September 12, 2011

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

Re: *Study on Assigned Credit Ratings,* File No. 4-629

Dear Ms. Murphy,

AFSCME submits this letter in response to the Commission's request for comment in Release No. 34-64456 (the "Release") regarding the study on assigned credit ratings for structured finance products mandated (the "Study") by section 939F of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). The American Federation of State, County and Municipal Employees ("AFSCME"), is the largest union in the AFL-CIO representing 1.6 million state and local government, health care and child care workers. AFSCME members participate in over 150 public pension systems whose assets total over $1 trillion. In addition, the AFSCME Employees Pension Plan (the "Plan") is a long-term shareholder that manages $850 million in assets for its participants, who are staff of AFSCME and its affiliates.

Last month, AFSCME commented on the Commission's Release No. 34-64515, "Proposed Rules for Nationally Recognized Statistical Rating Organizations" (the "Proposed Reforms"). There, we noted the abundant evidence that pervasive conflicts of interest had corrupted the methodologies and decisions of the nationally recognized statistical ratings organizations ("NRSROs") regarding structured finance products and thereby contributed significantly to the housing bubble and financial crisis. Recognizing that changes to the issuer-pay business model were not on the Commission's near-term regulatory agenda, we urged the Commission to bolster the provisions of the Proposed Reforms relating to conflicts of interest. We believe, however, that it may not be possible to manage effectively the conflicts inherent in this model, which are manifested not only in direct pressure on ratings personnel but also in more subtle ways that resist regulation.

Accordingly, it is vitally important that the Commission explore alternative business models, including a system in which a utility or self-regulatory organization assigns NRSROs to determine credit ratings for

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structured finance products (referred to herein as the "15E(w) System"). The Study is the first step in that process.

We urge the Commission not to be overly influenced by concerns regarding competition among NRSROs. The Commission has asked that commenters, in responding to the topics and questions in the Release, address "the likely impact the proposals would have on the concentration of issuance of credit ratings for structured finance products among NRSROs." The Release notes that approximately 94% of the outstanding credit ratings for structured finance products were determined by the three largest NRSROs. (Release, at 7)

In debates such as this one, it is often assumed that more competition among firms leads to higher quality output. But that only works if firms are competing on the basis of quality. Empirical evidence suggests this may not be the case when it comes to issuer-pay credit ratings. A 2010 study found that the growth in market share enjoyed by Fitch Ratings, 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.[1] The authors concluded that increased competition among ratings agencies "likely weakens reputational incentives for providing quality in the ratings industry, and thereby undermines quality."[2] Accordingly, we believe 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.

The Release seeks comment on the potential conflicts of interest in the issuer-pay model in rating structured finance products. Characterizing these conflicts and their impacts as "potential" (see, e.g., Release at 10-11) implies that they have not actually distorted the ratings process. Nothing could be further from the truth, however. Numerous investigations, hearings and studies have produced substantial evidence regarding both the conflicts of interest in the issuer-pay model and the impact of those conflicts on the ratings of structured finance products. Highlights, which we discussed in more detail in our comment on the Proposed Reforms, include the following:

- The Report of the U.S. Senate Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, "Wall Street and the Financial Crisis: Anatomy of a Financial Collapse," which found that NRSRO conflicts of interest arising from the issuer-pay model were a "significant cause" of inaccurate credit ratings, which in turn were a "key cause" of the financial crisis.
- Testimony of former NRSRO managers with responsibility for rating structured finance products, such as former Moody's Managing Director Eric Kolchinsky,

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[1] Bo Becker and Todd Milbourn, "How Did Increased Competition Affect Credit Ratings" (Harvard Business School working paper 2010).
[2] Id. at 9.

who described the negative effects of intense pressures to build market share and satisfy the demands of issuers and sponsors on ratings methodologies and decisions.

- Academic studies finding widespread deviations by NRSROs from their own models when rating certain structured finance products; relatively inflated ratings for mortgage-backed securities sold by larger underwriters (as defined by annual market share); and declines in credit quality correlating with the period in which revenue opportunities from rating structured finance products were highest, blunting reputational risks from issuing poor quality ratings.

The Commission also seeks comment on the conflicts of interest arising from a subscriber-pay system. In our view, a subscriber-pay model is not free from conflicts. Investors may not want to see a downgrade in the rating of a security they already hold, for example, and thus might not wish to pay for robust ratings surveillance. Moreover, ratings in a subscriber-pay system are not generally available to the public. To the extent ratings are communicated to non-paying investors, an NRSRO using a subscriber-pay model is not compensated fully for the value it creates. That fact may make it difficult for firms to thrive under a subscriber-pay model. (Indeed, many commentators have attributed the switch from a subscriber-pay to issuer-pay model in the 1970s to costs from free riding. (See Joseph Grundfest & Evgeniya Hochenberg, "Investor Owned and Controlled Rating Agencies: A Summary Introduction," at 4 (working paper 2009) (available at www.ssrn.com); John C. Coffee, Jr., "Ratings Reform: the Good, the Bad and the Ugly," Harvard Business Law Review, Vol. 1, pp. 231-278, at 255 (2011))

On balance, we favor a system that would separate issuer payment for ratings on structured finance products from issuer selection of an NRSRO. By eliminating ratings shopping, such a system would ease the market share pressures that led NRSROs to yield to issuer demands. In our view, an approach in which the neutral party assigning a rating is a government agency or its representatives has the benefits of simplicity and independence. We are concerned that an approach requiring investor cooperation, such as the investor-owned NRSRO model, may not be realistic given the competition among many institutional investors and the apparent reluctance of many investors to pay for research services.

We believe that it is possible to design a 15E(w) System in a way that would provide economic incentives for NRSROs to produce high quality ratings. Membership in the pool of NRSROs eligible to receive an assignment would depend on maintaining a minimum ratings quality, with ratings quality defined using input from investors and other users of ratings. NRSROs that produce the highest quality ratings could be eligible for a larger number of assignments, thus fostering competition on ratings quality rather than accommodation of issuers, as is currently the case. (Of course, other factors, such as an NRSRO's expertise and resources, should also affect the volume of assignments.)

Finally, in our experience, it is often much easier to quantify the costs of a new regulatory scheme than the benefits. We have no doubt that NRSROs and others with an interest in perpetuating the current system will set forth in great detail the costs and difficulties of transitioning to a new model for rating structured finance products. The benefits, though less easily toted up, are potentially enormous. The utter failure of the NRSROs to rate structured finance products accurately was a key factor in promoting a massive misallocation of capital in the U.S. markets, whose consequences were and continue to be disastrous for the economy as well as many of AFSCME's members, plan participants and plan sponsors. Meaningful credit rating agency reform will significantly reduce the likelihood that these events will recur, a substantial benefit to all participants in the capital markets.

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We appreciate the opportunity to share our views with the Commission on these important issues. If you have any questions, or need additional information, please do not hesitate to contact Lisa Lindsley at (202) 429-1275.

Sincerely,

Gerald W McEntee

GERALD W. McENTEE
INTERNATIONAL PRESIDENT