that is subject to the credit rating;

the rule if it issues or maintains a credit rating while having these conflicts regardless of whether it had disclosed the conflicts and established procedures to address them.[85] Furthermore, as discussed in more detail in section V below, Rule 17g-5 has provisions designed to address the issuer-pay conflict as it relates to structured finance products by providing a mechanism for NRSROs to determine unsolicited credit ratings for these instruments.[86]

The Dodd-Frank Act established additional requirements with respect to conflicts of interest. For example, section 932(a) of the Dodd-Frank Act added new paragraph (4) to section 15E(h) of the Exchange Act.[87] Sections 15E(h)(4)(A)(i) and (ii) of the Exchange Act require an NRSRO to establish, maintain, and enforce policies and procedures reasonably designed to ensure that, in any case in which an employee of a person subject to a credit rating of the NRSRO or the issuer, underwriter, or sponsor of a security or money market instrument subject to a credit rating of the NRSRO, was employed by the NRSRO and participated in any capacity in determining credit ratings for the person or the securities or money market instruments during the 1-year period preceding the date an action was taken with respect to the credit rating, the NRSRO shall: (1) conduct a review to determine whether any conflicts of interest of the employee influenced the credit rating (a "look-back review"); and (2) take action to revise the rating if appropriate, in accordance with such rules as the Commission shall prescribe.[88] Consequently, section 15E(h)(4)(A)(i) of the Exchange Act contains a self-executing provision requiring an NRSRO to establish, maintain, and enforce policies and procedures to conduct look-back reviews, and section 15E(h)(4)(ii) contains a provision mandating Commission rulemaking with respect to requirements for an NRSRO to revise a credit rating in certain circumstances.[89] The Commission has proposed a new rule to implement the rulemaking required in section 15E(h)(4)(A)(ii) of the Exchange Act.[90]

The NRSRO issues or maintains a credit rating with respect to an obligor or security where the NRSRO or a person associated with the nationally recognized statistical rating organization made recommendations to the obligor or the issuer, underwriter, or sponsor of the security about the corporate or legal structure, assets, liabilities, or activities of the obligor or issuer of the security;

The NRSRO issues or maintains a credit rating where the fee paid for the rating was negotiated, discussed, or arranged by a person within the NRSRO who has responsibility for participating in determining credit ratings or for developing or approving procedures or methodologies used for determining credit ratings, including qualitative and quantitative models; and

The NRSRO issues or maintains a credit rating where a credit analyst who participated in determining or monitoring the credit rating, or a person responsible for approving the credit rating received gifts, including entertainment, from the obligor being rated, or from the issuer, underwriter, or sponsor of the securities being rated, other than items provided in the context of normal business activities such as meetings that have an aggregate value of no more than $25.

[85] Id.

[86] See 17 CFR 240.17g-5(a)(3) and (b)(9).

[87] Pub. L. No. 111-203 § 932(a) and 15 U.S.C. 78o-7(h)(4).

[88] See 15 U.S.C. 78o-7(h)(4)(A)(i) and (ii) (emphasis added).

[89] Id.

[90] See Proposed Rules for Nationally Recognized Statistical Rating Organizations, 76 FR at 33429-31 (the new rule would require that the policies and procedures the NRSRO establishes, maintains, and enforces pursuant to Section 15E(h)(4)(A) of the Exchange Act must address instances in which a review conducted

In addition, section 932(a) of the Dodd-Frank Act added new paragraph (5) to section 15E(h) of the Exchange Act.[91] Section 15E(h)(5)(A) of the Exchange Act requires each NRSRO to report to the Commission any case the NRSRO knows or can reasonably be expected to know where a person associated with the NRSRO within the previous five years obtains employment with any obligor, issuer, underwriter, or sponsor of a security or money market instrument for which the NRSRO issued a credit rating during the 12-month period prior to such employment, if such employee was: (1) a senior officer of such NRSRO, (2) participated in any capacity in determining credit ratings for the covered company, or (3) supervised an employee who participated in any capacity in determining credit ratings for the covered company.[92] Section 15E(h)(5)(B) of the Exchange Act requires that upon receiving such a report, the Commission must make such information publicly available.[93] In order to facilitate implementation of these requirements, the Commission established a means for NRSROs to submit these reports electronically via the Commission's Internet website for NRSRO related matters.[94] In addition, a link to the reports submitted by NRSROs is publicly available on the same Internet web page.

Section 932(a) of the Dodd-Frank Act also added new paragraph (3) to section 15E(h) of the Exchange Act.[95] Section 15E(h)(3)(A) of the Exchange Act provides that the Commission shall issue rules to prevent the sales and marketing considerations of an NRSRO from influencing the production of credit ratings by the NRSRO.[96] The Commission has proposed amendments to Rule 17g-5 to implement the rulemaking required in section 15E(h)(3)(A) of the Exchange Act by establishing a new outright prohibition on conflicts of interest relating to sales and marketing activities.[97]

b. Comments on Requirements Designed to Address NRSRO Conflicts

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pursuant to those policies and procedures determines that a conflict of interest influenced a credit rating assigned to an obligor, security, or money market instrument by including, at a minimum, procedures that are reasonably designed to ensure the NRSRO will: (1) immediately place the credit rating on credit watch; (2) promptly determine whether the credit rating must be revised so it no longer is influenced by a conflict of interest and is solely the product of the NRSRO's documented procedures and methodologies for determining credit ratings; and (3) promptly publish a revised credit rating, if appropriate, or affirm the credit rating if appropriate).

91 Pub. L. No. 111-203 § 932(a) and 15 U.S.C. 78o-7(h)(5).

92 See 15 U.S.C. 78o-7(h)(5)(A).

93 See 15 U.S.C. 78o-7(h)(5)(B).

94 See http://www.sec.gov/divisions/marketreg/ratingagency.htm.

95 Pub. L. No. 111-203 § 932(a) and 15 U.S.C. 78o-7(h)(3).

96 15 U.S.C. 78o-7(h)(3)(A).

97 See Proposed Rules for Nationally Recognized Statistical Rating Organizations, 76 FR at 33425-26 (the proposed rule would prohibit an NRSRO from issuing or maintaining a credit rating where a person within the NRSRO who participates in the sales or marketing of a product or service of the NRSRO or a product or service of a person associated with the NRSRO 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 models).

The Commission requested comments on whether there were empirical data, studies, or other information that the statutory and regulatory requirements designed to address conflicts of interest have not mitigated the conflicts of interest in rating structured finance products.[98] In requesting comment, the Commission noted that much of the NRSRO activity in rating RMBS and CDOs linked to subprime mortgages occurred prior to the effectiveness of these requirements.[99]

One commenter claims that section 932 of the Dodd-Frank Act sufficiently addresses conflicts of interests, and "obviates the need for an assignment system by a 'Credit Rating Agency.'"[100] The commenter argues that the rules promulgated by the SEC pursuant to the Dodd-Frank Act, unlike the proposed Section 15E(w) System, address conflicts of interest without endangering the viability of the credit rating process.[101] Another commenter states that the Commission has made significant efforts with respect to managing conflicts of interest in the industry, but notes that eliminating conflicts in their entirety would be impossible.[102] The commenter also emphasizes that, in addition to the NRSRO oversight and registration program in the U.S., the International Organization of Securities Commissions has promulgated a code of conduct for rating agencies, which most, if not all, NRSROs follow.[103] The code includes measures to ensure the quality and integrity of the ratings process which the credit rating industry is pursuing. Another commenter opines that the Commission's current regulations, with some modifications, coupled with the many other reforms required under the Dodd-Frank Act will better serve the public interest and the protection of investors than implementation of the Section 15E(w) System.[104]

c. Other Structured Finance Initiatives

The Commission has undertaken a number of initiatives with respect to structured finance (the "structured finance initiatives"). For example, in April 2010, the Commission proposed certain revisions to the existing rules applicable to certain structured finance transactions.[105] The proposals, among other things, would require issuers of structured finance products, including RMBS and other ABS, to disclose additional information about the assets underlying the products.[106] For example, the issuer would be required to file with the Commission tagged,

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98 See Solicitation of Comment to Assist in Study on Assigned Credit Ratings, 76 FR at 28269.

99 Id. See also Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies, Commission staff (July 2008), available at http://www.sec.gov/news/studies/2008/craexamination070808.pdf.

100 See the Redwood Letter.

101 Id.

102 See the SIFMA Letter (citing the following regulations issued by the Commission under the Exchange: 17 CFR 240.17g-2; 17 CFR 240.17g-5; 17 CFR 240.17g-6; and 17 CFR 240.17g-7).

103 Id.

104 See the ASF Letter.

105 See Asset-Backed Securities, Securities Act Release No. 9117 (Apr. 7, 2010), 75 FR 23328 (May 3, 2010).

106 Id.

computer-readable, standardized information about the specific assets, or loans, in the pool. The issuer also would be required to file a computer program that provides investors with a tool to analyze information about specific loans within the pool of assets. These proposals are intended to provide investors with timely and sufficient information that they can access and review independently and thereby reduce the likelihood of undue reliance on credit ratings.

The Dodd-Frank Act also imposes other requirements on structured finance products. For example, section 942(b) of the Dodd-Frank Act amended section 7(c) of the Securities Act to require the Commission to implement regulations requiring an issuer of an ABS to disclose, for each tranche or class of security, certain loan-level information regarding the assets backing the security.[107] In light of section 942(b), the Commission requested comment on certain portions of the April 2010 proposal to require asset-level information to assist it in considering whether that requirement appropriately implements section 942(b) and whether additional information may be required. The staff expects to make recommendations to the Commission on these proposals in the coming months.

Section 941 of the Dodd-Frank Act amended the Exchange Act to add section 15G.[108] Section 15G requires the Commission, the Federal banking agencies, and, with respect to residential mortgages, the Secretary of Housing and Urban Development and the Federal Housing Finance Agency, to prescribe rules to require that a securitizer retain an economic interest in a material portion of the credit risk for any asset that it transfers, sells, or conveys to a third party.[109] The chairperson of the Financial Stability Oversight Council is tasked with coordinating this regulatory effort.[110] In March 2011, the Commission proposed rules (jointly with the other agencies) to implement the risk retention provisions in section 941.[111]

Section 943 of the Dodd-Frank Act required the Commission to issue rules on the use of representations and warranties in the market for ABS. In January 2011, the Commission adopted final rules implementing section 943.[112] The final rules require securitizers to file with the Commission, in tabular format, information about the history of repurchase requests they received and repurchases they made relating to their outstanding ABS. The final rules also require NRSROs to provide a description of the representations, warranties and enforcement mechanisms available to investors in an ABS offering.

Section 945 of the Dodd-Frank Act amended section 7 of the Securities Act to require the Commission to issue rules requiring certain structured finance issuers in a Securities Act

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107 See Pub. L. No. 111-203 § 942(b) and 15 U.S.C. 78o(d).

108 See Pub. L. No. 111-203 § 941 and 15 U.S.C. 78o-11.

109 See 15 U.S.C. 78o-11.

110 Id.

111 See Credit Risk Retention, Exchange Act Release No. 64148 (Mar. 31, 2011), 76 FR 24090 (Apr. 29, 2011).

112 See Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Securities Act Release No. 9175 (Jan. 20, 2011), 76 FR 4489 (Jan. 26, 2011).

registered transaction to perform a review of the assets underlying the structured finance product, and disclose the nature of such review.[113] In January 2011, the Commission adopted final rules implementing section 945.[114] These final rules also require issuers to disclose:

> Information about how the loans in the pool differ from the loan underwriting criteria disclosed in the prospectus;
>
> Information about loans that did not meet the disclosed underwriting criteria but were nonetheless included in the pool; and
>
> Information about the entity that made the determination that such loans should be included in the pool, despite not having met the disclosed underwriting standards.

Section 621 of the Dodd-Frank Act added section 27B to the Securities Act.[115] Section 27B of the Securities Act prohibits an underwriter, placement agent, initial purchaser, sponsor, or any affiliate or subsidiary of any such entity, of ABS from engaging in any transaction that would involve or result in any material conflict of interest with respect to any investor in a transaction arising out of such activity for a period of one year after the date of the first closing of the sale of the ABS.[116] In September 2011, the Commission proposed rules to implement section 27B.[117]

2. Reducing Reliance on Credit Ratings

a. Overview

Reducing reliance on credit ratings could mitigate conflicts of interest to the extent that it causes investors to use factors other than credit ratings to make investment decisions. If credit ratings are no longer used in statutes and regulations to confer benefits or relief, the incentive to obtain credit ratings that meet these requirements should be eliminated. However, credit ratings also are used in investment guidelines and private contracts such as collateral agreements. Similar to statutory and regulatory uses of credit ratings, investment guidelines and private contract use of credit ratings create incentives for issuers to obtain credit ratings at certain levels.

With respect to statutory and regulatory use of credit ratings, section 939A of the Dodd-Frank Act requires Federal agencies to "review any regulation issued by such agency that requires the use of an assessment of the credit-worthiness of a security or money market

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[113] See Pub. L. No. 111-203 § 945 and 15 U.S.C. 77g(d).

[114] See Issuer Review of Assets in Offerings of Asset-Backed Securities, Securities Act Release No. 9176 (Jan. 20, 2011), 76 FR 4231 (Jan. 25, 2011).

[115] See Pub. L. No. 111-203 § 621 and 15 U.S.C. 77z-2a.

[116] See 15 U.S.C. 77z-2a.

[117] See Prohibition Against Conflicts of Interest in Certain Securitizations, Exchange Act Release No. 65355 (Sep. 19, 2011), 76 FR 60320 (Sep. 28, 2011).

instrument and any references to or requirements in such regulations regarding credit ratings."[118] Once the agency has completed that review, the statute provides that the agency "remove any reference to or requirement of reliance on credit ratings, and to substitute in such regulations such standard of credit-worthiness" as the agency determines to be appropriate.[119] In addition, sections 939(c) and 939(e) of the Dodd-Frank Act deleted references to credit ratings in Federal statutes.[120]

The Commission began to remove references to credit ratings in its rules prior to the enactment of the Dodd-Frank Act. Specifically, in July 2008, the Commission proposed removing references to NRSROs in its rules.[121] In 2009, the Commission adopted some of the proposals and reopened others for comment.[122] In 2010, as part of the proposal discussed above, the Commission proposed to remove references to NRSROs in the context of registered asset-backed offerings.[123] Also in 2010, the Commission amended Rule 2a-7 under the Investment Company Act, which governs the operation of money market funds, to eliminate a requirement that an asset-backed security may be rated by at least one NRSRO in order to be an eligible security that a money market fund may acquire.[124]

In response to the Dodd-Frank Act, the Commission again proposed amendments to remove remaining references to NRSROs in its rules.[125] In July 2011, the Commission adopted

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118 See Pub. L. No. 111-203 § 939A(a)(1)-(2).

119 See Pub. L. No. 111-203 § 939A(b).

120 Pub. L. No. 111-203 § 939(e). The Commission issued interpretative guidance and a request for comment on the definitions of the terms "mortgage related security" and "small business related security" in sections 3(a)(41) and 3(a)(53)(A) of the Exchange Act, respectively, in light of section 939(e) of the Dodd-Frank Act. See Exchange Act Release No. 67448 (Jul. 17, 2012), 77 FR 42980 (Jul. 23, 2012). The Commission also adopted new Rule 6a-5 under the Investment Company Act of 1940 ("Investment Company Act") to establish a standard of creditworthiness in place of a statutory reference to credit ratings in section 6(a)(5)(A)(iv)(I), which was removed by section 939(c) of the Dodd-Frank Act. See Purchase of Certain Debt Securities by Business and Industrial Development Companies Relying on an Investment Company Act Exemption, Investment Company Act Release No. 30268 (Nov. 19, 2012), 77 FR 70117 (Nov. 23, 2012). This rule has an effective date of December 24, 2012.

121 See References to Ratings of Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 58070 (Jul. 1, 2008), 73 FR 40088 (Jul. 11, 2008); Security Ratings, Securities Act Release No. 8940 (Jul. 1, 2008), 73 FR 40106; References to Ratings of Nationally Recognized Statistical Rating Organizations, Investment Company Act Release No. 28327 (Jul. 1, 2008), 73 FR 40124 (Jul. 11, 2008).

122 See References to Ratings of Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 60789 (Oct. 5, 2009), 74 FR 52358 (Oct. 9, 2009). On the same day, in a companion release, the Commission also re-opened comment for rules under the Exchange Act, Investment Company Act and Investment Advisers Act. See References to Ratings of Nationally Recognized Statistical Rating Organizations, Securities Act Release No. 9069 (Oct. 5, 2009), 74 FR 52374 (Oct. 9, 2011).

123 See Asset-Backed Securities, Securities Act Release No. 9117 (Apr. 7, 2010), 75 FR 23328 (May 3, 2010).

124 See Money Market Fund Reform, Investment Company Act Release No. 29132 (Feb. 23, 2012), 75 FR 10060 (Mar. 4, 2010) at section II.A.3.

125 See Removal of Certain References to Credit Ratings under the Securities Exchange Act of 1934, Exchange Act Release No. 64352 (Apr. 27, 2011), 76 FR 26550 (May 6, 2011). See References to Credit Ratings in Certain Investment Company Act Rules and Forms, Securities Act Release No. 9193 (Mar. 3,

amendments removing references to credit ratings from the eligibility criteria for Form S-3 and Form F-3 and replacing those references with alternative criteria. The Commission amended Rules 138, 139 and 168 under the Securities Act to reflect the new criteria in form S-3 and Form F-3. The Commission rescinded Form F-9 because regulatory changes rendered the form unnecessary. The Commission also removed paragraph (a)(17) of Securities Act Rule 134, because the Commission did not believe that this provision was consistent with section 939A of the Dodd-Frank Act.[126]

b. Comments on Reducing Reliance on Credit Ratings

The Commission requested comments on the effectiveness that removing references to credit ratings in statutes and regulations would have on mitigating conflicts of interest.[127] One NRSRO asserts that removing references to credit ratings from rules and regulations removes one of the incentives for issuers to engage in "rating shopping."[128] The NRSRO argues that investors will not be as motivated to conduct their own credit analysis if the regulations permit them to use an officially recognized rating without independently assessing the quality and usefulness of the rating, and reliance on officially recognized ratings (as opposed to independent analysis) could encourage issuers to shop for the officially recognized credit rating agency that will assign the highest possible rating.[129] However, another NRSRO disagrees and states that it does not see any "basis for concluding that the removal of ratings from rules and regulations would mitigate conflicts of interest."[130]

3. Reputational Risk

a. Overview

Reputational risk could potentially mitigate the conflicts of interest inherent in the credit rating industry. Because investors and other users of the credit ratings value quality ratings, credit rating agencies operating under the issuer-pay model could attract business from issuers if they have a reputation among investors for producing quality credit ratings. Similarly, credit rating agencies operating under the subscriber-pay model could attract business from subscribers (i.e., investors and other users of credit ratings) if they have a reputation for producing quality credit ratings. This could motivate credit rating agencies to address conflicts of interest that could result in biased credit ratings if not managed.

2011), 76 FR 12896 (Mar. 9, 2011) and Security Ratings, Securities Act Release No. 63874 (Feb. 9, 2011), 76 FR 8946 (Feb. 16, 2011).

126 See Security Ratings, Securities Act Release No. 9245 (Jul. 27, 2011), 76 FR 46603 (Aug. 3, 2011).

127 See Solicitation of Comment to Assist in Study on Assigned Credit Ratings, 76 FR at 28269.

128 See the Moody's Letter.

129 Id. Moody's states that: "[t]his is particularly an issue in the structured finance market, where regulatory use is overwhelmingly skewed toward holding securities that have been rated Aaa by at least one NRSRO (but that need not hold a high rating from any other [credit rating agency])."

130 See the S&P Letter.

However, some observers have argued that credit rating agencies – as opposed to other "gatekeepers" – may be less motivated by concerns about reputational risk.[131] These observers argue that credit rating agencies are different from other gatekeepers due to certain characteristics of the credit rating industry, which include a lack of competition (or oligopolistic market), immunity from liability, and the conflicts of interest associated with the issuer-pay model.[132]

The level of complexity of the instrument being rated also has been cited as a factor affecting the influence of reputational risk on credit rating agencies.[133] Specifically, the authors of one study argue that the opacity of the instrument diminishes the effectiveness of reputational concern on maintaining ratings quality.[134] The authors contend that concerns about reputation only work when a sufficiently large fraction of the rating agency income results from sources other than rating complex products.[135] They cite empirical results to support this conclusion.[136]

Another study has found that competition in the credit rating industry diminishes the role of reputational concerns on the ratings quality.[137] It uses the entrance of Fitch into the credit ratings market as a unique experiment to examine how increased competition affects the market.[138] The paper finds that competition resulted in an increase in credit rating levels, a decline in the correlation between credit ratings and market-implied yields, and a decrease in the ability of ratings to predict default.[139] Another study suggests that the disciplining role of reputational concerns diminishes during economic "boom" times and that for this reason ratings quality is countercyclical.[140] Consequently, the study finds that credit rating agencies are more likely to issue lower quality ratings when their income from fees is high, the competition in the labor market for analysts is strong, and the default probabilities for the rated securities are low.

b. Comments on Reputational Risk

The Commission sought comment on how reputation concerns may mitigate conflicts of interest.[141] Two commenters cite reputational risk as an important mitigant to the issuer-pay conflict of interest.[142] One commenter opines that when rating agencies produce ratings that turn

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131 See Lombard; see also Partnoy.

132 Id.

133 See Mathis, McAndrews & Rochet.

134 Id.

135 Id.

136 Id.

137 See Becker & Milbourn.

138 Id.

139 Id.

140 See Bar-Isaac & Shapiro.

141 See Solicitation of Comment to Assist in Study on Assigned Credit Ratings, 76 FR at 28269.

142 See the SIFMA Letter and the S&P Letter.

out to be inaccurate, investors are likely to give less weight to that agency's ratings in the future and may even refuse to invest in transactions that are rated by that agency alone.[143] The commenter claims that this, in turn, influences issuers to use different rating agencies in the future.[144] Similarly, another commenter argues that if a significant number of market participants lose faith in a credit rating agency's ability to accurately rate structured finance products, then that credit rating agency would not be able to succeed in the market.[145] Accordingly, the commenter concludes that rating agencies are incentivized to protect their reputations by putting procedures and controls in place to guard against potential conflicts of interest.[146]

4. Internal Controls

The Commission requested comment on the types of actions that NRSROs could take or have taken, or internal controls they could put in place or have put in place to mitigate conflicts of interest.[147] One NRSRO states that market and regulatory forces have encouraged and are continuing to encourage NRSROs to improve the way they manage conflicts of interest internally and to enhance the disclosures made available to investors regarding the NRSRO selection process.[148] Another commenter cites the oversight provisions in the Dodd-Frank Act, which include stricter internal and external oversight of conflicts of interest, and suggests that any evaluation of the current system should involve waiting a reasonable period of time to assess the efficacy of these new oversight provisions at mitigating the conflicts of interest in the current system.[149]

E. Benefits of the Current Rating System

The Commission solicited comment on the benefits of the current system for determining credit ratings for structured finance products.[150]

A number of commenters identify potential benefits of the current system.[151] Some commenters state that the issuer-pay model gives investors free access to credit ratings, helping to mitigate the information asymmetry between investors and issuers.[152] For example, one commenter asserts that the issuer-pay model allows for broad market dissemination of credit

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143 See the SIFMA Letter.

144 Id.

145 See the S&P Letter.

146 Id.

147 See Solicitation of Comment to Assist in Study on Assigned Credit Ratings, 76 FR at 28269.

148 See the Fitch Letter.

149 See the CRE Letter.

150 See Solicitation of Comment to Assist in Study on Assigned Credit Ratings, 76 FR at 28269.

151 See, e.g., the SIFMA Letter, the Moody's Letter, the S&P Letter, the Morningstar Letter, and the FSR Letter.

152 See, e.g., the Moody's Letter.

ratings because the issuers fund the activities of the credit rating agencies.[153] Similarly, other commenters highlight that under the issuer-pay system, the investing public can view the ratings simultaneously and for free.[154] A third commenter asserts that this free flow of information creates a common basis for analyzing risk.[155] A fourth commenter, an NRSRO, highlights the efficiency of the current system in bringing transactions to market.[156] Another commenter argues that the current system gives issuers the autonomy to choose a credit rating agency acceptable to investors.[157] The commenter states that frequently, investors require a credit rating from a certain agency as a condition to buying the securities, and the current system allows issuers to cater to these requests.[158]

IV. FEASIBILITY OF ESTABLISHING AN ASSIGNMENT SYSTEM FOR CREDIT RATINGS

Section 939F(b)(2) provides that the Commission shall carry out a study of the feasibility of establishing a system in which a public or private utility or an SRO assigns NRSROs to determine the credit ratings of structured finance products.[159] In conducting the study, the Commission is required to consider four factors.[160] The Section 15E(w) System would establish an assignment system by creating a board to assign qualified NRSROs to rate structured finance products. The sections below describe the mechanics of the Section 15E(w) System and summarize comments received about the system in response to questions about the four factors specified section 939F(b)(2) and a framework developed by the U.S. Government Accountability Office (the "GAO") to analyze alternative compensation models for NRSROs.[161]

A. Mechanics of the Section 15E(w) System

The Section 15E(w) System, among other things, would require the Commission to: (1) establish a board ("CRA Board"), which would be an SRO; (2) select the initial members of the CRA Board; and (3) establish a schedule to ensure that the CRA Board begins assigning "Qualified NRSROs" to provide initial ratings not later than one year after the selection of the members of the CRA Board.[162] A "Qualified NRSRO" would be an NRSRO that the CRA

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153 See the SIFMA Letter.

154 See the Moody's Letter; see also the S&P Letter.

155 See the S&P Letter.

156 See the Morningstar Letter.

157 See the FSR Letter.

158 Id.

159 See Pub. L. No. 111-203 § 939F(b)(2).

160 See Pub. L. No. 111-203 § 939F(b)(2)(A) through (D).

161 See Securities and Exchange Commission Action Needed to Improve Rating Agency Registration Program and Performance-Related Disclosures, GAO Report 10-782 (Sep. 2010) ("GAO Report").

162 See subparagraph (2)(A) of the Section 15E(w) Provisions. The CRA Board initially would be composed of an odd number of members selected from the industry, with the total numerical membership of the CRA Board to be determined by the Commission. See subparagraph (2)(C)(i) of the Section 15E(w) Provisions. Of the members initially selected to serve on the CRA Board: (1) not less than a majority of the members

Board determines is qualified to issue initial credit ratings with respect to one or more categories of structured finance products.[163]

An issuer that seeks an initial credit rating for a structured finance product would be prohibited from requesting such a rating from an NRSRO and, instead, would be required to submit a request for the initial credit rating to the CRA Board.[164] The CRA Board would select a Qualified NRSRO to provide the initial credit rating to the issuer.[165] A Qualified NRSRO selected to determine an initial credit rating could refuse to accept a particular request by notifying the CRA Board of such refusal and submitting to the CRA Board a written explanation of the refusal.[166] The CRA Board then would select a different Qualified NRSRO to determine the initial credit rating.[167] Qualified NRSROs would be able to determine fees unless the CRA Board determines it is necessary to issue rules on fees.[168] If rules are deemed necessary, a

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would need to be representatives of the investor industry who do not represent issuers; (2) not less than one member would need to be a representative of the issuer industry; (3) not less than one member would need to be a representative of the credit rating agency industry; and (4) not less than one member would need to be an independent member. See subparagraphs (2)(C)(ii)(I) through (IV) of the Section 15E(w) Provisions. The initial members of the CRA Board would be appointed to terms of four years. See subparagraph (2)(C)(i) of the Section 15E(w) Provisions. Prior to the expiration of the terms of office of the initial CRA Board members, the Commission would be required to establish fair procedures for the nomination and election of future members of the Board. See subparagraph (2)(C)(iv) of the Section 15E(w) Provisions.

163 See subparagraphs (1)(B) and (3) of the Section 15E(w) Provisions. An NRSRO seeking to become a Qualified NRSRO with respect to a category of structured finance products would need to submit an application to the CRA Board. See subparagraphs (3)(A) and (B) of the Section 15E(w) Provisions. The application would need to contain: (1) information about the institutional and technical capacity of the NRSRO to issue credit ratings; (2) information on whether the NRSRO has been exempted by the Commission from any requirements under Section 15E of the Exchange Act; and (3) any additional information the Board may require. See subparagraphs (3)(A)(ii)(I) through (III) of the Section 15E(w) Provisions.

164 See subparagraph (4) of the Section 15E(w) Provisions. An issuer would be permitted to request or receive additional credit ratings for the structured finance product if the initial credit rating is provided using the CRA Board assignment process. See subparagraph (9) of the Section 15E(w) Provisions.

165 See subparagraph (5)(A) of the Section 15E(w) Provisions. The method of selecting the Qualified NRSRO would be based on an evaluation by the CRA Board of a number of alternatives designed to reduce the conflicts of interest that exist under the issuer-pays model, including a lottery or rotating assignment system. See subparagraph (5)(B) of the Section 15E(w) Provisions. In addition, in evaluating the selection method, the CRA Board would be required to consider: (1) the information submitted by the Qualified NRSRO in its application to become a Qualified NRSRO regarding the institutional and technical capacity of the Qualified NRSRO to issue credit ratings; (2) an, at least, annual evaluation of the performance of each Qualified NRSRO; (3) formal feedback from institutional investors; and (4) information from items (1) and (2) to implement a mechanism which increases or decreases assignments based on past performance. See subparagraph (5)(B)(ii) of the Section 15E(w) Provisions. The CRA Board, in choosing a selection method, would not be able to use a method that allows for the solicitation or consideration of the preferred NRSRO of the issuer. See subparagraph (5)(B)(iii) of the Section 15E(w) Provisions.

166 See subparagraph (5)(C)(i) of the Section 15E(w) Provisions.

167 See subparagraph (5)(C)(ii) of the Section 15E(w) Provisions.

168 See subparagraph (8)(B) of the Section 15E(w) Provisions.

Qualified NRSRO would be required to charge an issuer a reasonable fee as determined by the Commission.[169]

The CRA Board would be required to prescribe rules by which it evaluates the performance of each Qualified NRSRO, including rules that require, at a minimum, an annual evaluation of each Qualified NRSRO.[170] The CRA Board, in conducting the annual evaluation, would be required to consider: (1) the results of an annual examination of the Qualified NRSRO; (2) surveillance of credit ratings conducted by the Qualified NRSRO after the credit ratings are issued, including, how the rated instruments perform, the accuracy of the ratings as compared to the other NRSROs, and the effectiveness of the methodologies used by the Qualified NRSRO; and (3) any additional factors the CRA Board determines to be relevant.[171]

B. Statutory Factors

Section 939F(b)(2) specifies four specific factors the Commission should consider in studying the feasibility of establishing a system in which a public or private utility or an SRO assigns NRSROs to determine the credit ratings of structured finance products.[172] Those four factors are: (1) an assessment of potential mechanisms for determining fees for the NRSROs; (2) appropriate methods for paying fees to the NRSROs; (3) the extent to which the creation of such a system would be viewed as the creation of moral hazard by the Federal Government; and (4) any constitutional or other issues concerning the establishment of such a system.[173] Each of the four factors is discussed below in the context of the Section 15E(w) System, focusing on the comments received by the Commission on these issues.

1. Fee Determination

The first factor specified in section 939F(b)(2) is an assessment of potential mechanisms for determining fees for the NRSROs.[174] The Commission requested comments on this topic.[175] Commenters generally believe that market forces should set the fees, and that the CRA Board could intervene or provide oversight if there is disagreement among parties about the rating fees.[176] Specifically, one commenter states that "[t]he market, not the Commission, should decide whether such fees are reasonable and commensurate with the services provided."[177] A

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169 See subparagraph (8)(A) of the Section 15E(w) Provisions.

170 See subparagraph (7)(A) of the Section 15E(w) Provisions.

171 See subparagraph (7)(B) of the Section 15E(w) Provisions. While the evaluation contemplates an annual examination of the Qualified NRSRO, the Section 15E(w) Provisions do not contain an explicit requirement for the CRA Board to conduct an annual examination of each Qualified NRSRO.

172 See Pub. L. No. 111-203 § 939F(b)(2)(A) through (D).

173 Id.

174 See Pub. L. No. 111-203 § 939F(b)(2)(A).

175 See Solicitation of Comment to Assist in Study on Assigned Credit Ratings, 76 FR at 28272.

176 See the S&P Letter, the Morningstar Letter, and the Franken/Wicker Letter.

177 See the S&P Letter.

second commenter adds that the CRA Board could monitor the market rates for services and provide guidance on those rates if fee discussions break down.[178] Additionally, the commenter states that since issuers would still hire NRSROs directly to provide ratings in some instances, NRSROs would be incentivized to maintain competitive pricing and contract terms.[179] A third commenter states that the system "contemplates minimal involvement of the … board in the setting or collection of fees" and notes that the CRA Board would only intervene if rating agencies were charging unreasonable fees (as compared to fees charged for similar products not subject to the assignment system).[180]

2. Method of Payment

The second factor specified in section 939F(b)(2) is the appropriate methods for paying fees to the NRSROs.[181] The Commission requested comments on this topic.[182] One commenter notes that the Section 15E(w) System "does not prescribe a structure in which the board serves as an intermediary for the collection and distribution of fees."[183] Another commenter, an NRSRO, states that board involvement in the collection and distribution of fees "would add significant expense."[184]

Related to this topic, the Commission also asked for comments on whether credit rating fees should be paid over time, based on the performance of the rated security.[185] One NRSRO responded, indicating that it would not be "appropriate to withhold fees…[or] 'return' ratings fees to investors…[if] a rated security defaults [because] credit ratings are forward-looking expressions of opinion and not a guaranty of payment or other form or insurance."[186]

3. Moral Hazard

The third factor specified in section 939F(b)(2) is whether the creation of a board assignment system would be viewed as the creation of moral hazard by the Federal Government.[187] The Commission requested comments on this topic.[188] A number of commenters expressed concerns that the system would signal that the government endorses

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178 See the Morningstar Letter.

179 Id.

180 See the Franken/Wicker Letter.

181 See Pub. L. No. 111-203 § 939F(b)(2)(B).

182 See Solicitation of Comment to Assist in Study on Assigned Credit Ratings, 76 FR at 28272-73.

183 See the Franken/Wicker Letter.

184 See the S&P Letter.

185 See Solicitation of Comment to Assist in Study on Assigned Credit Ratings, 76 FR at 28273.

186 See the S&P Letter.

187 See Pub. L. No. 111-203 § 939F(b)(2)(C).

188 See Solicitation of Comment to Assist in Study on Assigned Credit Ratings, 76 FR at 28273.

reliance on credit ratings, and in particular, ratings from NRSROs that are deemed qualified by the CRA Board.[189]

Commenters generally are concerned that the Section 15E(w) System is contrary to government efforts to reduce investor reliance on credit ratings and that investors would rely too heavily on ratings if they were deemed vetted by the CRA Board.[190] One commenter argues that the system would further entrench certain NRSROs "by creating a government-sanctioned special category of NRSROs that are the only NRSROs that are permitted to issue initial credit ratings to issuers."[191] Another commenter argues that the system is inconsistent with government efforts to reduce reliance on ratings because investors might view the assigned NRSRO producing a rating as a government appointed and regulated entity.[192] Similarly, other commenters argue that the ratings produced by the system could be viewed as having a government seal of approval, running counter to the goal of reducing reliance on ratings generally.[193] Other commenters believe that investors would be less likely to perform appropriate analysis and due diligence if the ratings were seen as indirectly sanctioned by the government through the CRA Board or because the rating produced by the assigned NRSRO is the "right" or "government-sanctioned" rating.[194] Finally, multiple commenters argue that any disclaimer language would not be sufficient to counteract the impression that credit ratings are government sanctioned and the potential for moral hazard.[195]

Similarly, some commenters feel that investors could view the Section 15E(w) System as an implicit guarantee by the government.[196] One commenter states that "investors may interpret government regulation of the rating agency selection process as an implicit guarantee of the ratings by the U.S. government, which would be inconsistent with policymakers' efforts to eliminate perceptions that credit ratings have any government imprimatur."[197] Another commenter states that "greater government involvement in the [credit rating agency] industry

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189 See the ASF Letter, the FSR Letter, the S&P Letter, the Kroll Letter, the Fitch Letter, the ICI Letter, the DBRS Letter, the SIFMA Letter, the CRE Letter, the Moody's Letter, the Redwood Letter, and the MBA Letter. MBA commented that "a highly regulated prescriptive assignment process for credit ratings appears to be at odds with concerted government efforts to eliminate reliance on credit ratings in federal regulations."

190 See the ASF Letter, the FSR Letter, the S&P Letter, the Kroll Letter, the Fitch Letter, the ICI Letter, the DBRS Letter, and the MBA Letter.

191 See the ASF Letter.

192 See the FSR Letter.

193 See the S&P Letter, the Kroll Letter, the Fitch Letter, and the ICI Letter. Fitch stated that a "government sanctioned NRSRO selection system…fosters the very government sanctioning of rating agencies that Dodd-Frank seeks to end."

194 See the Moody's Letter; see also the ASF Letter.

195 See the ICI Letter, the DBRS Letter, the FSR Letter, and the Kroll Letter.

196 See the CRE Letter, the Moody's Letter, and the Redwood Letter.

197 See the CRE Letter.

could create the perception that the ratings produced are ‘more than opinions,’ and are instead statements of fact or performance guarantees.”[198]

Finally, one commenter expresses concerns with the level of government control over a private financial market that the Section 15E(w) System could engender.[199] The commenter states that the CRA Board “will set the rules of the game, determine who is allowed to play, and decide how much the players are paid” and opines that these are not “appropriate roles for the government in private-market financial transactions.”[200]

4. Constitutional and Other Issues Concerning the Establishment of the Section 15E(w) System

The fourth factor specified in section 939F(b)(2) is whether there are any constitutional or other issues concerning the establishment of the Section 15E(w) System.[201] The Commission requested comment on the operational and legal feasibility of the system.[202]

a. Operational Feasibility

Commenters raise operational issues concerning the establishment of the Section 15E(w) System.[203] One commenter observes that there would be thousands of structured finance products that would need to be rated at any given time, and that the CRA Board would need to have a detailed understanding of each NRSRO’s qualities in order to assign an NRSRO to rate each of those products.[204] The commenter concludes that this could lead to delays in assignments, preventing issuers’ timely access to capital and imposing additional costs on the market.[205] Additionally, the commenter expresses concern that the new assignment system could create uncertainty in the market, causing originators to shy away from structured finance products as a means of financing and investors to be reluctant to invest in such products, ultimately leading to a decline in securitizations.[206] A second commenter expands on this argument, stating that “some degree of continuity in the use of [a] particular NRSRO by an issuer results in economic and operational efficiencies in transactions,” and the process would be more time consuming if the NRSRO did not rate a previous transaction.[207] Another commenter believes there is a lack of clarity as to how the CRA Board members and staff would be compensated, noting both that the level of compensation available would determine the quality

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198 See the Moody’s Letter.

199 See the SIFMA Letter.

200 Id.

201 See Pub. L. No. 111-203 § 939F(b)(2)(D).

202 See Solicitation of Comment to Assist in Study on Assigned Credit Ratings, 76 FR at 28273-74.

203 See the S&P Letter and the SIFMA Letter.

204 See the S&P Letter.

205 Id.

206 Id.

207 See the Redwood Letter.

of employees the board would be able to attract and that the current budgetary and spending environment makes it unlikely that there would be large amount of funds available for compensation.[208]

b. Legal Feasibility

Commenters raise concerns regarding the legal feasibility of the Section 15E(w) System.[209] One commenter argues that the Section 15E(w) System would conflict with section 15E(c)(2) of the Exchange Act, which prohibits the Commission from regulating the substance of credit ratings or the procedures and methodologies by which an NRSRO determines credit ratings.[210] The commenter believes that the CRA Board's role of evaluating and making rating assignments based on the accuracy of a Qualified NRSRO's ratings and the effectiveness of its methodologies would be inconsistent with this provision.[211] This sentiment is echoed by other commenters, one of whom states that "[a]ny system aimed at defining 'quality' ratings" would be problematic under section 15E(c)(2).[212]

One commenter argues that, in addition to being unprecedented in forcing "one private party to deal with another private party of the government's choosing in a private business transaction," the Section 15E(w) System would raise Fifth Amendment issues.[213] The commenter opines that the system could violate the Fifth Amendment "to the extent that interference with issuers' or NRSROs' contract rights rises to the level of a taking without just compensation or to the extent that this provision is so arbitrary and irrational as to violate the Fifth Amendment's Due Process Clause."[214]

Two commenters believe there are potential First Amendment issues with the Section 15E(w) System.[215] One states that "government intervention into the selection of who can or cannot render an opinion about the creditworthiness of assets could attract litigation on First Amendment grounds."[216] Additionally, the commenter states that government actions penalizing rating agencies for stating their views on creditworthiness could impede the flow of information

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208 See the SIFMA Letter.

209 See, e.g., the DBRS Letter, the S&P Letter, and the SIFMA Letter.

210 See the DBRS Letter.

211 Id.

212 See the S&P Letter. See also the SIFMA Letter (stating that "given that the Board would set performance standards and allocate business based on achievement of those standards, it would also put the Board in a position very close to regulating the form and content of credit rating methodologies, which we do not believe is appropriate – it is important that rating agencies are able to independently develop methodologies and analysis techniques which they believe will produce the most accurate ratings without undue pressure from issuers, investors, or policymakers.").

213 See the DBRS Letter.

214 Id.

215 See the Reason Letter and the S&P Letter.

216 See the Reason Letter.

in investment markets and prevent investors from making fully informed investment decisions.[217] Another commenter states that a Commission decision that "an NRSRO's ratings (and, by extension, the criteria and methodologies by which those ratings were formed) lack 'quality' and therefore must be changed in order to maintain participation in the proposed system, could well violate [the First Amendment]."[218]

Lastly, one commenter suggests that the mere recognition by Congress that the Commission study the "possibility of a constitutional law challenge" evidences awareness that the Section 15E(w) System may not be feasible or constitutionally sound.[219] Furthermore, even the possibility of a constitutional law challenge could "delay or derail implementation of the rule."[220]

C. GAO Framework

Section 7 of the Rating Agency Act of 2006 required the GAO to conduct a study: (1) on the impact of the Act; (2) to identify problems that have resulted from the implementation of the Act; and (3) to recommend solutions, including any legislative or regulatory solutions, to the problems identified.[221] The GAO also was required to submit a report to Congress on the results of the study.[222] In response, the GAO submitted a report to Congress in September 2010.[223] The report included a framework for evaluating alternative models for compensating NRSROs (the "GAO Framework").[224] The report states that in carrying out the study required by section 939F, the Commission could use the GAO Framework to evaluate current proposals for compensating NRSROs, develop new proposals, and identify trade-offs among proposals.[225] The GAO Framework consists of seven factors that can be used to evaluate alternative compensation models for NRSROs: (1) independence; (2) accountability; (3) competition; (4) transparency; (5) feasibility; (6) market acceptance and choice; and (7) oversight.[226] The Commission requested that commenters use the GAO Framework to evaluate the Section 15E(w) System. The following sections summarize the comments.

1. Independence

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217 Id.

218 See the S&P Letter. The staff takes no position on the merits of the First and Fifth Amendment issues regarding the CRA Board raised by commenters.

219 See the Redwood Letter.

220 Id.

221 See Pub. L. No. 109-291 § 7.

222 Id.

223 See the GAO Report.

224 See id. at 85-93.

225 See id. at 92-93.

226 Id.

The first factor in the GAO Framework is "independence."[227] The GAO describes this factor as the ability for the compensation model to mitigate conflicts of interest inherent between the entity paying for the rating and the NRSRO.[228] Key questions with respect to this factor include: what potential conflicts of interest exist in the alternative compensation model and what controls, if any, would need to be implemented to mitigate these conflicts.[229]

Some commenters argue that the Section 15E(w) System will enhance independence.[230] For example, two commenters note that the Section 15E(w) System would increase independence because issuers would no longer have the ability to select the rating agency determining the initial rating.[231] One of those commenters, an NRSRO, states that credit rating agency independence would increase since agencies would no longer secure business by providing preliminary ratings.[232] The NRSRO acknowledges that the members of the CRA Board could be subject to certain conflicts of interest but suggests that these conflicts could be mitigated through various procedural protections, including requiring majority action by the board, publishing the board's selection criteria and results, and automating the selection process so that the board is not actively involved in individual selection decisions.[233]

The second commenter also believes the Section 15E(w) System would improve independence because a neutral party (namely a government agency or its representatives) would be assigning NRSROs to rate structured finance transactions.[234] The commenter opines that the Section 15E(w) System would separate issuer payment for ratings on structured finance products from issuer selection of an NRSRO and thereby eliminate "rating shopping."[235] The commenter explains that, as a result, the system would alleviate the economic pressures that have led NRSROs to cater to issuer demands in the past.[236] Another commenter adds that the Section 15E(w) System could not only limit the effects of the conflicts of interest currently faced by NRSROs but could also change the mindset NRSROs have of working with their issuer clients to achieve the rating the issuers desire.[237]

The majority of commenters, however, argue that the Section 15E(w) System would not lead to a substantial improvement in the independence of rating agencies.[238] Commenters argue

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227 See id. at 85.

228 Id.

229 Id.

230 See the AFSCME Letter and the Morningstar Letter.

231 Id.

232 See the Morningstar Letter.

233 Id.

234 See the AFSCME Letter.

235 Id.

236 Id.

237 See the Hill Letter.

238 See the FSR Letter, the Moody's Letter, the S&P Letter, the Kroll Letter, the SIFMA Letter, the ASF Letter, and the DBRS Letter.

that the ratings assignment system would have conflicts of its own and would not fully mitigate the conflicts of interest associated with the issuer-pay system.[239] Many believe that the Section 15E(w) System would simply replace one set of conflicts of interest with another.[240] As one commenter states, the "Section 15E(w) [System] fails entirely because its method of addressing the conflict creates more problems than it solves."[241]

A number of commenters argue that potential conflicts of interest could be created because the CRA Board would be affiliated with the U.S. government.[242] For example, one commenter argues that government issuers benefit from higher ratings because they lower the cost of borrowing and that, therefore, although the Section 15E(w) System could reduce issuers' incentives to maximize proceeds via higher ratings, it could instead result in "political pressure on rating agencies due to the direct impact of ratings on the cost of capital for both governments and their taxpayers."[243] Another commenter argues that governments may have competing financial market and social policy objectives and could "seek to have ratings 'protect' nationally or systemically important issuers such as large industrial employers or banks, or to protect ratings of government entities."[244] This commenter states that any government-selected NRSRO would need to adopt measures designed to prevent the government from influencing its ratings because of these types of conflicts that could exist in any system in which the government has significant involvement in the substance of the rating determination.[245] Another commenter argues that the government's involvement in the compensation of the CRA Board members would contribute to the conflict.[246] It comments that if the CRA Board were paid by the government, this would create a strong incentive for the board to select NRSROs that met the government's objectives, for instance by issuing relatively high ratings on U.S. sovereign and other government debt.[247]

Additionally, one NRSRO states that the government's involvement in the credit rating process could increase the liability of the government for ratings published by NRSROs selected by the CRA Board and cause the board to assume the liabilities of a rating agency.[248] The NRSRO argues that this will harm the independence of rating agencies and the perception of

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239 See, e.g., the FSR Letter, the Moody's Letter, the S&P Letter, the Kroll Letter, the SIFMA Letter, the ASF Letter, and the DBRS Letter.

240 See, e.g., the FSR Letter, the Moody's Letter, the S&P Letter, the Kroll Letter, the SIFMA Letter, and the ASF Letter.

241 See the ASF Letter.

242 See the FSR Letter, the Moody's Letter, the S&P Letter, and the Kroll Letter.

243 See the FSR Letter.

244 See the Moody's Letter.

245 Id.

246 See the S&P Letter.

247 Id.

248 See the Kroll Letter.

ratings published by NRSROs and the Commission's ability to conduct independent regulatory oversight.[249]

Some of the commenters also note that the individual members of the CRA Board could have potential conflicts of interest.[250] One commenter states that any potential member of the CRA Board with enough expertise and insight into the ratings industry to contribute to the selection process would most likely have some conflict of interest because that potential member either is or was affiliated with the financial services industry in some way.[251] An NRSRO echoes this sentiment, questioning how the Commission would ensure that potential members of the CRA Board both have sufficient expertise and are not conflicted.[252] A third commenter states that there is a potential for members of the CRA Board to develop significant conflicts of interest because of the incentives under the Section 15E(w) System for rating agencies to attempt to curry favor with particular board members in order to obtain more business.[253] This commenter also argues that board members could have existing personal interests in firms subject to the authority of the CRA Board and these conflicts would need to be managed through policies and procedures just as in the current issuer-pay system.[254] Another commenter focuses on the power of the CRA Board and its potential to create conflicts, noting that "by creating a board with the authority to determine the performance measurement and the method by which NRSROs would be selected to provide initial credit ratings, [the] Section 15E(w) [System] would create a risk of a more pernicious manipulation than the issuer-pay compensation model."[255] The commenter explains that the board could be pressured by various interest groups to adjust its methodology to achieve a particular agenda.[256]

Finally, several commenters believe that the Section 15E(w) System would not be able to effectively mitigate the issuer-pay conflict of interest since NRSROs would still have incentives to cater to issuers.[257] One commenter states that in addition to the rating from the selected NRSRO, issuers could still seek ratings from other NRSROs or non-NRSRO credit rating agencies that are not subject to that payment system.[258] Another commenter argues that, as a result, NRSROs would still seek business from issuers of structured finance products, and NRSROs might also seek to curry favor with these issuers in order to obtain business in the secondary market for other transactions.[259]

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249 See id.

250 See the FSR Letter, the Moody's Letter, the SIFMA Letter, and the ASF Letter.

251 See the FSR Letter.

252 See the Moody's Letter.

253 See the SIFMA Letter.

254 Id.

255 See the ASF Letter.

256 Id.

257 See the DBRS Letter and the S&P Letter.

258 See the S&P Letter.

259 See the DBRS Letter.

2. Accountability

The second factor in the GAO Framework is "accountability."[260] The GAO describes this factor as the ability of the compensation model to promote NRSROs' responsibility for the accuracy and timeliness of their ratings.[261] Key questions with respect to this factor include: how does the compensation model create economic incentives for NRSROs to produce quality ratings over the bond's life and how is NRSRO performance to be evaluated and by whom.[262]

Some commenters believe that the Section 15E(w) System will lead to improved accountability.[263] One NRSRO who commented believes accountability can be increased under the Section 15E(w) System through the qualification process.[264] The NRSRO states that the Commission's examination process and the enhanced ratings performance disclosures could provide a basis to evaluate ratings under the Section 15E(w) System, and NRSROs would be selected to rate transactions based on past performance.[265] The NRSRO believes that as a result, NRSROs would be held accountable for the accuracy and timeliness of their ratings.[266]

Another commenter indicates that the system would "prevent cherry picking and potentially prevent misguided opinions [by eliminating] the fear of removal over disagreements."[267] Another commenter states that rating quality could be improved since the CRA Board could create incentives for the rating agencies to produce higher ratings by maintaining minimum quality standards for the pool of NRSROs eligible to receive an assignment.[268] Similarly, a third commenter mentions that the system could improve accountability because NRSRO performance would be evaluated by the CRA Board, creating competition over accuracy among the agencies since NRSROs that performed well would be rewarded with future assignments.[269]

One commenter suggests further increasing the accountability of credit rating agencies under the Section 15E(w) System by adding a gross negligence liability standard for credit rating agencies.[270] The commenter explains that debt purchasers would have the ability to enforce the

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260 See the GAO Report at 85-86.

261 Id.

262 Id.

263 See the AFSCME Letter, the AFR Letter, the Huffaker Letter, the Manns Letter, the Morningstar Letter, and the Parsont Letter.

264 See the Morningstar Letter.

265 Id.

266 Id.

267 See the Huffaker Letter.

268 See the AFR Letter.

269 See Parsont Letter; see also the Parsont Article.

270 See the Manns Letter.

standard, and rating agencies would be financially liable for their ratings failures, to the extent a failure constitutes a gross deviation from a reasonable person's standard of care.[271]

Conversely, a number of commenters raise several potential issues with accountability in the Section 15E(w) System.[272] One commenter observes that political pressure could influence the CRA Board's initial determination of which NRSROs are qualified to issue ratings and the frequency of assignments to NRSROs in the future (the implication is that this would remove competition in the industry and prevent NRSROs from being held accountable for the accuracy of the ratings they produce.).[273] Continuing on this theme, another commenter states that the number of NRSROs that currently rate structured finance products is already limited, and under the Section 15E(w) System, this number may remain static or even shrink depending on the qualifications the CRA Board puts in place, further restricting competition in the market.[274] The commenter explains that this problem could be exacerbated by the fact that if there are a limited number of "qualified NRSROs," it may be difficult for the CRA Board to remove any one from the pool if its ratings prove to be frequently inaccurate without diminishing the credibility of the assignment system.[275]

Other commenters expand on this theme of a lack of competition in the Section 15E(w) System and express concern that the system would reduce innovation in the industry.[276] One commenter states that under the current system, rating agencies sometimes compete by publishing rating methodology papers that they hope will attract sophisticated investors.[277] Another commenter explains that the assignment system could stifle rating agency innovation by removing this financial incentive for rating agencies to improve their methodologies, which could, in turn, result in rating agency methodologies falling behind innovations in structured securities.[278] Similarly, other commenters argue that credit rating agencies would have limited incentives to develop special skills with respect to particular products and would stop investing in the research necessary to improve their methodologies.[279] One commenter states that some credit rating agencies could lose interest in any improvement or innovation unless they deemed it necessary to retain the minimum standard necessary for designation under the Section 15E(w) System.[280] The commenter explains that this lack of innovation could ultimately lead to more

[271] Id. at 66, n.260 (proposing various definitions of gross negligence from the common law).

[272] See the ASF Letter, the Reason Letter, the MBA Letter, the ICI Letter, the S&P Letter, and the Kroll Letter.

[273] See the ASF Letter.

[274] See the ICI Letter.

[275] Id.

[276] See the ASF Letter, the MBA Letter, and the S&P Letter. The issue of competition is discussed below in more detail in section III.C.3.

[277] See the ASF Letter.

[278] See the MBA Letter.

[279] See the ASF Letter and the S&P Letter. S&P also states that, under the Section 15E(w) System, "NRSROs would have little incentive to engage in thought leadership, investor outreach and other important educational activities, again, to the ultimate detriment of the market."

[280] See the S&P Letter.

homogenized rating opinions.[281] Other commenters argue that with the CRA Board evaluating the credit rating agencies' methodologies and accuracy, the CRA Board, in effect, would be dictating how to determine credit ratings, as Qualified NRSROs would tailor their methodologies to meet the requirements of the board, rather than basing them on the qualities of the security.[282]

In relation to rating agency accountability, the Commission also asked for comments on how the NRSROs' performance would be evaluated and how poor performance would be handled under the Section 15E(w) System.[283] Most commenters raise concerns regarding the measurement and evaluation of performance.[284] Several commenters argue that measuring the accuracy of ratings is a problematic way to evaluate performance because the accuracy of the initial ratings for many structured finance products cannot be measured for many years, in some cases after the securities have already been retired.[285] Additionally, two commenters state that in order to measure credit rating accuracy, the CRA Board essentially would be required to do its own analysis of the relevant transaction, and that type of determination would be costly and complicated for the board to undertake given the highly skilled staff and resources that would be required.[286] One commenter observes that the CRA Board's creation of performance measures would prevent rating agencies from developing new methodologies, as the agencies migrate to methodologies that are in line with the board's performance measures.[287] Furthermore, that commenter argues that if the performance measures developed by the CRA Board rely on downgrades alone to evaluate performance, credit rating agencies could be incentivized to produce overly conservative initial ratings to protect against the need for future downgrades and/or to avoid downgrading securities when it may be necessary to take such action.[288]

3. Competition

The third factor in the GAO Framework is "competition."[289] The GAO describes this factor as the extent to which the compensation model creates an environment in which NRSROs compete for customers by producing higher-quality ratings at competitive prices.[290] Key questions include: to what extent does the compensation model encourage competition around the quality of credit ratings, credit rating fees, and product innovation and to what extent does it allow for flexibility in the differing sizes, resources, and specialties of NRSROs.[291]

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281 Id.

282 See the ASF Letter and the Kroll Letter.

283 See Solicitation of Comment to Assist in Study on Assigned Credit Ratings, 76 FR at 28271. The issue of measuring accuracy is discussed below in more detail in section IV.

284 See, e.g., the AFR Letter, the SIFMA Letter, and the ASF Letter.

285 See the AFR Letter and the SIFMA Letter.

286 See the ASF Letter and the SIFMA Letter.

287 See the ASF Letter.

288 Id.

289 See the GAO Report at 86-87.

290 Id.

291 Id.

Some commenters believe the Section 15E(w) System would enhance competition in the credit rating agency industry.[292] Some commenters note that the Section 15E(w) System would help to make the credit rating agency industry more competitive because new entrants would be given a chance to build their reputations.[293] One commenter states that there "is considerable 'stickiness' in the practice of market participants," leading to concentration of business in the hands of the largest NRSROs and limiting entry into the market.[294] This commenter suggests that under the Section 15E(w) System, smaller NRSROs "would presumably sometimes (and perhaps often) be selected, helping market participants become accustomed to the use of such agencies."[295] A second commenter believes that since the Section 15E(w) System would require the CRA Board to examine credit rating accuracy and timeliness as it makes assignments of future credit rating engagements, the system will foster competition to secure future business by providing the most accurate and timely ratings.[296] Similarly, a third commenter echoes this idea and opines that smaller credit rating agencies would be given "an opportunity to compete by producing a track record of quality ratings."[297] A fourth commenter argues that the Section 15E(w) System creates "a level playing field for lesser established NRSROs to compete" because smaller NRSROs could be hired to issue second ratings and could also issue unsolicited ratings.[298]

However, the majority of commenters addressing this factor argue that the Section 15E(w) System would hinder competition within the credit rating industry.[299] One commenter uses the example of CMBS to illustrate the difficulty of entering the credit rating market for structured finance products under the Section 15E(w) System.[300] The commenter states that a rating agency must have a significant amount of resources and expertise in order to conduct "the intensive, specialized review" necessary to rate commercial real estate assets.[301] The commenter explains that credit rating agencies that do not already possess these resources will be reluctant to make the kind of investment required to enter the market without more concrete prospects for a financial return than a system where assignments are made randomly and prices are regulated.[302] This commenter also believes that there may be disincentives for innovation inherent in the

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292 See the Hill Letter, the Franken/Wicker Letter, the Morningstar Letter, and the Parsont Letter.

293 See the Hill Letter, the Morningstar Letter, and the AFSCME Letter.

294 See the Hill Letter.

295 Id.

296 See the Morningstar Letter.

297 See the Franken/Wicker Letter.

298 See the Parsont Letter.

299 See the ASF Letter, the CRE Letter, the Kroll Letter, the Moody's Letter, the DBRS Letter, the ICI Letter, the MBA Letter, and the S&P Letter.

300 See the CRE Letter.

301 Id.

302 Id.

Section 15E(w) System due to the random selection process as discussed above in section IV.C.2.[303]

Several commenters also express concern that the Section 15E(w) System "may further entrench the largest incumbents."[304] One commenter observes that the Section 15E(w) System may make it more difficult for small or new NRSROs to enter the market or increase their market share because incumbents would be able to offer lower credit rating fees since the allocation method under the Section 15E(w) System would take past performance into account.[305] The commenter concludes that it could be difficult for NRSROs with little or no track record for rating structured finance securities to break into the market.[306] Another commenter similarly argues that, because the CRA Board's assignment system will require an established track record for NRSROs to qualify, the ability of newer NRSROs to compete will be limited.[307] Another explains that this problem will worsen as time passes since "it will be difficult [for newer NRSROs] to become 'qualified' to rate a structured finance product if the NRSRO does not have the opportunity to rate such structured finance products because it is not 'qualified' to do so."[308] A third argues that characterizing certain NRSROs as "qualified" suggests that other NRSROs are "unqualified" to rate structured finance products, and this stigma could make it hard for an NRSRO to gain market acceptance for its ratings.[309]

Two commenters argue that the increased regulatory burden associated with becoming a "Qualified NRSRO" under the Section 15E(w) System could deter NRSROs from entering the structured finance ratings market.[310] One NRSRO believes that the regulatory burdens have negatively impacted the willingness of credit rating agencies to engage in NRSRO credit rating activities.[311] It states that: "[s]ince the 2006 [Rating Agency Reform] Act was implemented, regulatory burdens have caused two NRSROs to withdraw their registrations in the class of credit ratings for issuers of asset-backed securities; one NRSRO to curtail plans to expand its rating activities; and at least one rating agency to forego NRSRO registration altogether."[312]

Additionally, some commenters suggest that the Section 15E(w) System would negatively impact competition, credit rating quality, and industry innovation because credit rating agencies would be guaranteed business rather than competing for the business, as discussed above in section IV.C.2.[313] One commenter asserts that NRSROs would be

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303 Id.

304 See the Kroll Letter; see also the Moody's Letter and the DBRS Letter.

305 See the ASF Letter.

306 Id.

307 See the Kroll Letter.

308 See the Moody's Letter.

309 See the DBRS Letter.

310 See the ICI letter and the DBRS Letter.

311 See the DBRS Letter.

312 Id.

313 See the Moody's Letter and the MBA Letter.

incentivized "to simply wait their turn" to be assigned business, rather than competing to produce the highest quality analysis and credit ratings.[314] The commenter explains that if credit rating agencies are guaranteed fees, the incentive for them to innovate and improve their methodologies may be removed, and instead, they may be motivated to do the least amount of work possible to remain a Qualified NRSRO eligible to receive assignments under the Section 15E(w) System.[315] Another commenter argues that the expense of staying current on all the necessary information "in order to be in a position to provide a credit rating under an assignment system would be prohibitive, not only to the NRSROs," but also to the issuers tasked to provide the information.[316] Keeping every NRSRO current on information so it stands ready for an assignment could be "paralyzing" to issuers.[317]

Finally, one commenter urges the Commission not to be overly influenced by concerns regarding competition among NRSROs. The commenter states that it is often assumed that more competition among firms leads to higher quality output, but that this only works if firms are competing on the basis of quality, and that evidence suggests greater competition among credit rating agencies does not lead to higher quality output under the issuer-pay system.[318] The commenter cites a 2010 paper that found that the growth in market share enjoyed by Fitch, which emerged shortly after 2000 as a "credible competitor" to Moody's and S&P, coincided with lower quality ratings, as measured by the correlation between ratings and market-implied yields.[319] The authors of this paper concluded that increased competition among ratings agencies "likely weakens reputational incentives for providing quality in the ratings industry, and thereby undermines quality."[320] Accordingly, the commenter believes that relying on greater competition among NRSROs using an issuer-pay model may produce lower quality ratings than a system using a different business model in which fewer NRSROs participate.[321]

4. Transparency

The fourth factor in the GAO Framework is "transparency."[322] The GAO describes this factor as the accessibility, usability, and clarity of the compensation model and the dissemination of information on the model to market participants.[323] Key questions with respect to this factor include: how transparent are the model's processes and procedures for determining credit ratings fees and compensating NRSROs and how would NRSROs obtain ratings business.[324]

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314 See the Moody's Letter.

315 Id.

316 See the Redwood Letter.

317 Id.

318 See the AFSCME Letter.

319 See id. (citing Becker & Milbourn).

320 Id.

321 See the AFSCME Letter.

322 See the GAO Report at 88.

323 Id.

324 Id.

One commenter believes that a requirement for the CRA Board to publish its NRSRO assignment methodology would aid in the transparency of the system.[325] Otherwise, the response from commenters was mainly negative. One NRSRO states that the system "could be as transparent as necessary" but should not "require the public disclosure of fees."[326] Several other commenters either do not believe the system would be transparent or think transparency is irrelevant to the value of the system.[327] One commenter believes that the proposed system "has the potential to confuse market participants," and does "not believe that any amount of transparency regarding the proposed Section 15E(w) System can remedy these concerns."[328] Another commenter expresses concern that "there may be insufficient transparency regarding who truly pays the cost of the additional rating (*e.g.* investors or issuers?)."[329] Another commenter argues that transparency in credit rating performance would not mitigate the replacement of market selection by a "government-established board" determination.[330]

5. Feasibility

The fifth factor in the GAO Framework is "feasibility."[331] The GAO describes this factor as the simplicity and ease with which the compensation model can be implemented in the securities market.[332] Key questions with respect to this factor include: what are the costs to implement the compensation model and who would fund them, who would administer the compensation model, and what, if any, infrastructure would be needed to implement the model.[333]

Comments with respect to this factor centered on: (1) staffing, funding, and costs of the CRA Board; (2) credit rating fees and contract terms; and (3) the selection criteria for assigning the NRSRO to produce a credit rating. One commenter, an NRSRO, believes that the Section 15E(w) System "is administratively feasible" and that the authority to establish it has been "clearly set forth" under the Dodd-Frank Act.[334]

However, several commenters believe the Section 15E(w) System is not feasible.[335] For example, several commenters express concern about the feasibility of sufficiently staffing the

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[325] See the Franken/Wicker Letter.

[326] See the Morningstar Letter.

[327] See the S&P Letter, the CRE Letter, and the ASF Letter.

[328] See the S&P Letter.

[329] See the CRE Letter.

[330] See the ASF Letter.

[331] See the GAO Report at 88-90.

[332] Id.

[333] Id.

[334] See Morningstar Letter.

[335] See the ASF Letter, the Better Markets Letter, the CRE Letter, the DBRS Letter, the FSR Letter, the ICI Letter, the Moody's Letter, the S&P Letter, and the SIFMA Letter.

CRA Board with highly skilled personnel.[336] One commenter expresses similar concerns about staff sufficiency and expertise and states that the CRA Board "will be required to do tasks it simply will not have the expertise to perform [such as to] be able to fully understand, compare and contrast the merits of one agency's MBS criteria … and modeling versus another rating agency's [criteria and modeling]."[337] Commenters also express concern about the qualifications of the CRA Board members and potential conflicts of interest.[338]

Some commenters believe it would be very costly to create and maintain the CRA Board.[339] For example, one NRSRO states that although the Section 15E(w) Provisions authorize the CRA Board to levy fees on Qualified NRSROs and applicants, no provision is made to defray the CRA Board's "considerable start-up expenses," and opines that any start-up funding mechanism would not be "sustainable" for the CRA Board's continued operation.[340] As an example of such costs, the commenter notes that the CRA Board would need to be supported by a "highly skilled" staff capable of evaluating the credit rating process for each type of existing and future structured finance product, and be able to assess the methodologies and performance metrics of each rating agency that chooses to participate in the Section 15E(w) System, and that the CRA Board staff will need to take a number of steps before the first application from a prospective qualified NRSRO is even submitted.[341] The commenter further opines that the high cost of funding the CRA Board's operations would be "divided among only four or five rating agencies" and be "so high that it would discourage all but the largest rating agencies" from participating.[342]

Another commenter states that "the costs to the market would be significant, both the cost to create and operate the board and the cost in the form of decreased market efficiency."[343] Another commenter argues that in addition to the substantial start-up time and expense that would be required to create the CRA Board and the ongoing administrative costs of maintaining it, transactions in structured finance products would likely become more expensive and time consuming as a result of the imposition of this new layer of bureaucracy in the credit rating

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336 See, e.g., the ASF Letter, the DBRS Letter, and the SIFMA Letter.

337 See the SIFMA Letter (stating that "rating agency stuff [*sic*] must consider a broad range of issues, alternately analytical, conceptual, and legal, when calibrating models and determining credit ratings criteria, and apply that wide variety of factors to specific transactions when producing ratings. This includes but is not limited to: knowledge of a broad array of asset classes; the wide structural variety of securitization design; a wide variety of underlying assets; appreciation for the macro asset environment (e.g., the housing market or auto purchase market); issuer strength, transaction counterparty qualifications (e.g., servicer ratings); the value or weaknesses in specific representation and warranty provisions, compliance with applicable law.").

338 See, e.g., the CRE Letter and the Moody's Letter. Moody's asked "[H]ow would the Commission ensure that Board members have both sufficient expertise and are not conflicted?"

339 See the ASF Letter, the MS Letter, and the FSR Letter.

340 See the DBRS Letter.

341 Id.

342 Id.

343 See the ASF Letter.

process.[344] A third commenter argues that the costs of creating the CRA Board would not be insubstantial and would ultimately be passed on to consumers.[345]

However, some commenters disagree that cost would be an issue.[346] One commenter, an NRSRO, observes that transaction fees based on the size of the transaction and funded by the proceeds could be used to cover the costs of the CRA Board, similar to the Financial Industry Regulatory Authority's system of determining transaction-based fees.[347] The commenter also states that the Section 15E(w) System might be operated without the CRA Board (or with substantially reduced operations for the CRA Board) if rotation criteria and technology could be established to manage the assignments.[348] The commenter explains that an automated process would decrease costs and avoid unnecessary delays.[349] As an additional cost-saving measure, the commenter suggests that the Section 15E(w) System should leave in place the current payment system (whereby payments are made directly by the issuer to the NRSRO).[350]

Some commenters also question the CRA Board's ability to set rating fees and contract terms.[351] One commenter observes that the Section 15E(w) System would require the creation of a complex new regulatory structure dictating contract terms between issuers and rating agencies and setting price controls.[352] The commenter believes that this would prevent issuers from coming up with unique and heterogeneous collateral pools and innovative asset classes, and questions what would happen if an issuer and its assigned credit rating agency could not agree on a rating fee.[353] Continuing on this theme, another commenter argues that under the Section 15E(w) System, issuers would have no leverage in contract negotiations and could be forced by the CRA Board to accept terms and conditions they would ordinarily reject.[354]

Finally, two commenters express concern regarding the CRA Board's ability to determine selection criteria for the assignment system and evaluate the accuracy of credit ratings provided under the system.[355] One commenter questions how the CRA Board would come up with the criteria to determine how assignments are made and how it would define the success or failure of the selected credit rating agency once the credit rating was produced.[356] The commenter states

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344 See the MS Letter.

345 See the FSR Letter.

346 See the Morningstar Letter, the AFR Letter, and the AFSCME Letter.

347 See the Morningstar Letter.

348 Id.

349 Id.

350 Id.

351 See the CRE Letter and the FSR Letter.

352 See the CRE Letter.

353 Id.

354 See the FSR Letter.

355 See the ICI Letter and the S&P Letter.

356 See the ICI Letter.

that gauging success would be difficult because of the "complexity, diversity and novelty" of structured finance products.[357] Another commenter observes that in order to make assignments, the CRA Board would need to have a detailed understanding of each NRSRO's areas of expertise among the thousands of securities to be rated and predicts that this would cause significant delays in assignments for new issuances.[358]

6. Market Acceptance and Choice

The sixth factor in the GAO Framework is "market acceptance and choice."[359] The GAO describes this factor as the willingness of the securities market to accept the compensation model, the credit ratings produced under that model, and any new market players established by the compensation model.[360] Key questions with respect to this factor include: what role do market participants have in selecting NRSROs to produce ratings, assessing the quality of ratings, and determining NRSRO compensation.[361]

One commenter believes that the Section 15E(w) System could gain market acceptance.[362] Specifically, the commenter argues that the Section 15E(w) System "represents an opportunity to promote competition among NRSROs by encouraging investors to review [their investment] policies and consider other NRSROs," thereby expanding the number of acceptable NRSROs in the market.[363]

However, many commenters raised concerns about issuers' inabilities to choose an NRSRO under the proposed Section 15E(w) System and the potential effect this reduced influence could have on the quality of credit ratings, demand for and pricing of securities, and issuance costs.[364] For example, one commenter lists a number of potential problems associated with eliminating the issuer's ability to choose an NRSRO.[365] First, the commenter argues that issuers need the freedom to choose an NRSRO that is acceptable to investors because some investors could be prohibited by private contract or investment guidelines from buying a structured finance product rated by the assigned NRSRO.[366] Second, the commenter states that if the assigned NRSRO is disfavored by investors (or investors are prohibited from purchasing a product rated by that NRSRO), then it will hurt the issuer's ability to execute the transaction,

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357 Id.

358 See the S&P Letter.

359 See the GAO Report at 90-91.

360 Id.

361 Id.

362 See the Morningstar Letter.

363 Id.

364 See the ASF Letter, the Better Markets Letter, the MS Letter, the CRE Letter, the S&P Letter, the SIFMA Letter, the ICI Letter, the MBA Letter, and the Hill Letter.

365 See the ASF Letter.

366 Id.; see also the Redwood Letter (stating that "Selection by the [CRA] board of a rating agency that is not on the investment guidelines list would preclude these investors from participating in an offering.").

resulting in uncertainty in the market that "could effectively remove securitization as a viable source of financing for sponsors" and lead to a higher cost of funding for originators.[367] Third, the commenter explains that the issuer's loss of choice could increase the cost of capital because the identity of the NRSRO rating the structured finance product affects the price investors are willing to pay for the product.[368] Another commenter states that investors tend to be more comfortable with, and more fluent in, the "procedures and methodologies" of a particular NRSRO such that the assignment of a different NRSRO to a transaction could have an impact on investor interest, thereby causing disinterest in the security altogether.[369]

Other commenters focus on how the pricing of structured finance products would be affected by the Section 15E(w) System.[370] One commenter argues that issuers sometimes choose a particular NRSRO because investors will put a premium on products rated by that NRSRO, and that the Section 15E(w) System, by eliminating this choice, would increase costs and burden the credit rating process.[371] Others commenters state that security prices might be discounted if either the assigned "NRSRO does not have an established track record for the category of securitization"[372] or the assignment process is flawed or not transparent.[373]

Two commenters note that the Section 15E(w) System could increase costs by forcing issuers to seek a second credit rating if investors are not satisfied with the credit rating by the assigned NRSRO.[374] One commenter states that if investors are unsatisfied with a credit rating, underwriters or investors "may be induced to procure additional ratings from NRSROs who are thought to provide greater value" and, therefore, the "the value received from the selection process might be disproportionately low compared with the cost."[375] Another commenter argues that if the credit rating from the assigned NRSRO is not accepted, issuers would need to get a second credit rating, adding significant cost to the transaction that either the investors (through reduced yield) or the borrowers on the collateral that secures the structured finance product would be forced to incur.[376]

Other commenters express concern that under the Section 15E(w) System, the assigned NRSRO might not have the requisite expertise to rate the structured finance product.[377] One commenter highlights "the uniquely complex requirements that the credit rating process entails for certain structured finance products, particularly commercial mortgage-backed securities…,

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367 Id.

368 Id.

369 See the Redwood Letter.

370 See the MS Letter, the ICI Letter, and the MBA Letter.

371 See the MS Letter.

372 See the MBA Letter

373 See the ICI Letter.

374 See the Better Markets Letter and the SIFMA Letter.

375 See the Better Markets Letter.

376 See the SIFMA Letter.

377 See the CRE Letter, the MS Letter, and the S&P Letter.

which are composed of pools of heterogeneous assets," making it likely that an inexperienced NRSRO could be assigned a transaction in an asset class in which it does not have expertise.[378] The commenter also argues that this possibility could increase uncertainty for issuers who will be unsure as to whether their issuances will be fairly and accurately rated, leading to a potential decrease in issuers' appetite for these types of transactions.[379] Similarly, a second commenter states that "many NRSROs cannot possibly have the expertise to rate all types of structured finance products"[380] and that sometimes investors will not accept credit ratings from an NRSRO without a certain level of expertise.[381] Continuing with these themes, a third commenter takes issue with the Section 15E(w) System because it may potentially force issuers and arrangers to accept credit ratings from NRSROs that lack the requisite expertise to rate a particular structured finance product.[382]

Several commenters worry that the Section 15E(w) System would slow down the speed at which structured finance transactions are rated and negatively affect deal volume.[383] One commenter observes that each NRSRO has different criteria for rating a transaction and unless the assigned NRSRO happens to have worked with the issuer in the past, the Section 15E(w) System will slow the speed at which a transaction can come to market because it will take time for the assigned NRSRO to gather all the information it needs from the issuer.[384] The commenter also states that this impediment to an issuer's timely access to the capital markets will impose costs on the issuer that will "simply be passed onto the consumer in the form of higher rates and fees, with little if any corresponding benefit to the consumer."[385] Another commenter observes that in "the case of commercial and residential mortgage backed securities (CMBS and RMBS), the uncertainty of transitioning to a new rating regiment could potentially slow new issuance."[386] Similarly, another commenter argues that markets may have difficulty adjusting to the Section 15E(w) System, and as a result, deal volume could decrease (at least in the short term).[387]

Other commenters note that the Section 15E(w) System may not take into account investor preferences.[388] One commenter states that "investors clearly do not consider all NRSRO

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378 See the CRE Letter (stating "[t]he degree of specialized expertise and effort that is required to rate such products makes it likely that a system of assigned credit ratings, such as that being studied by the Commission in this proceeding, would actually lead to lower quality ratings, and less competition and innovation in the credit rating industry.").

379 See the CRE Letter.

380 See the MS Letter.

381 See the CRE Letter.

382 See the S&P Letter.

383 See the ASF Letter, the Hill Letter, and the MBA Letter.

384 See the ASF Letter.

385 Id.

386 See the MBA Letter.

387 See the Hill Letter.

388 See the MS Letter and the S&P Letter.

ratings to be equally valuable, and we believe that investors themselves are in the best position to determine whether an NRSRO's opinion is an effective classification tool for their investments."[389] As a result, the commenter states that "the Section 15E(w) System, or any other system that involves the random or arbitrary selection of NRSROs to rate structured finance products, would harm investors by preventing their preferences from being taken into account."[390] Another commenter also expresses the belief that issuers and investors have a superior understanding of each NRSRO's qualities and experience and argues that by taking choice out of their hands, the Section 15E(w) System could lessen the quality of credit ratings.[391]

7. Oversight

The seventh factor in the GAO Framework is "oversight."[392] The GAO describes this factor as evaluation of the model to ensure it works as intended.[393] Key questions with respect to this factor include: does the model provide for an independent internal control function and what external oversight does the compensation model provide to ensure it is working as intended.[394]

One commenter suggests establishing a creditor committee to oversee the system, foster accountability and mitigate the ability of "regulated parties to … influence regulators."[395] Another commenter suggests that oversight of the CRA Board could be accomplished through "an annual public disclosure process of the criteria and formula used in selecting the NRSROs."[396]

On the other hand, one commenter questions how the Section 15E(w) System could be evaluated and how any problems identified with the assignment process could be corrected.[397] Another commenter suggests that "at a minimum, internal and external auditors would be necessary," and "[g]iven the vast number of ratings that would need to be assigned on a prompt and regular basis, the resources necessary to implement such oversight would likely be exorbitant."[398] Another commenter raises concerns about the CRA Board's evaluations of an NRSRO in determining a method of assigning NRSROs to a transaction.[399] The commenter argues that an NRSRO may employ criteria closely aligned with the criteria in the board's evaluation.[400] In addition, an NRSRO could apply overly "conservative criteria to try to ensure

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389 See the MS Letter.

390 Id.

391 See the S&P Letter.

392 See the GAO Report at 92-93.

393 Id.

394 Id.

395 See the Manns Letter.

396 See the Morningstar Letter.

397 See the ASF Letter.

398 See the S&P Letter.

399 See the Redwood Letter.

400 Id.

positive evaluations," which among other things, could lead to higher costs for issuers, lenders and borrowers.[401]

V. METRICS FOR DETERMINING THE ACCURACY OF CREDIT RATINGS

Section 939F(b)(3) provides that the Commission shall carry out a study of the range of metrics that could be used to determine the accuracy of credit ratings.[402] The Commission solicited comments on this topic.[403] While some commenters simply note that measuring ratings accuracy could be difficult, others suggest a few ideas as to how it could be accomplished.

The NRSROs that commented on this topic generally argue that measuring rating accuracy is difficult.[404] One NRSRO rejects "the notion that credit ratings can be 'accurate' or 'inaccurate,'" noting that ratings are not statements of fact but forward-looking opinions.[405] The NRSRO states that the creditworthiness of a security can change over time based on a variety of factors, including events that could not be foreseen at the time of the original rating.[406] Another NRSRO highlights that different rating systems often have different objectives, making it extremely difficult to compare accuracy across systems since rating systems should be evaluated against their objectives.[407]

Some commenters offer suggestions as to how accuracy could be measured.[408] One commenter recommends that ratings quality be defined "using input from investors and other users of ratings."[409] Another suggests using a proposal made by Professor John Coffee under which the Commission could "define 'default' and 'impaired', calculate the rates of default and impaired over five year periods for each credit rating agency, and . . . subsequently publish them."[410] The same commenter also suggests that the CRA Board "could compile a total metric based on standards that Professor Lynn Bai has identified for gauging accuracy - the default ratio, 'fallen angels' ratio, rating change ratio, and large rating change ratio."[411] Professor Bai describes these four standards as follows:

> The default ratio is the ratio of the total number of defaults to the total number of ratings that a rating agency has assigned during a

[401] Id.

[402] See Pub. L. No. 111-203 § 939F(b)(3).

[403] See Solicitation of Comment to Assist in Study on Assigned Credit Ratings, 76 FR at 28274-75.

[404] See the S&P Letter and the Moody's Letter.

[405] See the S&P Letter.

[406] Id.

[407] See the Moody's Letter.

[408] See the AFSCME Letter and the Franken/Wicker Letter.

[409] See the AFSCME Letter.

[410] See the Franken/Wicker Letter.

[411] Id. See also Lin (Lynn) Bai, The Performance Disclosures of Credit Rating Agencies: Are They Effective Reputational Sanctions?, 7-1 N.Y.U. J. L. & Bus. (2010).

> specified time period. The "fallen angels" ratio is the total number of ratings that were of investment grade at the start of the period but migrated to a non-investment grade or a default rating by the end of the period, divided by the total number of investment grade ratings that the rating agency has assigned during the period. The rating change ratio is the total number of rating changes divided by the total number of ratings assigned during a specified period. The large rating change ratio is the total number of large rating changes divided by the total number of ratings assigned during a specified period. In this regard, the number of large rating changes is defined as the number of ratings that have experienced changes of three or more notches during an annual period.[412]

VI. ALTERNATIVE MEANS FOR COMPENSATING NRSROS

Section 939F(b)(4) provides that the Commission shall carry out a study of alternative means for compensating NRSROs that would create incentives for accurate credit ratings.[413] To facilitate this aspect of the study, the Commission solicited comment on the requirements in Exchange Act Rule 17g-5 that are designed to allow a non-hired NRSRO to provide an initial rating for a structured finance product and on four unique alternative compensation models for NRSROs identified in the GAO Report.[414] The four models are: (1) the investor-owned credit rating agency model; (2) the stand-alone model; (3) the designation model; and (4) the user-pay model.[415] Commenters' views regarding the models identified above and their proposals for alternative models are described below. In addition to the models identified in the original GAO Report, three other alternative models are discussed below: (1) the issuer and investor-pays model, (2) the alternative user-pays model, and (3) the investor owned rating agency model.[416] The Commission also met with the authors of these models, and their feedback is incorporated into the descriptions below.[417]

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412 Id.

413 Id.

414 See Solicitation of Comment to Assist in Study on Assigned Credit Ratings, 76 FR at 28275-78. See also the GAO Report at 79-84 (describing the four unique alternative compensation models). These models also were discussed at an April 2009 roundtable sponsored by the Commission to examine oversight of credit rating agencies. Information regarding the roundtable, including a webcast and unofficial transcript, is available on the Commission's Internet website at http://www.sec.gov/spotlight/cra-oversight-roundtable.htm.

415 See the GAO Report at 79-84.

416 The first of these two models (the issuer and investor-pays model and the alternative user-pays model) were included in a second GAO report, published in January 2012, subsequent to the Commission's publication of its Request for Comment. See Credit Rating Agencies: Alternative Compensation Models for Nationally Recognized Statistical Rating Organizations, GAO Report 12-240 (2012) ("GAO 2012 Report"). The third (the investor owned rating agency model) was proposed to the Commission in a comment letter for the April 2009 roundtable but was not included in the Request for Comment because it is substantially similar to the investor-owned credit rating agency model.

417 Documentation of these meetings with model authors is available on the Commission's Internet website at: http://www.sec.gov/comments/4-629/4-629.shtml.

A. Rule 17g-5 Program

1. Mechanics of the Rule 17g-5 Program

The Commission has adopted requirements codified in Rule 17g-5 under the Exchange Act designed to create a mechanism for an NRSRO that is not hired to determine a credit rating for a structured finance product to nonetheless obtain the same information the hired NRSRO receives from the arranger to determine the initial credit rating at the same time such information is provided to the hired NRSRO (the "Rule 17g-5 Program").[418] The Rule 17g-5 Program is intended to create a means for an NRSRO not hired to rate the structured finance product to nonetheless determine an initial credit rating at the same time the hired NRSRO determines an initial credit rating and to conduct surveillance on that credit rating along with the hired NRSRO.[419] In other words, similar to the goal of section 939F, the Rule 17g-5 Program is intended to prevent the arranger of the structured finance product from selecting the NRSRO or NRSROs that *exclusively* can determine initial credit ratings for the structured finance product.[420] When adopting the Rule 17g-5 Program, the Commission stated that the program was designed to make it more difficult for arrangers to exert influence over the NRSROs they hire because any inappropriate rating could be exposed to the market through the unsolicited ratings issued by

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[418] 17 CFR §§ 240.17g-5(a)(3) and (b)(9). The Commission has granted a conditional exemption to NRSROs from Rule 17g-5(a)(3) with respect to credit ratings where: (1) the issuer of the structured finance product is a non-U.S. person; and (2) the NRSRO has a reasonable basis to conclude that the structured finance product will be offered and sold upon issuance, and that any arranger linked to the structured finance product will effect transactions in the structured finance product after issuance, only in transactions that occur outside the U.S. These conditions are designed to confine the exemption's application to credit ratings of structured finance products issued in, and linked to, financial markets outside the U.S. See Order Granting Temporary Conditional Exemption for Nationally Recognized Statistical Rating Organizations from Requirements of Rule 17g-5 under the Securities Exchange Act of 1934 and Request for Comment, Exchange Act Release No. 62120 (Feb. 11, 2008), 75 FR 28825 (May 24, 2010); Order Extending Temporary Conditional Exemption for Nationally Recognized Statistical Rating Organizations from Requirements of Rule 17g-5 under the Securities Exchange Act of 1934 and Request for Comment, Exchange Act Release No. 63363 (Nov. 23, 2010), 75 FR 73137 (Nov. 29, 2010); Order Extending Temporary Conditional Exemption for Nationally Recognized Statistical Rating Organizations from Requirements of Rule 17g-5 under the Securities Exchange Act of 1934 and Request for Comment, Exchange Act Release No. 65765 (Nov. 16, 2011), 76 FR 72227 (Nov. 22, 2011).

[419] The Commission noted, when adopting the Rule 17g-5 Program, that "when an NRSRO is hired to rate a structured finance product, some of the information it relies on to determine the rating is generally not made public. As a result, structured finance products frequently are issued with ratings from only one or two NRSROs that have been hired by the arranger, with the attendant conflict of interest. The [Rule 17g-5 Program is] designed to increase the number of credit ratings extant for a given structured finance product and, in particular, to promote the issuance of credit ratings by NRSROs that are not hired by the arranger." See Amendments to Rules for Nationally Recognized Statistical Rating Organizations, 74 FR at 63844.

[420] See Pub. L. No. 111-203 § 939F(d) ("After submission of the report under subsection (c), the Commission shall, by rule, as the Commission determines is necessary or appropriate in the public interest or for the protection of investors, establish a system for the assignment of [NRSROs] to determine the initial credit ratings of structured finance products, in a manner that prevents the issuer, sponsor, or underwriter of the structured finance product from selecting the [NRSRO] that will determine the initial credit ratings and monitor such credit ratings.").

NRSROs not hired to rate the structured finance product.[421] Also, investors seeking a credit rating from an NRSRO not hired to rate the structured finance product can pay an NRSRO of their choosing to rate the structured finance product using the Rule 17g-5 Program. Thus, it provides a mechanism for investors to select an NRSRO to rate a structured finance product they are considering purchasing or have purchased. In other words, investors can use the Rule 17g-5 Program to obtain credit ratings from NRSROs other than those hired by the issuer.

The Rule 17g-5 Program operates by requiring an NRSRO hired to determine initial credit ratings for structured finance products to maintain a password-protected Internet website containing a list of each such structured finance product for which it currently is in the process of determining an initial credit rating.[422] The list must be in chronological order and must identify the type of security or money market instrument, the name of the issuer of the structured finance product, the date the credit rating process was initiated, and the Internet website address where the arranger of the structured finance product represents that information provided to the hired NRSRO can be accessed by other NRSROs.[423] The hired NRSRO must provide free and unlimited access to the Internet website to any other NRSRO that provides it with a copy of a certification stating, among other things, that it is accessing the Internet website solely for the purpose of determining or monitoring credit ratings.[424]

In addition, the hired NRSRO must obtain a written representation from the arranger of the structured finance product that the NRSRO can reasonably rely on.[425] The arranger must represent, among other things, that it will maintain a password-protected Internet website that other NRSROs can access.[426] Further, the arranger must represent that it will post on this Internet website all information the arranger provides to the hired NRSRO, or contracts with a third party to provide to the hired NRSRO, for the purpose of determining the initial credit rating and undertaking credit rating surveillance.[427] The arranger also must represent that this information will be posted to the Internet website at the same time such information is provided to the hired NRSRO.[428]

2. Comparing the Rule 17g-5 Program to the Section 15E(w) System

The Commission asked commenters to provide a comparative evaluation of the Section 15E(w) System and the Rule 17g-5 Program.[429] Two commenters favor the Section 15E(w) System over the Rule 17g-5 Program, stating that the Section 15E(w) System would create

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421 See Amendments to Rules for Nationally Recognized Statistical Rating Organizations, 74 FR at 63844.

422 See 17 CFR 240.17g-5(a)(3)(i).

423 Id.

424 See 17 CFR 240.17g-5(a)(3)(ii).

425 See 17 CFR 240.17g-5(a)(3)(iii).

426 See 17 CFR 240.17g-5(a)(3)(iii).

427 Id.

428 Id.

429 See Solicitation of Comment to Assist in Study on Assigned Credit Ratings, 76 FR at 28275-76.

competition over accuracy among credit rating agencies.[430] Certain other commenters who opined on the Rule 17g-5 Program, however, favor the Rule 17g-5 Program over the Section 15E(w) System,[431] although, as discussed below, many commenters believe additional modifications to the Program are needed to sufficiently address concerns with the current system. Some commenters said that the Rule 17g-5 Program – which creates an established framework for issuing unsolicited ratings – has the potential to better reduce conflicts of interest because unsolicited credit ratings provide a check against biased credit ratings.[432] One commenter states that "the realistic prospect of a non-hired NRSRO rating or issuing a comment on a transaction will serve to impose more transparency and discipline on both the issuer and the hired NRSRO."[433] Another commenter believes that the simultaneous access to information provided by the Rule 17g-5 Program pressures hired NRSROs to provide quality ratings.[434] A third commenter believes that "Rule 17g-5 offers investors a superior means to address potential conflicts of interest inherent in the 'issuer-pay' rating agency business model" because it provides market participants with tools to protect themselves from the risks of rating agencies' potential conflicting interests.[435]

In comparing the two systems, many commenters argue that the Rule 17g-5 Program better encourages competition and that it makes information needed to rate a transaction simultaneously available to all NRSROs.[436] One commenter believes that the Rule 17g-5 Program "significantly promotes competition by allowing any NRSRO access to the information required to rate a transaction."[437] Similarly, another commenter states that in contrast to the Section 15E(w) System, "the Rule 17g-5 Program seeks to encourage *multiple* ratings … by providing non-hired NRSROs access to arranger websites."[438] Some NRSROs praise the fact that the Rule 17g-5 Program ensures that the same information is provided to all NRSROs, even those hired to rate a transaction.[439] Other NRSROs believe the Section 15E(w) System would be anti-competitive and costly.[440] Specifically, one NRSRO states that the Section 15E(w) System would create "a closed, non-competitive environment where NRSROs have little or no incentive to improve their ratings processes, criteria and methodology."[441] Another NRSRO expresses

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430 See the Parsont Letter and the Franken/Wicker Letter.

431 See, e.g., the ASF Letter, the CRE Letter, the Fitch Letter, the FSR Letter, the ICI Letter, the MBA Letter, the Moody's Letter, the MS Letter, the S&P Letter, and the SIFMA Letter.

432 See the MS Letter, the ICI Letter, and the FSR Letter.

433 See the MS Letter.

434 See the ICI Letter.

435 See the FSR Letter.

436 See the SIFMA Letter, the ASF Letter, the S&P Letter, and the Fitch Letter.

437 See the SIFMA Letter.

438 See the ASF Letter (emphasis in the original).

439 See the Moody's Letter.

440 See the S&P Letter and the Fitch Letter.

441 See the S&P Letter.

concern that the system could result in "securitization market disruption, greater transaction expenses and, ultimately, an increase in the fiscal burden faced by taxpayers."[442]

Some commenters believe that the Rule 17g-5 Program promotes accountability in a way that the Section 15E(w) System could not.[443] One commenter – who believes that the Section 15E(w) System is "unworkable" – argues that, under the Rule 17g-5 Program, NRSROs would be held accountable for their ratings via multiple checks: issuer selection; investor influence on issuer selection; and investors' ability to obtain unsolicited ratings from non-hired NRSROs.[444] Another commenter believes that the Rule 17g-5 Program makes NRSROs accountable for their ratings.[445] A third commenter opines that the assigned ratings under the Section 15E(w) System "would not significantly improve the accuracy of the ratings process" and that instead, they could hurt the ratings process because "assigned credit ratings could stifle NRSRO innovation by eliminating the financial incentive to refine and improve rating models."[446]

Commenters also specifically identify existing and pending rules already are designed to address conflicts of interest in the credit rating process.[447] One commenter believes that the recent reforms under the Dodd-Frank Act will aid the market in holding NRSROs accountable for their ratings and that the Rule 17g-5 Program will be more effective at mitigating the risk of the issuer-pay model than the Section 15E(w) System.[448] Another commenter argues that the Rule 17g-5 Program is cost-effective, builds on existing regulatory initiatives, and (particularly if strengthened) makes alternative selection and compensation models for NRSROs unnecessary.[449]

One commenter states that the Rule 17g-5 Program, unlike the Section 15E(w) System, would be compatible with other alternative compensation models.[450] It states that the Rule 17g-5 Program "could facilitate the creation of a user-paid, or an investor-owned NRSRO by providing it with the information it needs to rate transactions."[451] The commenter also believes that the Rule 17g-5 Program currently allows investors who are not comfortable with an issuer-selected NRSRO to hire an NRSRO of their choice to provide additional ratings since the investor-hired NRSRO can now obtain the requisite information to produce the rating.[452]

3. Use of the Rule 17g-5 Program

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[442] See the Fitch Letter.

[443] See the ASF Letter, the SIFMA Letter, and the MBA Letter.

[444] See the ASF Letter.

[445] See the SIFMA Letter.

[446] See the MBA Letter.

[447] See the ASF Letter and the Fitch Letter.

[448] See the ASF Letter.

[449] See the Fitch Letter.

[450] See the SIFMA Letter.

[451] Id.

[452] Id.

The Commission also requested comments on how the Rule 17g-5 Program currently is being used to determine credit ratings for structured finance products.[453] In general, commenters stated that, as of the date of their letters, the Rule 17g-5 Program has not been used to produce an unsolicited credit rating, although some analytical commentary has been issued by non-hired NRSROs.[454] A few commenters state that the program, in its current form, is not effective.[455] Others commenters suggest that the program's efficacy needs to be tested over a longer period of time before looking for other ways to reduce conflicts of interest and improve the integrity and quality of credit ratings.[456] One commenter observes that the Rule 17g-5 Program has not been utilized because NRSROs are unlikely to be in a position to offer free credit ratings due to the high cost and labor required to issue a rating.[457] Another commenter echoes these thoughts, pointing to the uncompensated costs of unsolicited credit ratings and arrangers' and investors' lack of interest in these credit ratings.[458] The commenter believes that most investors are unwilling to pay NRSROs for unsolicited credit ratings because the arranger usually obtains ratings from at least two NRSROs.[459] The commenter explains that this makes it difficult for smaller NRSROs to take advantage of the Rule 17g-5 Program.[460] The commenter also contends that NRSROs do not receive information under the Rule 17g-5 Program in time to market unsolicited ratings to investors.[461]

Some commenters criticize issuers for being overbroad in marking information posted to their Rule 17g-5 websites as confidential.[462] One NRSRO states that "issuers often … designat[e] all information as confidential, without distinguishing information that is already public … or will become public when the hired NRSRO publishes its reports."[463] Additionally, the NRSRO expresses concern that in complying with the Rule 17g-5 Program, issuers could simply include all their communications with hired NRSROs on the website, which "could cause issuers and NRSRO analysts to be more inhibited and less open and transparent in their communications."[464] The NRSRO also alleges that the Rule 17g-5 Program is causing some issuers to direct trustees to restrict the information they share with NRSROs for fear of violating Rule 17g-5.[465]

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[453] See Solicitation of Comment to Assist in Study on Assigned Credit Ratings, 76 FR at 28275-76.

[454] See, e.g., the CRE Letter, the Morningstar Letter, and the Fitch Letter. Subsequent to the solicitation of comment and the comments received on the solicitation, one NRSRO has informed the staff that it has used the Rule 17g-5 Program on a limited basis to produce unsolicited credit ratings.

[455] See the Morningstar Letter and the CRE Letter.

[456] See the Fitch Letter and the ICI Letter.

[457] See the CRE Letter.

[458] See the Morningstar Letter.

[459] Id.

[460] Id.

[461] See the Morningstar Letter.

[462] See, e.g., the S&P Letter.

[463] See the S&P Letter.

[464] Id.

[465] Id.

Some NRSROs suggest that the Rule 17g-5 Program website may not always have all the information a non-hired NRSRO would require for its analytical process.[466] This lack of information may prevent the non-hired NRSRO from providing an unsolicited rating.[467] Another concern raised by NRSROs is the slower credit rating process.[468] To ensure that all NRSROs have access to the same information and at the same time, arrangers are posting formal, written responses to NRSROs' inquiries on the arrangers' websites. This process can cause delays in the initial credit rating process and in the surveillance of outstanding credit ratings.

One NRSRO has a more positive view on the current use of the Rule 17g-5 Program.[469] It observes that the program has increased both the amount of unsolicited commentary available from NRSROs and the level of disclosure provided by issuers and underwriters regarding the process through which they select NRSROs.[470] It states that "over the past 12 months … transaction prospectuses have described which NRSROs were shown the transaction, which were selected and why."[471]

4. Potential Modifications to the Rule 17g-5 Program

The Commission solicited comment on how the Rule 17g-5 Program could be modified.[472] Several of the commenters suggest that enhancements to the Rule 17g-5 Program would make this program a stronger alternative to the Section 15E(w) System.[473] As discussed below, suggested improvements include: issuer disclosure of preliminary credit ratings and enhancement levels from NRSROs that were "shopped" but where the issuer did not accept the credit rating; increasing the information available to investors; modifying the requirement that non-hired NRSROs rate at least 10% of the transactions they view on an arrangers' website (the "10% requirement"); and addressing confidentiality constraints imposed by arrangers.

Some commenters recommend that issuers be required to disclose details regarding whether they "shopped" for preliminary ratings or enhancement levels from NRSROs for a

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466 The Commission held meetings and received input from NRSROs, which are documented on the Commission's Internet website at: http://www.sec.gov/comments/4-629/4-629.shtml#meetings ("Commission Meetings with NRSROs").

467 Id.

468 Id.

469 See the Fitch Letter.

470 Id.

471 See id. Fitch provided the following example of increased disclosure in a prospectus, noting that the sample language was typical of the type of language used: "[i]n the case of Class A and Class B Certificates, Fitch indicated preliminarily that it would require significantly higher subordination in order to assign a ratings of "AAA" and "A" to the classes respectively. If Fitch elects to assign ratings to these Classes such ratings may be significantly lower than the ratings assigned by XYZ rating agency."

472 See Solicitation of Comment to Assist in Study on Assigned Credit Ratings, 76 FR at 28276.

473 See, e.g., the ASF Letter, the SIFMA Letter, and the Fitch Letter.

particular transaction.[474] One commenter proposes that issuers disclose this information in their offering documents.[475] Another commenter suggests that issuers could identify the credit rating agencies that were initially contracted but not ultimately selected to rate a transaction.[476] A third commenter offers that all NRSROs should be required to "list publicly on their websites the [Rule] 17g-5 related transactions for which they have been engaged, regardless of whether they provide final ratings."[477] The commenter suggests that publicly disclosing the NRSROs asked to review a transaction and the NRSROs that ultimately rated the transaction would expose whether "rating shopping" occurred on the transaction.[478]

One NRSRO believes that if the Commission decides to require that NRSROs disclose preliminary ratings, then the NRSROs should be compensated for providing them to cover the costs of providing an analysis that will be publicly available.[479] The NRSRO also suggests that if such disclosure is required, the arrangers could disclose their reasons for selecting certain credit rating agencies to provide preliminary credit ratings and any reasons for differences between the preliminary and final credit ratings.[480]

Some commenters suggest that issuers should be required to provide transaction information to investors and not just NRSROs, so that investors can make their own conclusions about the credit risk of a transaction.[481] One commenter suggests that the Rule 17g-5 Program be enhanced by requiring arrangers to make transaction data available to all investors, credit rating agencies, and issuers by posting the data on the trustee's website.[482] Another commenter believes that if the Commission increases the direct flow of information from issuers to the broader market (and investors in particular) by requiring issuers to disclose enhanced information about structured finance products and the assets underlying them in the offering prospectus, it will discourage issuers from engaging in "rating shopping."[483] The commenter believes that when investors can more easily "look under the hood" of structured finance products, they can form their own views of credit risk and knowledgably assess the credibility of credit rating agencies on a rating-by-rating basis.[484] A third commenter suggests making the Rule 17g-5 Program available to all market participants and not just NRSROs, noting that this would increase "the market's ability to compare the rating issued with the NRSRO's published rating standards."[485]

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474 See the ASF Letter, the SIFMA Letter, and the Fitch Letter.

475 See the ASF Letter.

476 See the SIFMA Letter.

477 See the Fitch Letter.

478 Id.

479 See the Morningstar Letter.

480 Id.

481 See the CRE Letter, the Moody's Letter, and the Kroll Letter.

482 See the CRE Letter.

483 See the Moody's Letter.

484 Id.

485 See the Kroll Letter.

Alternatively, one commenter suggests that the Rule 17g-5 Program be enhanced by instituting an assignment system to select an NRSRO to provide an unsolicited rating for each transaction using the information provided under Rule 17g-5.[486] The commenter states that this system could "address some of the criticisms of the Section 15E(w) System, while still ensuring that NRSROs are being compensated."[487] The commenter states that NRSROs could be eligible to participate in the assignment system following "a confirmation that the NRSROs are prepared to rate the particular class of securities through the publication and release of adequate criteria."[488] Under the commenter's proposed assignment system, NRSROs would be selected on a rotational basis.[489] The commenter states that arrangers would still hire an NRSRO of their choosing, but the unsolicited rating provided by the assigned NRSRO "would act as an alternative, independent voice for investors to consider."[490] The commenter explains that oversight of the assignment system would be accomplished through the Commission's existing NRSRO examination process.[491]

Several commenters believe that the 10% requirement in Rule 17g-5 should be modified or eliminated.[492] One commenter believes that eliminating the 10% requirement would "enable non-hired NRSROs to survey more deals in an effort to identify transactions on which their views diverge from the hired NRSROs."[493] The commenter suggests that NRSROs should be able to count any transaction for which it provides commentary (but not necessarily a credit rating) towards its 10% ratings requirement.[494] The commenter argues that commentary is useful in allowing NRSROs to give their independent views on a transaction.[495] The commenter also argues that smaller or new NRSROs could gain exposure and credibility through a track record of providing commentary, which would be easier for them to undertake than producing unsolicited credit ratings.[496] Similarly, another commenter agrees that unsolicited commentary should count towards the credit ratings requirement but also suggests that the 10% requirement be reduced to 5%.[497] The commenter states that this would relieve "NRSROs from some of the cost and liability burden of issuance of formal ratings (such as the cost of surveillance, and liability associated with that)."[498] A third commenter suggests increasing the number of times

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486 See the Morningstar Letter.

487 Id.

488 Id.

489 Id.

490 Id.

491 Id.

492 See the ASF Letter, the SIFMA Letter, the ICI Letter, and the Kroll Letter.

493 See the ASF Letter.

494 Id.

495 Id.

496 Id.

497 See the SIFMA Letter.

498 Id.

that an NRSRO would be permitted to access information under the rule before a credit rating would need to be produced.[499] Finally, a fourth commenter believes that the 10% requirement should be eliminated.[500] The commenter states that removing the limits around the information NRSROs can view through the Rule 17g-5 Program would encourage NRSROs to access the data because NRSROs would no longer be forced to invest resources in providing a credit rating for which they will not be compensated.[501] The commenter suggests that this wider access would in turn lead to improved methodologies and more accurate ratings.[502]

Finally, one commenter suggests that the Commission should evaluate the confidentiality requirements that are required of NRSROs accessing information through the Rule 17g-5 Program.[503] The commenter states that there has been criticism that arrangers are holding non-hired NRSROs to a higher standard for confidentiality.[504] The commenter explains that this prevents some NRSROs from issuing unsolicited credit ratings or being able to include certain information in their credit rating rationales.[505] NRSROs believe that these higher standards would prohibit them from publishing meaningful analytical commentary with unsolicited credit ratings produced through the Rule 17g-5 Program.[506]

B. Investor-Owned Credit Rating Agency Model

1. Mechanics of the IOCRA Model

Under the investor-owned credit rating agency ("IOCRA") model, sophisticated investors – referred to as highly sophisticated institutional purchasers ("HSIP") – would create and operate NRSROs that would produce ratings.[507] Issuers would be required to obtain two ratings, one from an IOCRA and the second from their choice of NRSRO. More specifically, an NRSRO would be prohibited from publicly releasing a rating that was paid for by the issuer or sponsor, unless the NRSRO received written notification that the issuer had made arrangements and paid an IOCRA to publicly release its rating. The IOCRA and the hired NRSRO would publish their ratings simultaneously.

An institutional investor would have to qualify as an HSIP before forming an IOCRA or joining an existing IOCRA. To qualify as an HSIP, an institutional investor would have to demonstrate that it was large and sophisticated, managed billions of dollars in assets, and could be relied upon to represent the buy-side interest in accurately rating debt market instruments.

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499 See the ICI Letter.

500 See the Kroll Letter.

501 Id.

502 Id.

503 See the ICI Letter.

504 Id.

505 Id.

506 See Commission Meetings with NRSROs.

507 The description of this model is derived from the GAO Report at 82; see also GAO 2012 Report at 9-10.

HSIPs would hold majority voting and operational control over the IOCRA. The model contemplates that IOCRAs could be for-profit or not-for-profit entities. There would be no regulatory limit on the number of IOCRAs that could be formed.

Under the IOCRA model, market forces would set IOCRA fees. The credit rating released by the IOCRA and the underlying research would be free to the public. According to the GAO, proponents of this model believe it would improve the rating process by changing the incentive structure of the NRSRO's business.[508] They said the IOCRA model would affect competition and ratings quality by introducing new competition to the industry, and the investors' interest would be counter-balanced against the interest of the issuers.[509]

2. Commenters' Reactions to the IOCRA Model

Some commenters question the feasibility of implementing the IOCRA model.[510] For example, one NRSRO questions how an IOCRA "would accumulate the extensive resources necessary to form quality rating opinions on all or virtually all asset-backed securitizations, as the proposal anticipates."[511] Another commenter is concerned that the IOCRA model is unrealistic because of its reliance on investor cooperation, given the competition among institutional investors and investors' unwillingness to pay for research services in the past.[512] Additionally, some commenters argue that, while the IOCRA model may help to manage the issuer-pay conflict of interest, it could create new conflicts of interest.[513] Commenters are concerned that investors have as much interest in a security's rating as issuers do and therefore, an IOCRA rating would not be free of conflicts.[514] One NRSRO states that IOCRAs "could face pressure to issue lower ratings, generally benefiting investors by increasing the risk premium that investors can demand from issuers."[515] Similarly, another commenter argues that just as issuers want to obtain high credit ratings, investors can have incentives to have credit ratings issued or maintained at a certain level.[516] The commenter states that investment guidelines have certain credit rating requirements and offers the example of investors wanting "cheap" assets to receive high credit ratings so that the investors can purchase these assets, which can produce high yields for their funds.[517] The commenter explains that the cheap price of the security could compensate for any decrease in performance.[518] The commenter also offers a second example where

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508 See the GAO Report at 82.

509 Id.

510 See the S&P Letter and the AFR Letter.

511 See the S&P Letter.

512 See the AFR Letter.

513 See the S&P Letter and the SIFMA Letter.

514 See id.

515 See the S&P Letter.

516 See the SIFMA Letter.

517 Id.

518 Id.

investors might want to avoid downgrades for a troubled security as long as possible so that the security would not need to be marked down on the investor's books or sold at a loss.[519]

Finally, one commenter questions whether the IOCRA model would address the issuer-pay conflict of interest since financial institutions (who would be the HSIPs controlling the IOCRAs) may have many different roles in the securitization market.[520] It states that "there is often no clear distinction between investors and issuers. There are instances where the 'investor', the 'issuer' and the 'government' are either the same entity or a group of tightly interconnected entities."[521]

C. Stand-Alone Model

1. Mechanics of the Stand-Alone Model

Under the stand-alone model, the issuer would continue to select the NRSRO, and NRSROs would continue to interact with the issuer.[522] However, the issuer would not provide payment for the NRSRO's credit rating services. Instead, the NRSROs would be compensated through transaction fees imposed on original issuance and on secondary market transactions. Part of the fee would be paid by the issuer or secondary-market seller, and the other portion of the fee would be paid by the investor purchasing the security in either the primary or secondary market. The NRSRO would be compensated over the life of the security based on these transaction fees. The credit rating provided by the NRSRO would be free to the public. According to the GAO, proponents of this model believe that by creating a funding source that is beyond the influence of both issuers and investors, the NRSROs' focus will be on producing the most accurate and timely credit analysis rather than on satisfying the desires of any other vested interest.[523]

2. Commenters' Reactions to the Stand-Alone Model

Several commenters believe that the stand-alone model would not eliminate the conflicts of interest associated with the issuer-pay system or deter "rating shopping."[524] For example, one commenter states that "if the issuer selects the NRSRO to provide the initial ratings, NRSROs would remain incentivized to court the favor of issuers."[525] Similarly, another commenter adds "this model does not address concerns that flow from having an entity with an interest in the rating, such as an issuer or subscriber, select the credit rating agency."[526] A third commenter

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[519] Id.

[520] See the Moody's Letter.

[521] Id.

[522] The description of this model is derived from the GAO Report at 82-83; see also GAO 2012 Report at 10.

[523] GAO Report at 82-83.

[524] See the ASF Letter, the CRE Letter, and the S&P Letter.

[525] See the ASF Letter.

[526] See the CRE Letter.

observes that conflicts of interest associated with the issuer-pay system would not necessarily be reduced simply because a portion of the NRSRO's fees would be paid by investors in the future when the rated security is purchased in the secondary market.[527]

A number of commenters also question the feasibility of implementing the stand-alone model.[528] Several commenters note that the payment system would create implementation problems.[529] One NRSRO highlights the complexity of the payment system under the stand-alone model and questions how it would function and who would manage it.[530] The NRSRO feels that the payment system would require extensive resources to implement and would likely impose significant burdens on the market.[531] Another commenter also argues that the payment system under the stand-alone model would be difficult to set up and administer.[532] The commenter states that some entity would need to be formed to "administer, monitor, and audit the payment system and it is unclear what entity would be in a position to handle such tasks, particularly for secondary market transactions."[533] The same commenter also expresses concerns about how the stand-alone model would affect the competitiveness of the industry.[534] It questions how many credit rating agencies the stand-alone model could support, noting that the model could lead to consolidation and reduced competition in the industry.[535]

Additionally, commenters raise some feasibility concerns with tying credit rating agency fees to secondary market trading.[536] One commenter states that "structured finance securities are more thinly traded than corporate securities, and it would seem difficult, if not impossible, to compensate NRSROs on any meaningful basis through secondary market trading, unless the per transaction fee was prohibitively high or the bulk of the fee was borne by issuers."[537] Another commenter echoes these concerns, noting that due to the comparatively small amount of trading in securitized products and the correspondingly low revenue generated from such trading, the fee paid to NRSROs at issuance would have to be quite high relative to the transactional fee.[538] A third commenter worries that NRSROs would not be adequately compensated under the stand-alone model, stating that "it is difficult to see how such contingent fees could be factored into

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527 See the S&P Letter.

528 See the S&P Letter, the CRE Letter, the ASF Letter, and the SIFMA Letter.

529 See the S&P Letter and the CRE Letter.

530 See the S&P Letter.

531 Id.

532 See the CRE Letter.

533 Id.

534 Id.

535 Id.

536 See the ASF Letter, the SIFMA Letter, and the S&P Letter.

537 See the ASF Letter.

538 See the SIFMA Letter.

pricing decisions in a way that provides adequate assurances that the NRSRO will earn an appropriate return for its work."[539]

D. Designation Model

1. Mechanics of the Designation Model

Under the designation model, all NRSROs would have the option of rating a new issuance, and investors would direct, or designate, fees to the NRSROs of their choice, based on the proportion of securities that the investors owned.[540] The issuer would be required to provide all interested NRSROs with the information necessary to rate the structured finance product and would pay the rating fees to a third-party administrator, which would manage the designation process. The model suggests that the issuer's transfer agent (who is currently responsible for maintaining investor ownership records) could perform the responsibilities of the third-party administrator. When the security was issued, the investors would designate which of the NRSROs that rated the security should receive fees, based on the investors' perception of the research underlying the credit ratings. The investors could designate one or several NRSROs. The third-party administrator would be responsible for disbursing the fees to the NRSROs in accordance with the investors' designations. After the initial rating, the issuer would continue to pay maintenance rating fees to the third-party administrator, which bond holders also would allocate through the designation process every quarter over the life of the security. When the debt was repaid (or repurchased by the issuer), a final rating fee would be paid in conjunction with the retirement of the security. The credit rating would be free to the public, while the research underlying it would be distributed to investors and (at the discretion of the relevant NRSROs) to potential investors.

According to the GAO, the proponents of the designation model believe it would eliminate the conflict of interest between the issuer paying for the rating and the NRSRO.[541] They also believe it would increase competition by encouraging NRSROs to prepare unsolicited ratings because each NRSRO would be assured of receiving compensation for its rating, provided that some group of investors or other users of ratings found the NRSRO's credit rating useful enough to allocate to the NRSRO a portion of the fees.[542]

2. Commenters' Reactions to the Designation Model

All of the comments the Commission received regarding the designation model were negative. Several commenters are concerned with the uncertainty as to whether an NRSRO would be compensated under the designation model.[543] One commenter highlights that NRSROs

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[539] See the S&P Letter.

[540] The description of this model is derived from the GAO Report at 83-84; see also GAO 2012 Report at 10.

[541] See the GAO Report at 83-84.

[542] Id.

[543] See the SIFMA Letter, the CRE Letter, and the S&P Letter.

would be forced to rate transactions without any guaranty of payment.[544] The commenter states that the NRSRO "might receive its full customary fee, or it might receive part of it, or it might receive nothing."[545] The commenter also argues that NRSROs would then have to maintain the credit rating through surveillance without any guarantee of additional compensation.[546] The commenter concludes that "[n]ot only it is unclear how rating agencies would be able to operate broadly focused businesses on these uncertain terms, but also whether rating agencies would continue to rate asset-backed securities at all."[547] Another commenter observes that the uncertain revenue stream for NRSROs under the designation model would cause ratings quality, competition and innovation in the industry to suffer because NRSROs would be incentivized to invest the fewest possible resources in their ratings.[548] The commenter states that "NRSROs cannot be expected to invest the resources that would be necessary to perform labor-intensive ratings and develop specialized expertise in exchange for a mere hope that they will be compensated for their efforts."[549] Another commenter echoes this sentiment, asking "would any rating agency want to invest the resources to rate a transaction if it might not be selected?"[550]

An additional concern commenters raised relates to the feasibility of implementing the compensation system.[551] Three commenters highlight the complexity of the payment system and question how it would function and who would be responsible for managing it.[552] One commenter questions how investors would know to which NRSROs to designate fees since the investors would not purchase the security until after it was rated.[553] This commenter also questions how issuers could budget for a transaction if they could not predict how much the surveillance fees would be.[554]

Several commenters raised similar feasibility or practicality concerns with respect to the designation model.[555] One commenter argues that the model "raises many concerns, not the least of which is the complexity of attempting to administer such a system."[556] Another commenter worries that the uncertainty surrounding which NRSROs would ultimately be hired to provide ratings would decrease efficiencies at each stage of the securitization process.[557] Finally, one

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544 See the SIFMA Letter.

545 Id.

546 Id.

547 Id.

548 See the CRE Letter.

549 Id.

550 See the ASF Letter.

551 See the S&P Letter and the CRE Letter.

552 See the S&P Letter, the ASF Letter, and the CRE Letter.

553 See the CRE Letter.

554 Id.

555 See the CRE Letter, the ASF Letter, and the SIFMA Letter.

556 See the CRE Letter.

557 See the ASF Letter.

commenter highlights the burden that the designation model would place on the issuer, noting that if a large number of NRSROs were interested in rating the transaction, the issuer could end up responding to numerous requests for information.[558]

Commenters also note that the designation model raises additional conflicts of interests.[559] One commenter argues that the model would "create incentives for rating agencies to curry the favor of particular investors in transactions."[560] Similarly, another commenter argues that NRSROs could face pressure to issue lower ratings (which may benefit investors because of the increased risk premium they can demand) since it would be up to the investors to decide which NRSROs would receive fees.[561]

E. User-Pay Model

1. Mechanics of the User-Pay Model

Under the user-pay model, issuers would not pay for ratings.[562] The model specifies that all users of ratings would be required to enter into a contract with the NRSRO and pay for its rating services. The proposal defines "user" as any entity that included a rated security, loan, or contract as an element of its assets or liabilities as recorded in an audited financial statement. Users of ratings would include holders of long or short positions in a fixed-income instrument, as well as parties that refer to a credit rating in contractual commitments or that are parties to derivative products that rely on rated securities or entities. A user would be required to pay for ratings services supplied during each period in which it booked the related asset or liability.

The model relies on third-party auditors to ensure that NRSROs receive payment from users of ratings for their services. Any entity required to obtain audited financial statements in which the rated instrument or covenant was included would be required to demonstrate to the auditors that the holder had paid for the rating services. No audit opinion would be issued until the auditor was satisfied that the rating agencies had been properly compensated. The model would require the close cooperation of the auditing community and the Public Company Auditing Oversight Board. According to the GAO, the proponents of this model believe that, while more cumbersome, the model attempts to capture "free riders" – users of ratings that do not compensate NRSROs for the credit ratings they produce.[563]

2. Commenters' Reactions to the User-Pay Model

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[558] See the SIFMA Letter.

[559] See the SIFMA Letter and the S&P Letter.

[560] See the SIFMA Letter.

[561] See the S&P Letter.

[562] The description of this model is derived from the GAO Report at 84-85; see also GAO 2012 Report at 11.

[563] See the GAO Report at 84-85.

Commenters question the feasibility of the user-pay model.[564] One commenter states that "[t]his model represents perhaps the most insurmountable operational challenge of any of the alternatives because it will be difficult, if not impossible, to figure out who the 'user' is in every case."[565] The commenter cites the example of investors who hold securities under the name of their broker-dealer.[566] Another commenter questions "how a user could be compelled to pay for a credit rating."[567]

Other commenters are concerned with the conflicts of interest created by the user-pay model.[568] One commenter argues that just as issuers have incentives to obtain high credit ratings, investors and other users have incentives to obtain credit ratings at a certain level as well.[569] The commenter states that "[u]ser-paid models do not eliminate all conflicts of interest, just some conflicts of interest, and introduce others."[570] Continuing with this theme, another commenter argues that investors who are short a bond may be motivated to encourage a negative rating action and that investors who are long a bond also may prefer lower ratings to obtain higher yields.[571]

F. Other Alternative Models

1. Issuer and Investor-Pays Model

The issuer and investor-pays model incorporates characteristics from a number of the models described above and leverages an existing structure as the basis for collecting and distributing ratings fees.[572] Under this model, accredited NRSROs would be assigned to rate new issuances. Initially, all NRSROs would be placed in a continuous queue and would receive rating assignments when their respective numbers came up, unless they were unable or unwilling to rate a particular issue. In the future, credit ratings would be assigned based on the performances of the NRSROs, with those agencies that produced superior performance receiving more assignments. Performance would be measured as the correlation between an NRSRO's credit ratings and default and recovery rates on issues rated, and tracked using "a common, transparent, and defensible methodology."[573] Under this model, at least two and possibly three NRSROs would be assigned to rate each issuance "to help ensure rigor and fairness."[574]

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564 See the CRE Letter and the SIFMA Letter.

565 See the CRE Letter.

566 Id.

567 See the SIFMA Letter.

568 See the SIFMA Letter and the Moody's Letter.

569 See the SIFMA Letter.

570 Id.

571 See the Moody's Letter.

572 The description of this model is derived from the GAO 2012 Report at 13-14.

573 Id.

574 Id.

Payments for ratings would come from a fee levied on issuers of new debt issues and investors as parties to secondary market trades. These fees would be deposited in a dedicated fund—the U.S. Ratings Fund—and would be determined and reset periodically. The periodic review would consider the historic and projected volumes of primary issuances and of secondary market trading to determine a fee that would in the aggregate allow the ratings business to attract and retain qualified individuals. The U.S. Ratings Fund would be modeled after the Municipal Securities Rulemaking Board, which is authorized to collect fees on new and secondary market municipal issues to fund its activities. It would be overseen by a governing board representing issuers, investors, rating agencies, intermediaries, and independent directors. The fees collected would be used to pay the selected accredited NRSROs for issuing each solicited rating and other necessary administrative activities such as tracking NRSROs' performance and tracking deals to be rated. The model authors note that these other activities could be outsourced or performed by the U.S. Ratings Fund.[575] The fund also would advise the Commission on the eligibility and accreditation of the NRSROs. All ratings and related research reports paid for through the U.S. Ratings Fund would be freely available to the public.

According to the GAO, the authors of this model believe NRSROs would have incentives to provide accurate ratings and be objective because ratings would be monitored by a regulator and the accreditation of NRSROs would be subject to periodic renewal.[576] The authors also note that legislation likely would be required to establish the system contemplated by the model.[577] Specifically, the authors said that legislation would need to enumerate the functions and the governance structure of the U.S. Ratings Fund, provide its mandate and methodology for determining the fees to be charged for ratings, and elaborate on how the new rating model would be introduced.[578]

2. Alternative User-Pays Model

The alternative user-pays model would pool creditors' resources to obtain credit ratings before debt was issued.[579] A government agency or independent board would administer a user-fee system financed by debt purchasers, which would fund a competitive bidding process for the selection of credit rating agencies. The agency or board would solicit credit ratings before the debt issuance and then pay for the expense and related administrative costs through the user fee. The user fee could be assessed through a flat fraction or a percentage fee on the initial purchasers of the rated debt offerings. The user fee would allow the agency or board to finance initial credit ratings on a rolling basis, with the ratings for a given debt issuance being secured before the issuance of the debt.

NRSROs would bid on the right to issue ratings, with the agency or board determining how best to judge the bids and award the right to rate the issuance. For example, the agency or

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575 Id.

576 Id.

577 Id.

578 Id.

579 The description of this model is derived from the GAO 2012 Report at 12-13.

board could weigh factors such as price, extent of diligence the NRSRO proposed to undertake, and the disclosures the NRSRO would demand from issuers as a condition for the rating. The author of this model believes the bidding process would serve to contain the costs for credit ratings through price competition, level the playing field for smaller competitors and new entrants, and balance the desire for market-based assessments of risk with a greater role for the government agency, such as the Commission, or an independent board in defining credit rating agencies' responsibilities.[580]

This model contemplates the establishment of additional accountability mechanisms. Specifically, users of credit ratings would be given enforceable rights and would require NRSROs to assume certification and mandatory reporting duties to creditors. The system would set up creditor committees that would serve as a channel for creditors to monitor ratings and assert limited rights against NRSROs. If an NRSRO breached duties owed to the creditors, the committee would serve as the representative in any potential actions and preempt actions brought by individual creditors. The model would require that all contracts with NRSROs detail duties owed to their creditors, to delineate the potential liability exposure for breach of these duties, and channel adjudication of any disputes to a Commission administrative process. For example, NRSROs could be required to certify on a quarterly basis that they exercised reasonable care in conducting due diligence of issuers' financial and nonfinancial disclosures to make accurate assessments of risk exposure. To provide NRSROs with incentives for compliance without jeopardizing their financial viability, the model would limit NRSRO financial liability to cases of gross negligence, coupled with an earnings-based cap on liability and other safeguards.

While acknowledging the large volume of transactions that the administrator of the user-fee system would have to manage, comparing the system to the Section 15E(w) System, the author of the model states that the "SEC may be far better positioned to select low bidders and to set floors for rating agency diligence than to engage in more difficult and subjective choices of what rating agency approaches are preferable."[581]

3. Investor Owned Rating Agency Model

Under the investor owned rating agency model, investor owned rating agencies ("IORAs") would be formed with a majority of their boards consisting of the largest fixed income investors ("FIIs") that use credit ratings and whose economic interests in the IORAs would be minimal.[582] The extent of the FIIs' economic interest in the IORAs would be a function of the type of shares they own. Moreover, the priorities of accuracy and transparency would be provided for in the IORAs' charters, bylaws and shareholder agreements.

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[580] Id.

[581] See the Manns Letter.

[582] A description of this model is set forth in a comment letter provided to the Commission for the April 2009 roundtable examining oversight of credit rating agencies. See letter from Neil Baron dated May 3, 2009 ("Baron Letter"). The letter is available on the Commission's Internet website at: http://www.sec.gov/comments/4-579/4-579.shtml. The staff also met with the commenter.

The author of this model believes that FIIs would ask issuers to obtain a rating from an IORA.[583] The "buying power" of the FIIs with respect to instruments that are rated would be sufficient to require that issuers obtain a rating from an IORA in order to market their securities. As a result, the ability of an issuer to ratings shop would be minimized and, at the same time, the issuer-pay model – which the proponent believes is necessary to funding a rating agency's operations – would be preserved. There also would be an oversight board with full-time employees whose sole responsibility would be to challenge credit rating methodologies. The oversight board or designees of the board would publish critiques of the methodologies.

4. Additional Suggestions From Commenters

In addition to the models discussed above, three commenters provide suggestions regarding alternative models.[584] Instead of developing a new model, one commenter recommends that the Commission "explore changes to current rules, including creating mechanisms that defer payment of a portion of an initial rating fee over the life of a transaction, or other measures that help to ensure that a rating agency has 'skin in the game' along with other securitization transaction participants."[585] Similarly, another commenter "supports a compensation system in which fees earned by NRSROs are required to vest: (1) over a period of time equal to the average duration of the bonds; and (2) based on the performance of the original ratings and changes to those ratings over time relative to the credit performance of the bonds."[586] The third commenter suggested a "term limit" under which an NRSRO that has rated three consecutive securitization transactions of an issuer or one of its affiliates within a specific asset class would be precluded from rating the next securitization transaction of the issuer or one of its affiliates within that asset class.[587]

VII. FINDINGS

Section 939F provides that the Commission must submit to the Committee on Banking, Housing and Urban Affairs of the Senate, and the Committee on Financial Services of the House of Representatives, not later than 24 months after the enactment of the Dodd-Frank Act, a report that contains: (1) the findings of the study, and (2) any recommendations for regulatory or

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[583] Id.

[584] See the SIFMA Letter, the CII Letter, and the Redwood Letter.

[585] See the SIFMA Letter.

[586] See the CII Letter.

[587] See the Redwood Letter. In 2011, the European Commission proposed amendments to European Union regulations applicable to credit rating agencies. See A Regulation Of The European Parliament And Of The Council Amending Regulation (EC) No 1060/2009 On Credit Rating Agencies, 2011/0361 (COD) (Nov. 15, 2011), available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2011:0747:FIN:EN:PDF. This proposal included a requirement that credit rating agencies be rotated. See id. On June 19, 2012, the Economic and Monetary Committee of the European Parliament voted on the proposal that would modify it in certain respects. See Press Service, Credit rating agency reform: sovereign debt ratings to be regulated (Jun. 19, 2012), available at http://www.europarl.europa.eu/news/en/pressroom/content/20120619IPR47242/html/Credit-rating-agency-reform-sovereign-debt-ratings-to-be-regulated.

statutory changes that the Commission determines should be made to implement the findings of the study.[588] The sections below analyze the potential benefits and concerns of three potential courses of action: (1) implementation of the Section 15E(w) System; (2) implementation of enhancements to the Rule 17g-5 Program; and (3) implementation of one or more of the alternative compensation models discussed in section VI. The sections also identify for consideration by the Commission potential regulatory and statutory changes that could be undertaken with respect to each course of action. The staff recognizes that further action to implement any of these courses of action through Commission rulemaking would require additional study of relevant information, including information, as applicable, related to the costs and benefits of the course of action and the consideration, as applicable, of public comment. The staff recommends that the Commission, as a next step, convene a roundtable at which proponents and critics of the three courses of action are invited to discuss the study and its findings.

A. Section 15E(w) System

1. Potential Benefits

There are several potential benefits associated with the Section 15E(w) System. The primary potential benefit is that it could mitigate the issuer-pay conflict, which creates the potential that an NRSRO will be influenced to produce credit ratings desired by issuer clients to the detriment of the objectivity and quality of its credit ratings. Having the CRA Board assign a Qualified NRSRO to provide an initial credit rating would remove issuers from the NRSRO selection process with respect to the initial credit rating. This could result in less pressure on NRSROs to cater to the clients from whom they routinely seek business.

A second potential benefit of the Section 15E(w) System is that it could reward Qualified NRSROs for good performance and punish poor performance. Under one of the selection criteria, Qualified NRSROs producing credit ratings that prove to be accurate over time could receive more rating assignments in the future. Thus, their performance in determining accurate ratings could directly affect the volume of ratings business assigned to them. This could encourage NRSROs to compete based more heavily on the accuracy of their credit ratings.

A third potential benefit of the Section 15E(w) System is that the CRA Board's assignment system could provide smaller NRSROs with the opportunity to develop a reputation for producing quality credit ratings and potentially increase their market share. Smaller NRSROs that meet the CRA Board's criteria for becoming a Qualified NRSRO could be assigned to provide initial credit ratings for issuers that might not otherwise have hired them. This would give the smaller NRSROs the opportunity to develop a positive track record with issuers and investors, potentially leading to more business for those NRSROs in the future, thus fostering greater competition among NRSROs.

A fourth potential benefit of the Section 15E(w) System is that the majority of the CRA Board would represent the investor community. Investors should have an incentive to develop a system that best promotes quality ratings. As discussed in section III.C.2, investors, like issuers,

[588] Pub. L. No. 111-203, 124 Stat. 1376 (2010).

may have their own conflicts of interest and could seek to influence NRSROs to provide particular credit ratings. However, members of the CRA Board acting as representatives of the investor community at large would arguably focus on the promotion of quality ratings more than any other group, instead of seeking a credit rating for a particular investment.

2. Potential Concerns

There are several potential concerns associated with the Section 15E(w) System. One concern is that it may not substantially mitigate the issuer-pay conflict because issuers could continue to engage in "rating shopping" as they would be permitted to hire NRSROs to provide credit ratings to supplement the initial credit rating published by the assigned Qualified NRSRO. Furthermore, the NRSRO that is assigned to be the Qualified NRSRO in a particular transaction could be motivated to issue a favorable credit rating with the goal of being hired by the issuer at a later date and on an unrelated transaction when the Qualified NRSRO is not assigned by the CRA Board to perform an initial credit rating.

A second potential concern is the risk that some NRSROs may choose not to apply to become Qualified NRSROs and thereby not participate in the Section 15E(w) System. For example, an NRSRO may choose not to rely on the Section 15E(w) System to obtain rating business and instead continue to solicit business directly from the issuers to perform supplemental credit ratings. Issuers ultimately may need to hire the NRSRO because investors or investment guidelines often require a product to be rated by more than one NRSRO or by a particular NRSRO. Thus, the business models of NRSROs that currently are hired to rate structured finance products may not be significantly affected if they do not participate in the Section 15E(w) System. Their lack of participation could undermine the potential benefits of the Section 15E(w) System and adversely affect the market for structured finance products. For example, the NRSROs that become Qualified NRSROs may not have the capacity or expertise to produce an initial credit rating for each structured finance product brought to market. This could stall or significantly delay the issuance of new securitizations.

A related concern is that even if most NRSROs were to participate in the Section 15E(w) System, there is a risk that it would not change the current dynamics of the market for rating structured finance products. As noted above, investors and investment guidelines often require that a debt instrument be rated by specific NRSROs. As a result, if a Qualified NRSRO not accepted by investors or investment guidelines is assigned to perform an initial credit rating, the issuer may still need to solicit ratings from the NRSROs that have traditionally rated structured finance products in order to complete the issuance. This would raise costs to issuers, which could be passed on to investors. Alternatively, the CRA Board could factor investor acceptance into its selection criteria. However, this could result in initial ratings being assigned largely to the same NRSROs that currently are hired by issuers to rate structured finance products, which could undermine the objective of the Section 15E(w) System to broaden the pool of NRSROs rating these products.

Another concern is that the Section 15E(w) System may be costly to implement and administer. Substantial funding may be necessary to hire CRA Board members and staff with the requisite expertise to efficiently assign Qualified NRSROs to produce initial credit ratings (given the volume of new issuances) and to assess the performance of Qualified NRSROs' credit

ratings. The Section 15E(w) Provisions specify that the CRA Board would have authority to levy fees from Qualified NRSROs to fund its operations. This approach raises the issue of how the cost of establishing the CRA Board would be funded as the board would need to be operational before Qualified NRSROs are approved and begin paying fees.[589] It also raises a question of whether there would be sufficient Qualified NRSROs to fund the operations of the CRA Board on an ongoing basis. For example, there currently are nine NRSROs and they range in size. This pool could be too small to fund the operations of the CRA Board without imposing substantial fee burdens on each Qualified NRSRO. Moreover, the requirement to pay the fees could operate as a disincentive for some NRSROs to seek to become Qualified NRSROs, thereby further increasing the fee burden on the Qualified NRSROs. The fee costs to the Qualified NRSROs also likely would be passed on to the issuers, raising the costs of securitizations, which, in turn, would likely be passed on to investors.

Another concern is the operational complexity of the Section 15E(w) System and the impact this may have on the quality of credit ratings and the functioning of the structured finance markets. The ability of a given Qualified NRSRO to produce a quality credit rating for a particular structured finance product will depend on its capacity and expertise. The selection process utilized by the CRA Board would need to take these factors into account. Consequently, it would need to exercise a degree of judgment as to which Qualified NRSRO should undertake a particular initial ratings assignment. Thus, a completely random selection process (which would be the easiest to administer) probably would not be workable. Assessing the capacity and expertise of each Qualified NRSRO on an ongoing basis could be a fairly complex process. If not done properly, the selection process could misallocate initial ratings assignments to Qualified NRSROs that do not have sufficient resources to handle the volume of assignments or the in-house expertise to rate a type of transaction. This could result in lower quality credit ratings or cause delays in bringing structured finance products to market.

The Section 15E(w) System – by linking ratings assignments to the past performance of a Qualified NRSRO's credit ratings – has the potential to create incentives that run contrary to the goal of ratings quality. For example, these incentives could lead NRSROs to be overly conservative in determining the initial credit rating in order to avoid having to downgrade the credit ratings in the future and have those downgrades negatively impact their performance statistics. They also could cause an NRSRO to be reluctant to downgrade a credit rating. These outcomes would run contrary to the goal of credit rating quality. Furthermore, the CRA Board's evaluation of the performance of Qualified NRSROs could have unintended negative consequences. For example, if the metric for measuring ratings accuracy is not calibrated to account for legitimate differences in approach across the Qualified NRSROs and for economic cycles, certain NRSROs could be unfairly punished (or rewarded) for rating performance. Using a metric to measure accuracy and hold NRSROs accountable also could discourage innovation by NRSROs and lead to homogeneity of credit ratings to satisfy the particular metrics chosen by the CRA Board.

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[589] See, e.g., section 109(k) of the Sarbanes-Oxley Act of 2002 (providing for start-up expenses for the Public Company Accounting Oversight Board). 15 U.S.C. 7231(k).

Moreover, a flawed metric could result in the misallocation of initial ratings assignments to Qualified NRSROs that are not necessarily producing quality credit ratings. Moreover, if the metric assesses a large Qualified NRSRO as not performing well, the CRA Board could be faced with the decision of either reducing that firm's assignments, even though the remaining Qualified NRSROs do not have the capacity or expertise to take on the additional initial credit ratings (thereby slowing new issuance in the structured finance market), or continuing to assign the Qualified NRSRO initial credit ratings in order to keep the market functioning, notwithstanding the assessed poor performance (thereby raising questions about the credibility of the system to make NRSROs accountable).

The CRA Board's role as an evaluator of NRSRO performance raises other potential concerns. In particular, assessing performance could be viewed as interfering with the substance of the credit ratings or the procedures and methodologies by which the NRSROs determine credit ratings and, consequently, be contrary to section 15E(c)(2) of the Exchange Act. Different rating methodologies may produce different outcomes. For example, one credit rating agency may seek to produce credit ratings that remain stable through market cycles; whereas another credit rating agency may seek to produce credit ratings that are sensitive to changes in market factors and, thereby, are more volatile. In addition, one credit rating agency may issue credit ratings that assess the relative likelihood that an issuer or obligation will default regardless of any recovery after default; whereas another credit rating agency may issue credit ratings that include assessments of loss given default. A metric for measuring the accuracy of credit ratings could inadvertently favor one credit rating approach over another and thereby prevent certain NRSROs from seeking to become Qualified NRSROs or force them to change their approach to producing credit ratings in order to accommodate the metric. In addition, commenters have raised concerns that ratings are opinions that are protected under the First Amendment, and therefore, any attempt to influence these opinions, such as by evaluating performance and punishing bad performance, may be a violation of the NRSROs' First Amendment rights.[590] Additionally, commenters have raised concerns that requiring issuers to hire the assigned Qualified NRSRO regardless of issuer or market preference or terms of engagement could raise Fifth Amendment issues.[591]

A further concern is that the Section 15E(w) System could create new conflicts of interest. Individuals serving on the CRA Board or employed as staff may have their own interests in mind, and NRSROs could seek to influence these board members and staff members in a bid to receive more business. For example, an NRSRO could construct its ratings on government-issued debt in an effort to increase the likelihood that the CRA Board, which would be overseen by the government, would designate that NRSRO as a Qualified NRSRO. While some of these conflicts of interest could potentially be managed through CRA Board governance policies, such as requiring recusals where appropriate, some are inherent to the 15E(w) System and cannot be completely eliminated. Moreover, they add an extra layer of complexity and would have to be monitored and managed in the same manner as conflicts impacting the issuer-pay model.

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[590] The staff takes no position on the merits of these legal arguments.

[591] The staff takes no position on the merits of these legal arguments.

Finally, the Section 15E(w) System may conflict with the Congress' goal in the Dodd-Frank Act of reducing reliance on credit ratings. The CRA Board's approval of NRSROs to operate as Qualified NRSROs and its ongoing monitoring and assessment of their performance could be perceived as a seal of approval on the Qualified NRSROs and the credit ratings issued by Qualified NRSROs. This could lead investors to believe that these ratings are government-sanctioned and encourage them to forego additional due diligence on the structured finance product.

3. Potential Considerations

The Commission – if it determines to implement the Section 15E(w) System – might consider the following actions:

- Seeking start-up funding from Congress to finance the initial establishment of the CRA Board and authority from Congress to permit the CRA Board to assess fees on issuers and other users of credit ratings to fund the on-going operations of the CRA Board.

- Requesting that Congress modify section 15E(c)(2) of the Exchange Act to make explicit that section 15E(c)(2) permits the CRA Board to link ratings assignments to the past performance of a Qualified NRSRO's credit ratings.

B. Rule 17g-5 Program

1. Potential Benefits

There are several potential benefits associated with the Rule 17g-5 Program. One potential benefit is that it can mitigate conflicts of interest associated with the issuer-pay compensation model if it is used to produce unsolicited credit ratings. The Rule 17g-5 Program is designed to create a mechanism for non-hired NRSROs to obtain information from the arranger at the same time as the hired NRSROs to allow the non-hired NRSROs to determine and monitor an unsolicited credit rating. Thus, it is designed to make it more difficult for arrangers of structured finance products to exert influence over the NRSROs they hire because any inappropriate credit rating could be exposed to the market through the unsolicited credit ratings issued by the non-hired NRSROs. Thus, the program is intended to mitigate the issuer-pay conflict by encouraging hired NRSROs to provide more accurate, unbiased credit ratings because of the possibility that a biased rating could be exposed by a non-hired NRSRO through an unsolicited credit rating.

The Rule 17g-5 Program also can address the issuer-pay conflict by providing investors with potential alternatives to structured finance credit ratings issued by hired NRSROs. Unsolicited credit ratings provide investors with additional, independent evaluations of creditworthiness. In addition, investors seeking a credit rating from an NRSRO not hired to rate the structured finance product can pay an NRSRO of their choosing to rate the structured finance product using the Rule 17g-5 Program. Thus, it provides a mechanism for investors to select an NRSRO to rate a structured finance product they are considering purchasing or have purchased.

In other words, investors can use the Rule 17g-5 Program to obtain credit ratings from NRSROs other than those hired by the issuer.

Another potential benefit of the Rule 17g-5 Program is that it could possibly promote competition and mitigate barriers to entry naturally arising in the credit rating industry by allowing smaller NRSROs to compete for market share by developing a track record through the publication of unsolicited ratings. Issuers and investors may eventually choose to hire a particular NRSRO after observing the quality of its unsolicited credit ratings. This could lead to less concentration and greater competition in the credit rating industry.

The Rule 17g-5 Program also can be a means to improve accountability in the credit rating process for structured finance products because it requires issuers to post the information provided to the hired NRSRO on their internet websites. This transparency may make it more difficult for issuers to exert influence over NRSROs, given that all communications and information shared between the issuer and the hired NRSRO must also be provided to the non-hired NRSROs.

Another potential benefit of the Rule 17g-5 Program is that NRSROs and issuers already have established the systems and infrastructures necessary to comply with the requirements in Rule 17g-5. NRSROs and issuers are familiar with the rule and have developed industry practices with respect to complying with the rule (e.g., data rooms to facilitate the required sharing of information have been deployed and refined). Consequently, enhancements to the Rule 17g-5 Program to improve its efficacy could be less burdensome and costly to implement than other alternatives.

2. Potential Concerns

There are several potential concerns associated with the Rule 17g-5 Program. The foremost concern is that most NRSROs have not been using it to produce unsolicited credit ratings. The requirement that a non-hired NRSRO rate at least 10% of the transactions it views on arrangers' websites (the "10% requirement") is cited as a reason for why the Rule 17g-5 Program is not being used as designed.

Another concern is that NRSROs, particularly smaller ones, have stated that structured finance credit ratings are too costly to produce for free. Smaller NRSROs also have argued that if they issue ratings for free, there is no incentive for an issuer to hire them. Further, although investors have the ability to solicit ratings from non-hired NRSROs, they may not be willing to pay for credit ratings when they can receive them from the hired NRSROs for free.

The provision of free credit ratings raises other ancillary concerns. NRSROs are concerned about the potential liability connected to unsolicited ratings where there are no rating fees to offset the liability. In addition, there is a concern that NRSROs may not devote adequate resources to produce unsolicited credit ratings if they are not compensated, which could negatively impact credit rating quality.

Another potential concern associated with the Rule 17g-5 Program cited by NRSROs is that arrangers may classify all the information on their websites as confidential. Because this

information may need to be used to explain the rationale for a credit rating in a companion report released with a credit rating, the confidentiality provisions may frustrate the issuance of unsolicited credit ratings to the extent an NRSRO believes that a report should accompany a credit rating. Additionally, an NRSRO may view the information posted on the websites as insufficient to perform a credit rating analysis. As a result, the Rule 17g-5 websites may not always contain all the information a non-hired NRSRO would need to produce a credit rating, given its particular methodologies.

3. Potential Considerations

The Commission – if it determines to enhance the Rule 17g-5 Program – might consider the following actions:

> Modifying the 10% requirement to permit non-hired NRSROs to publish unsolicited commentary in lieu of unsolicited ratings. NRSROs recently have published unsolicited commentary about new structured finance issuances in which they explain why they would not have issued credit ratings at the same levels as the hired NRSROs. This provides investors with alternative credit assessments and could serve as a template for enhancing Rule 17g-5. Unsolicited commentary would be less costly than issuing and maintaining a credit rating. In addition, it would provide the non-hired NRSROs with an opportunity to develop a track record for performing credit analysis that could lead to greater investor acceptance of their credit ratings.
>
> Eliminating the 10% requirement or, alternatively, lessening the requirement by, for example, making it a 5% or 2% requirement.
>
> Providing in the rule that hired and un-hired NRSROs must be treated the same with respect to the terms of any confidentiality agreements required by an arranger.
>
> Evaluating whether it would be appropriate to seek to address concerns expressed by some NRSROs about liability in connection with issuing unsolicited ratings through the establishment of statutory or regulatory safe harbors.
>
> Establishing a hybrid model that combines the Rule 17g-5 Program with elements of the Section 15E(w) System or another model. For example, the Commission could implement a selection or rotation process that assigns the right to issue initial credit ratings to NRSROs that participate in the Rule 17g-5 Program or that requires an issuer that is seeking more than one rating to have at least one rating issued by an NRSRO that is participating in the program. Additional statutory authority may be necessary to implement a hybrid model depending on the form of the model.

C. Other Alternative Compensation Models

In addition to the Section 15E(w) System and the Rule 17g-5 Program, the study outlines four alternative compensation models for NRSROs that were identified in the GAO Report and

proposed at the 2009 Commission roundtable, as well as three other alternative compensation models, and additional suggestions from commenters.

1. Potential Benefits

There are several potential benefits associated with the alternative compensation models. One common potential benefit of many of the alternative models is that they could help to mitigate the conflicts of interest inherent in the issuer-pay model and, as a result, make NRSROs more accountable to the investors using their ratings. For example, several of the alternative compensation models would require users of credit ratings (e.g., investors) to contribute to the compensation of NRSROs. In addition, several of the alternative compensation models would require an entity other than the issuer to determine which NRSROs are hired to rate a given transaction or are compensated for rating the transaction. Similar to the Section 15E(w) System, these measures could mitigate the potential for issuers to exert influence over NRSROs.

A second potential benefit provided by several of the alternative compensation models is that they seek to improve the quality of credit ratings by aligning the interests of NRSROs and investors. For example, one of the alternative compensation models could improve the quality of ratings because investors would own and control an NRSRO and, consequently, that NRSRO may be less likely to respond to pressure from issuers to produce favorable ratings. Because an investor-owned NRSRO could have an interest in assuring the high quality of credit ratings, it could likely have a stronger interest in maintaining controls at the NRSRO to keep the ratings process independent from the issuers seeking the ratings.

Additionally, the alternative compensation models could help to promote competition among the NRSROs and increase market choice for users of credit ratings. For example, several of the alternative compensation models suggest the establishment of a third-party to assign which NRSROs are hired to rate a given transaction. This would provide an opportunity for NRSROs that currently are not hired to rate a large number of transactions to obtain more ratings business, increasing both their market share and their exposure to various issuers and investors. Going forward, these NRSROs may be selected by a greater number of issuers and investors to rate transactions thereby increasing competition among NRSROs. Furthermore, the formation of one or more investor-owned NRSROs as contemplated by one of the models would necessarily increase the number of NRSROs and give investors a greater choice in terms of the credit ratings for structured finance products. It also would create greater diversity among the types of NRSROs that provide ratings for structured finance products. Investors may gain greater confidence in the quality of credit ratings if ratings are available from NRSROs with different ownership and governance structures. This difference in operating models for NRSROs could provide a greater comparison among the credit ratings for structured finance products. For example, investors could compare the ratings produced from traditional NRSROs against those from an investor-owned NRSRO to evaluate whether the ownership structure produces different ratings. In addition, investors could, over time, determine the efficacy of each of the different models by comparing the historical ratings produced by each type of NRSRO.

2. Potential Concerns

There are several potential concerns associated with the alternative compensation models. One concern with some of the alternative compensation models is that the conflicts associated with the issuer-pay model likely could not be eliminated altogether, even if an alternative compensation model is implemented. For example, under some of the alternative compensation models, the issuers of structured finance products could still exert influence over an NRSRO because of the volume of ratings business the issuers bring to the NRSRO. Even if the issuers do not pay fees directly to the NRSRO or control how the fees are paid to the NRSRO, they may still exert influence on the NRSRO. In addition, under one of the alternative compensation models, the distinction between investors and issuers may be blurred or, in some cases, issuers and investors may be the same entity or a group of interconnected entities, potentially exacerbating the issuer-pay conflict of interest.

A second concern associated with the alternative compensation models is that, even if the conflicts associated with the issuer-pay model are substantially mitigated, implementation of the alternative compensation models could create new conflicts of interest. The presumption underlying many of the models is that investors are interested solely in high quality ratings and have no other motivations that would cause them to seek a credit rating that is higher or lower than warranted. However, investors, or groups of investors, may have conflicts of interest of their own that could affect the quality of ratings. For example, if a rating or rating adjustment will impact the value of an investment, the investor could seek to influence an NRSRO to provide or maintain an artificially high rating if the investor owns the rated security or an artificially low rating if the investor has a short position. In other instances, NRSROs could be pressured to issue ratings that favor investors, since the investors would decide which NRSROs would receive fees.

The feasibility of administering some of the alternative compensation models presents a third concern. These difficulties could hinder the effective implementation of several models. For example, payment systems under some models are complex and could be difficult to implement and carry out in practice. It may be difficult to find a third party that is qualified to assign ratings work to NRSROs based on their performance, particularly because there is no universally accepted metric for measuring the accuracy of credit ratings. Such a third party could also be subject to influence and pressure from the NRSROs, which would be in competition for ratings assignments from the third party. As a result, the third party may itself have to be monitored in order to assure it is performing its obligations fairly and objectively. Another issue associated with some models is that an imbalance in the regulatory burdens could affect the competitiveness of the industry. Specifically, implementing one of the models could create a competitive disadvantage for those NRSROs rating structured finance products and also could cause such NRSROs to cease rating structured finance products. This could hinder competition for structured finance products ratings. In addition, NRSROs may feel pressure to meet the performance metrics, or even follow the same practices used by the third party assigning issues to NRSROs, thereby discouraging innovation in the credit ratings process. Similarly, implementation of one model could reduce competitiveness in the industry because of concerns over how many credit rating agencies that model could actually support, potentially leading to consolidation and reduced competition in the industry. Furthermore, the Commission may need authority to implement certain aspects of the alternative compensation models.

Consequently, absent Congressional action, the Commission may not be able to fully and successfully implement a given alternative compensation model.

Adequately compensating NRSROs is a fourth concern associated with the alternative compensation models. Specifically, under some of the models, there is no assurance that NRSROs will be compensated for their work. NRSROs would be required to rate transactions, and then maintain the credit rating through surveillance, without any guarantee of initial payment or additional compensation. This could cause NRSROs to not participate in the alternative compensation models.

3. Potential Considerations

The Commission – if it determines to implement one or more of the other models – might consider the following actions:

> Seeking authority from Congress to establish the selected model by rule, particularly if the model requires the establishment of a third-party entity to participate in the process and the collection of fees from users of credit ratings.

APPENDIX

19 ***SEC. 939D. INITIAL CREDIT RATING ASSIGNMENTS.***

20 *Section 15E of the Securities Exchange Act of 1934*
21 *(15 U.S.C. 78o–7), as amended by this Act, is amended by*
22 *adding at the end the following:*

23 *"(w) INITIAL CREDIT RATING ASSIGNMENTS.—*

24 *"(1) DEFINITIONS.—In this subsection the fol-*
25 *lowing definitions shall apply:*

1 "(A) BOARD.—The term 'Board' means the
2 Credit Rating Agency Board established under
3 paragraph (2).
4 "(B) QUALIFIED NATIONALLY RECOGNIZED
5 STATISTICAL RATING ORGANIZATION.—The term
6 'qualified nationally recognized statistical rating
7 organization', with respect to a category of struc-
8 tured finance products, means a nationally rec-
9 ognized statistical rating organization that the
10 Board determines, under paragraph (3)(B), to be
11 qualified to issue initial credit ratings with re-
12 spect to such category.
13 "(C) REGULATIONS.—
14 "(i) CATEGORY OF STRUCTURED FI-
15 NANCE PRODUCTS.—
16 "(I) IN GENERAL.—The term 'cat-
17 egory of structured finance products'—
18 "(aa) shall include any asset
19 backed security and any struc-
20 tured product based on an asset-
21 backed security; and
22 "(bb) shall be further defined
23 and expanded by the Commission,
24 by rule, as necessary.

1 "(II) CONSIDERATIONS.—*In*
2 *issuing the regulations required under*
3 *subclause (I), the Commission shall*
4 *consider—*
5 *"(aa) the types of issuers*
6 *that issue structured finance prod-*
7 *ucts;*
8 *"(bb) the types of investors*
9 *who purchase structured finance*
10 *products;*
11 *"(cc) the different categories*
12 *of structured finance products ac-*
13 *cording to—*
14 *"(AA) the types of cap-*
15 *ital flow and legal structure*
16 *used;*
17 *"(BB) the types of un-*
18 *derlying products used; and*
19 *"(CC) the types of terms*
20 *used in debt securities;*
21 *"(dd) the different values of*
22 *debt securities; and*
23 *"(ee) the different numbers of*
24 *units of debt securities that are*
25 *issued together.*

1 *"(ii) REASONABLE FEE.—The Board*
2 *shall issue regulations to define the term*
3 *'reasonable fee'.*
4 *"(2) CREDIT RATING AGENCY BOARD.—*
5 *"(A) IN GENERAL.—Not later than 180*
6 *days after the date of enactment of the Restoring*
7 *American Financial Stability Act of 2010, the*
8 *Commission shall—*
9 *"(i) establish the Credit Rating Agency*
10 *Board, which shall be a self-regulatory orga-*
11 *nization;*
12 *"(ii) subject to subparagraph (C), se-*
13 *lect the initial members of the Board; and*
14 *"(iii) establish a schedule to ensure*
15 *that the Board begins assigning qualified*
16 *nationally recognized statistical rating or-*
17 *ganizations to provide initial ratings not*
18 *later than 1 year after the selection of the*
19 *members of the Board.*
20 *"(B) SCHEDULE.—The schedule established*
21 *under subparagraph (A)(iii) shall prescribe*
22 *when—*
23 *"(i) the Board will conduct a study of*
24 *the securitization and ratings process and*

1 *provide recommendations to the Commis-*
2 *sion;*
3 *"(ii) the Commission will issue rules*
4 *and regulations under this section;*
5 *"(iii) the Board may issue rules under*
6 *this subsection; and*
7 *"(iv) the Board will—*
8 *"(I) begin accepting applications*
9 *to select qualified national recognized*
10 *statistical rating organizations; and*
11 *"(II) begin assigning qualified*
12 *national recognized statistical rating*
13 *organizations to provide initial rat-*
14 *ings.*
15 *"(C) MEMBERSHIP.—*
16 *"(i) IN GENERAL.—The Board shall*
17 *initially be composed of an odd number of*
18 *members selected from the industry, with*
19 *the total numerical membership of the*
20 *Board to be determined by the Commission.*
21 *"(ii) SPECIFICATIONS.—Of the mem-*
22 *bers initially selected to serve on the*
23 *Board—*
24 *"(I) not less than a majority of*
25 *the members shall be representatives of*

1 *the investor industry who do not rep-*
2 *resent issuers;*
3 *"(II) not less than 1 member*
4 *should be a representative of the issuer*
5 *industry;*
6 *"(III) not less than 1 member*
7 *should be a representative of the credit*
8 *rating agency industry; and*
9 *"(IV) not less than 1 member*
10 *should be an independent member.*
11 *"(iii) TERMS.—Initial members shall*
12 *be appointed by the Commission for a term*
13 *of 4 years.*
14 *"(iv) NOMINATION AND ELECTION OF*
15 *MEMBERS.—*
16 *"(I) IN GENERAL.—Prior to the*
17 *expiration of the terms of office of the*
18 *initial members, the Commission shall*
19 *establish fair procedures for the nomi-*
20 *nation and election of future members*
21 *of the Board.*
22 *"(II) MODIFICATIONS OF THE*
23 *BOARD.—Prior to the expiration of the*
24 *terms of office of the initial members,*
25 *the Commission—*

1 *"(aa) may increase the size*
2 *of the board to a larger odd num-*
3 *ber and adjust the length of future*
4 *terms; and*
5 *"(bb) shall retain the com-*
6 *position of members described in*
7 *clause (ii).*
8 *"(v) RESPONSIBILITIES OF MEM-*
9 *BERS.—Members shall perform, at a min-*
10 *imum, the duties described in this sub-*
11 *section.*
12 *"(vi) RULEMAKING AUTHORITY.—The*
13 *Commission shall, if it determines necessary*
14 *and appropriate, issue further rules and*
15 *regulations on the composition of the mem-*
16 *bership of the Board and the responsibilities*
17 *of the members.*
18 *"(D) OTHER AUTHORITIES OF THE*
19 *BOARD.—The Board shall have the authority to*
20 *levy fees from qualified nationally recognized*
21 *statistical rating organization applicants, and*
22 *periodically from qualified nationally recognized*
23 *statistical rating organizations as necessary to*
24 *fund expenses of the Board.*

1 "(E) REGULATION.—The Commission has
2 the authority to regulate the activities of the
3 Board, and issue any further regulations of the
4 Board it deems necessary, not in contravention
5 with the intent of this section.

6 "(3) BOARD SELECTION OF QUALIFIED NATION-
7 ALLY RECOGNIZED STATISTICAL RATING ORGANIZA-
8 TION.—

9 "(A) APPLICATION.—

10 "(i) IN GENERAL.—A nationally recog-
11 nized statistical rating organization may
12 submit an application to the Board, in such
13 form and manner as the Board may re-
14 quire, to become a qualified nationally rec-
15 ognized statistical rating organization with
16 respect to a category of structured finance
17 products.

18 "(ii) CONTENTS.—An application sub-
19 mitted under clause (i) shall contain—

20 "(I) information regarding the in-
21 stitutional and technical capacity of
22 the nationally recognized statistical
23 rating organization to issue credit rat-
24 ings;

1 "(II) information on whether the
2 nationally recognized statistical rating
3 organization has been exempted by the
4 Commission from any requirements
5 under any other provision of this sec-
6 tion; and
7 "(III) any additional information
8 the Board may require.
9 "(iii) REJECTION OF APPLICATIONS.—
10 The Board may reject an application sub-
11 mitted under this paragraph if the nation-
12 ally recognized statistical rating organiza-
13 tion has been exempted by the Commission
14 from any requirements under any other
15 provision of this section.
16 "(B) SELECTION.—The Board shall select
17 qualified national recognized statistical rating
18 organizations with respect to each category of
19 structured finance products from among nation-
20 ally recognized statistical rating organizations
21 that submit applications under subparagraph
22 (A).
23 "(C) RETENTION OF STATUS AND OBLIGA-
24 TIONS AFTER SELECTION.—An entity selected as
25 a qualified nationally recognized statistical rat-

1 *ing organization shall retain its status and obli-*
2 *gations under the law as a nationally recognized*
3 *statistical rating organization, and nothing in*
4 *this subsection grants authority to the Commis-*
5 *sion or the Board to exempt qualified nationally*
6 *recognized statistical rating organizations from*
7 *obligations or requirements otherwise imposed by*
8 *Federal law on nationally recognized statistical*
9 *rating organizations.*

10 *"(4) REQUESTING AN INITIAL CREDIT RATING.—*
11 *An issuer that seeks an initial credit rating for a*
12 *structured finance product—*

13 *"(A) may not request an initial credit rat-*
14 *ing from a nationally recognized statistical rat-*
15 *ing organization; and*

16 *"(B) shall submit a request for an initial*
17 *credit rating to the Board, in such form and*
18 *manner as the Board may prescribe.*

19 *"(5) ASSIGNMENT OF RATING DUTIES.—*

20 *"(A) IN GENERAL.—For each request re-*
21 *ceived by the Board under paragraph (4)(B), the*
22 *Board shall select a qualified nationally recog-*
23 *nized statistical rating organization to provide*
24 *the initial credit rating to the issuer.*

25 *"(B) METHOD OF SELECTION.—*

1 *"(i) IN GENERAL.—The Board shall—*

2 *"(I) evaluate a number of selec-*
3 *tion methods, including a lottery or ro-*
4 *tating assignment system, incor-*
5 *porating the factors described in clause*
6 *(ii), to reduce the conflicts of interest*
7 *that exist under the issuer-pays model;*
8 *and*

9 *"(II) prescribe and publish the se-*
10 *lection method to be used under sub-*
11 *paragraph (A).*

12 *"(ii) CONSIDERATION.—In evaluating*
13 *a selection method described in clause (i)(I),*
14 *the Board shall consider—*

15 *"(I) the information submitted by*
16 *the qualified nationally recognized sta-*
17 *tistical rating organization under*
18 *paragraph (3)(A)(ii) regarding the in-*
19 *stitutional and technical capacity of*
20 *the qualified nationally recognized sta-*
21 *tistical rating organization to issue*
22 *credit ratings;*

23 *"(II) evaluations conducted under*
24 *paragraph (7);*

1 *"(III) formal feedback from insti-*
2 *tutional investors; and*
3 *"(IV) information from subclauses*
4 *(I) and (II) to implement a mecha-*
5 *nism which increases or decreases as-*
6 *signments based on past performance.*
7 *"(iii) PROHIBITION.—The Board, in*
8 *choosing a selection method, may not use a*
9 *method that would allow for the solicitation*
10 *or consideration of the preferred national*
11 *recognized statistical rating organizations*
12 *of the issuer.*
13 *"(iv) ADJUSTMENT OF PROCESS.—The*
14 *Board shall issue rules describing the proc-*
15 *ess by which it can modify the assignment*
16 *process described in clause (i).*
17 *"(C) RIGHT OF REFUSAL.—*
18 *"(i) REFUSAL.—A qualified nationally*
19 *recognized statistical rating organization*
20 *selected under subparagraph (A) may refuse*
21 *to accept a selection for a particular request*
22 *by—*
23 *"(I) notifying the Board of such*
24 *refusal; and*

1 *"(II) submitting to the Board a*
2 *written explanation of the refusal.*
3 *"(ii) SELECTION.—Upon receipt of a*
4 *notification under clause (i), the Board*
5 *shall make an additional selection under*
6 *subparagraph (A).*
7 *"(iii) INSPECTION REPORTS.—The*
8 *Board shall annually submit any expla-*
9 *nations of refusals received under clause*
10 *(i)(II) to the Commission, and such explan-*
11 *atory submissions shall be published in the*
12 *annual inspection reports required under*
13 *subsection (p)(3)(C).*
14 *"(6) DISCLAIMER REQUIRED.—Each initial*
15 *credit rating issued under this subsection shall in-*
16 *clude, in writing, the following disclaimer: 'This ini-*
17 *tial rating has not been evaluated, approved, or cer-*
18 *tified by the Government of the United States or by*
19 *a Federal agency.'.*
20 *"(7) EVALUATION OF PERFORMANCE.—*
21 *"(A) IN GENERAL.—The Board shall pre-*
22 *scribe rules by which the Board will evaluate the*
23 *performance of each qualified nationally recog-*
24 *nized statistical rating organization, including*
25 *rules that require, at a minimum, an annual*

1 *evaluation of each qualified nationally recog-*
2 *nized statistical rating organization.*
3 *"(B) CONSIDERATIONS.—The Board, in*
4 *conducting an evaluation under subparagraph*
5 *(A), shall consider—*
6 *"(i) the results of the annual examina-*
7 *tion conducted under subsection (p)(3);*
8 *"(ii) surveillance of credit ratings con-*
9 *ducted by the qualified nationally recog-*
10 *nized statistical rating organization after*
11 *the credit ratings are issued, including—*
12 *"(I) how the rated instruments*
13 *perform;*
14 *"(II) the accuracy of the ratings*
15 *provided by the qualified nationally*
16 *recognized statistical rating organiza-*
17 *tion as compared to the other nation-*
18 *ally recognized statistical rating orga-*
19 *nizations; and*
20 *"(III) the effectiveness of the*
21 *methodologies used by the qualified na-*
22 *tionally recognized statistical rating*
23 *organization; and*
24 *"(iii) any additional factors the Board*
25 *determines to be relevant.*

1 *"(C) REQUEST FOR REEVALUATION.—Sub-*
2 *ject to rules prescribed by the Board, and not less*
3 *frequently than once a year, a qualified nation-*
4 *ally recognized statistical rating organization*
5 *may request that the Board conduct an evalua-*
6 *tion under this paragraph.*
7 *"(D) DISCLOSURE.—The Board shall make*
8 *the evaluations conducted under this paragraph*
9 *available to Congress.*
10 *"(8) RATING FEES CHARGED TO ISSUERS.—*
11 *"(A) LIMITED TO REASONABLE FEES.—A*
12 *qualified nationally recognized statistical rating*
13 *organization shall charge an issuer a reasonable*
14 *fee, as determined by the Commission, for an*
15 *initial credit rating provided under this section.*
16 *"(B) FEES.—Fees may be determined by*
17 *the qualified national recognized statistical rat-*
18 *ing organizations unless the Board determines it*
19 *is necessary to issue rules on fees.*
20 *"(9) NO PROHIBITION ON ADDITIONAL RAT-*
21 *INGS.—Nothing in this section shall prohibit an*
22 *issuer from requesting or receiving additional credit*
23 *ratings with respect to a debt security, if the initial*
24 *credit rating is provided in accordance with this sec-*
25 *tion.*

1 "(10) NO PROHIBITION ON INDEPENDENT RAT-
2 INGS OFFERED BY NATIONALLY RECOGNIZED STATIS-
3 TICAL RATING ORGANIZATIONS.—
4 "(A) IN GENERAL.—Nothing in this section
5 shall prohibit a nationally recognized statistical
6 rating organization from independently pro-
7 viding a credit rating with respect to a debt se-
8 curity, if—
9 "(i) the nationally recognized statis-
10 tical rating organization does not enter into
11 a contract with the issuer of the debt secu-
12 rity to provide the initial credit rating; and
13 "(ii) the nationally recognized statis-
14 tical rating organization is not paid by the
15 issuer of the debt security to provide the ini-
16 tial credit rating.
17 "(B) RULE OF CONSTRUCTION.—For pur-
18 poses of this section, a credit rating described in
19 subparagraph (A) may not be construed to be an
20 initial credit rating.
21 "(11) PUBLIC COMMUNICATIONS.—Any commu-
22 nications made with the public by an issuer with re-
23 spect to the credit rating of a debt security shall
24 clearly specify whether the credit rating was made
25 by—

1 *"(A) a qualified nationally recognized sta-*
2 *tistical rating organization selected under para-*
3 *graph (5)(A) to provide the initial credit rating*
4 *for such debt security; or*
5 *"(B) a nationally recognized statistical rat-*
6 *ing organization not selected under paragraph*
7 *(5)(A).*
8 *"(12) PROHIBITION ON MISREPRESENTATION.—*
9 *With respect to a debt security, it shall be unlawful*
10 *for any person to misrepresent any subsequent credit*
11 *rating provided for such debt security as an initial*
12 *credit rating provided for such debt security by a*
13 *qualified nationally recognized statistical rating orga-*
14 *nization selected under paragraph (5)(A).*
15 *"(13) INITIAL CREDIT RATING REVISION AFTER*
16 *MATERIAL CHANGE IN CIRCUMSTANCE.—If the Board*
17 *determines that it is necessary or appropriate in the*
18 *public interest or for the protection of investors, the*
19 *Board may issue regulations requiring that an issuer*
20 *that has received an initial credit rating under this*
21 *subsection request a revised initial credit rating,*
22 *using the same method as provided under paragraph*
23 *(4), each time the issuer experiences a material*
24 *change in circumstances, as defined by the Board.*
25 *"(14) CONFLICTS.—*

1 *"(A) MEMBERS OR EMPLOYEES OF THE*
2 *BOARD.—*
3 *"(i) LOAN OF MONEY OR SECURITIES*
4 *PROHIBITED.—*
5 *"(I) IN GENERAL.—A member or*
6 *employee of the Board shall not accept*
7 *any loan of money or securities, or*
8 *anything above nominal value, from*
9 *any nationally recognized statistical*
10 *rating organization, issuer, or investor.*
11 *"(II) EXCEPTION.—The prohibi-*
12 *tion in subclause (I) does not apply to*
13 *a loan made in the context of disclosed,*
14 *routine banking and brokerage agree-*
15 *ments, or a loan that is clearly moti-*
16 *vated by a personal or family relation-*
17 *ship.*
18 *"(ii) EMPLOYMENT NEGOTIATIONS*
19 *PROHIBITION.—A member or employee of*
20 *the Board shall not engage in employment*
21 *negotiations with any nationally recognized*
22 *statistical rating organization, issuer, or in-*
23 *vestor, unless the member or employee—*

1 *"(I) discloses the negotiations im-*
2 *mediately upon initiation of the nego-*
3 *tiations; and*
4 *"(II) recuses himself from all pro-*
5 *ceedings concerning the entity involved*
6 *in the negotiations until termination*
7 *of negotiations or until termination of*
8 *his employment by the Board, if an*
9 *offer of employment is accepted.*
10 *"(B) CREDIT ANALYSTS.—*
11 *"(i) IN GENERAL.—A credit analyst of*
12 *a qualified nationally recognized statistical*
13 *rating organization shall not accept any*
14 *loan of money or securities, or anything*
15 *above nominal value, from any issuer or in-*
16 *vestor.*
17 *"(ii) EXCEPTION.—The prohibition de-*
18 *scribed in clause (i) does not apply to a*
19 *loan made in the context of disclosed, rou-*
20 *tine banking and brokerage agreements, or*
21 *a loan that is clearly motivated by a per-*
22 *sonal or family relationship.*
23 *"(15) EVALUATION OF CREDIT RATING AGENCY*
24 *BOARD.—Not later than 5 years after the date that*
25 *the Board begins assigning qualified nationally recog-*

1 *nized statistical rating organizations to provide ini-*
2 *tial ratings, the Commission shall submit to Congress*
3 *a report that provides recommendations of—*
4 *"(A) the continuation of the Board;*
5 *"(B) any modification to the procedures of*
6 *the Board; and*
7 *"(C) modifications to the provisions in this*
8 *subsection.".*