THE FINANCIAL SERVICES ROUNDTABLE

Financing America's Economy

VIA http://www.sec.gov/rules.shtml

September 13, 2011

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

Re: Study on Assigned Credit Ratings, Securities Exchange Act Release No. 64456 [File No. 4-629] (May 10, 2011) (the "Release")

Dear Ms. Murphy:

The Financial Services Roundtable (the "Roundtable") respectfully submits these comments in response to the Securities and Exchange Commission's (the "Commission") request for comment to assist it in conducting a study on the feasibility of establishing a system in which a public or private utility or a self-regulatory organization assigns credit rating agencies to determine the credit ratings for structured finance products under section 939F of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[1]

The Roundtable represents 100 of the largest integrated financial services companies providing banking, insurance, and investment products and services to the American consumer. Among the Roundtable's Core Values are *fairness* ("We will engage in practices that provide a benefit and promote fairness to our customers, employees or other partners."); *integrity* ("[E]verything we do [as an industry] is built on trust. That trust is earned and renewed based on every customer relationship."); *respect* ("We will treat the people on whom our businesses depend with the respect they deserve in each and every interaction."); and *community involvement* ("We will make a positive contribution to our

[1] Subtitle C, *Improvements to the Regulation of Credit Rating Agencies*, Pub. Law No. 111-203, § 931-939H, 124 Stat. 1872-90 (July 21, 2010).

communities as individuals and through our companies.").[2] Member companies participate through the Chief Executive Officer and other senior executives nominated by the CEO. Roundtable member companies provide fuel for America's economic engine, accounting directly for $92.7 trillion in managed assets, $1.2 trillion in revenue, and 2.3 million jobs.

Executive Summary

Section 939F(c) of the Dodd-Frank Act directs the Commission to study the credit rating process for structured finance products and the conflicts of interest associated with the issuer-pays and subscriber-pays models; and the feasibility of establishing a public or private utility or a self-regulatory organization to assign nationally recognized statistical rating organizations to rate specific structured finance products.[3]

After the Commission submits its section 939F(c) report, the Commission is directed to establish a system as it determines is necessary or appropriate in the public interest or for the protection of investors to (a) assign credit rating agencies to determine the initial credit rating on particular structured finance products in a manner that prevents an issuer, sponsor, or underwriter from selecting the credit rating agency, and (b) monitor the ratings assigned by credit rating agencies.[4] In establishing this new initial credit rating and monitoring system, the Commission also is required to consider and implement the "Section 15E(w) System," unless the Commission determines that an alternative initial credit rating and monitoring system would better serve the public interest and the protection of investors.

With the exception of the "subscriber-pays" and "issuer-pays" models, none of the other rating agency compensation models identified in the Release have been used historically by the market. Each compensation model has unavoidable conflicts of interest. Our members believe that rather than impose a costly, imperfect, and untested system for determining initial credit ratings and monitoring ratings assigned to structured finance products (*e.g.*, the "Section 15E(w) System"), the Commission should instead use its authority to establish a system embodied in existing rules that would allow market participants—rather than governmental or quasi-governmental entities or officials—to determine whether credit ratings are desirable or necessary for specific structured finance products. Moreover, having rating assignment decisions made by persons who are

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[2] *See Roundtable Statement of Core Values, available at* http://www.fsround.org/.

[3] Section 939F(c) of the Dodd-Frank Act, Pub. L. No. 111-203, § 939F(c), 124 Stat. 1889 (2010).

[4] Section 939F(d) of the Dodd-Frank Act, Pub. L. No. 111-203, § 939F(d), 124 Stat. 1889 (2010).

not involved as a "buyer" or "seller" in the particular transaction (as would be the case with governmental or quasi-governmental officials) is fundamentally flawed.

An important consideration is that issuers do <u>not</u> choose the rating agencies that they hire—rather, issuers engage those credit rating agencies that investors require as a condition to buying the securities. Investors do not believe credit ratings are fungible. The methodologies, skills, capabilities, and talents of each rating agency influence the development of the credit rating for particular transactions. Thus, issuers are particularly sensitive to the fact that there is a very limited subset of rating agencies that are acceptable to investors that participate in the structured finance markets.

Therefore, the Roundtable encourages the Commission to implement regulatory policies that allow market participants to exercise their prerogative to determine which rating agency's opinion(s) on credit-worthiness are most relevant for their evaluation of the specific transaction. In a process where inherent conflicts of interest are unavoidable, we believe that proper disclosure and market participant choice—coupled with enhanced internal controls and better conflict management for rating agencies (as contemplated by current regulatory proposals)—offer a better solution than the impossible task of trying to extract all conflicts of interest out of the marketplace. We believe these steps are not only sound public policy, but they serve the public interest and further the protection of investors.

In summary, the Roundtable's comments are:

- The "Section 15E(w) System" would not eliminate conflicts of interest and could instead result in greater potential conflicts of interest and distortions in credit ratings than are present under the "issuer-pays" model.

- The "Section 15E(w) System" would not be an effective regulatory or policy response to credit agencies' potential conflicts of interest in rating structured finance products.

- Under the "Section 15E(w) System," potential conflicts would <u>not</u> be eliminated—just shifted to governmental or quasi-governmental authorities.

- The "Section 15E(w) System" would embed moral hazards in the rating of structured finance products.

- The "Section 15E(w) System" would impose a further tax on U.S. capital formation.

- The "Section 15E(w) System" also would subject issuers to an arbitrary process where issuers lack any means of assuring either the quality of the designated rating agency's performance or the acceptability of the rating by potential investors. Moreover, the exercise of any right to appeal to a governmental or quasi-governmental entity would likely result in the issuer's inability to finance its capital requirements in a timely manner.

- The Commission would be taking a step back from recent initiatives to reduce inordinate reliance on credit ratings if it adopted the "Section 15E(w) System."

- Rule 17g-5 under the Securities Exchange Act of 1934 offers investors a superior means to address potential conflicts of interest inherent in the "issuer-pays" ratings agency business model.

- Rule 17g-5 provides market participants with the tools to protect themselves from the risks of potential conflicts of interest in the ratings of structured finance products.

- Further enhancements to rule 17g-5 would be a better alternative to wholesale replacement of existing rules with a flawed system.

- None of the other alternatives presented by the Commission would offer practical or effective solutions to the risks of potential conflicts engendered by the issuer-pays model.

I. Introduction

The Roundtable welcomes this opportunity to present its views on alternatives for assigning credit rating agencies to rate structured finance products.[5] Our members use credit ratings in their capacities as institutional investors, portfolio fund managers, investment advisers, insurance companies, financial institutions, originators of assets that are securitized, and securitization sponsors.[6]

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[5] *See* Section 939F(a) of the Dodd-Frank Act, Pub. L. No. 111-203, § 939F(a), 124 Stat. 1889 (2010) (defining "structured finance products" as asset-backed securities).

[6] In today's credit-backed securities market, the Roundtable believes the credit agencies' role should be that of an "*independent, third-party, risk information intermediary*." *See*, Russell Walker, *Role of Credit Rating Agencies as Risk Information Brokers*: Study Prepared for the Anthony T. Cluff Fund, THE FINANCIAL SERVICES ROUNDTABLE at 1 (Sept. 10, 2010). The risk information intermediary business model would be similar to that employed by the consumer credit bureau, which sells "risk data and risk scores" to lenders for use in a consumer lending transaction. *Id*. at 2. As a risk information intermediary, the credit rating agency in the structured finance market would provide the underlying risk

Beginning in the early part of the Twentieth Century, credit rating agencies began to provide assessments of credit-worthiness of railroad and corporate bonds.[7] Those assessments of credit-worthiness were expressed as "credit ratings."[8] Eventually, rating agencies expanded their services to provide credit ratings on residential mortgage-backed securities, commercial mortgage-backed securities, credit card receivables, auto loan receivables, and other asset-backed securities transactions (collectively, "ABS transactions").

For the first 60 years, the rating agencies used a "subscriber-pays" business model and delivered their ratings reports to investors, either as paid subscriptions or on a per-report basis.[9] By the early 1970s, the major rating agencies had converted to an "issuer-pays" business model.

We commend the Commission for its recent accomplishments in regulating credit rating agencies. The Commission adopted rules 17g-2, 17g-5, and 17g-6[10] under the Credit Rating Agency Reform Act of 2006,[11] which we believe have improved the regulatory oversight of credit rating agencies, and the transparency of ratings determinations.

For example, registered credit rating agencies are required to maintain records on ratings actions, and to disclose publicly certain ratings' performance measurement statistics.[12] Rating agencies also are required to disclose and manage conflicts of interest in accordance with written policies and procedures.[13] Ratings agencies are prohibited from engaging in certain "unfair, coercive, or abusive practices" associated with its ratings' business, including tying ratings to an issuer's obligation to purchase other services or products from the rating agency; or issuing or modifying ratings in a manner that is inconsistent with the rating agencies' "established procedures and methodologies."[14] We further note

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data, thereby "allow[ing] investors and third parties, including regulators, to consider specific economic stress-tests, access data to confirm risk reviews, and answer questions about credit-backed securities." *Id*.

[7] *See* Lawrence J. White, *The Credit Rating Agencies*, 24 JOURNAL OF ECONOMIC PERSPECTIVES 211 (2010).

[8] *Id*. at 213 (observing that ratings were expressed as letter grades, such as "AAA" for Standard & Poor's highest category of investment grade securities).

[9] *See*, Walker, *supra* note 6 at 14; *See*, White, *supra* note 7 at 211, 213 (noting that prior to the Commission's requirement that "corporations . . . issue standardized financial statements[,]" Moody's, [Standard & Poor's], and Fitch sold their credit ratings directly to investors).

[10] Rules 17g-2, 17g-5, and 17g-6 under the Securities Exchange Act of 1934 [17 C.F.R. §§ 240.17g-2, 240.17g-5, and 240.17g-6 (2011)].

[11] Pub. Law No. 109-291, 120 Stat. 1327 (Sept. 29, 2006).

[12] *See*, Rule 17g-2(a)(8) [17 C.F.R. §240.17g-2(a)(8) (2011)]; Form NRSRO [17 C.F.R. §249b.300 (2011)], Item 7B—Public Ratings and Ratings Actions and Exhibit 1—Credit Ratings Performance Measurement Statistics.

[13] Rule 17g-5(a)(2) [17 C.F.R. §240.17g-5(a)(2)(2011)].

[14] Rule 17g-6(a) [17 C.F.R. §240.17g-6(a) (2011)].

that credit rating agencies also have been active in addressing their business conduct standards (including management of potential conflicts of interest).[15]

In addition, the Dodd-Frank Act builds on the rating agency reforms initiated by the Credit Rating Agency Reform Act.[16] These reforms not only enhance regulation of, and transparency by, rating agencies, they strengthen the efficacy of the Commission's oversight role. The proposed rules generally would address (1) the rating agency's internal controls over the credit rating process; (2) transparency of ratings performance; (3) procedures for adopting and revising credit ratings; (4) procedures for conducting reviews of any credit rating that may have been influenced by any employee who formerly was associated with issuer, underwriter, or other transaction party during the one-year period prior to assignment of the rating (the "look-back review"); and (5) training, experience, and competence standards applicable to credit rating analysts.[17]

Given the significance of its expected adverse impact on market participants and capital formation, we begin the discussion with our views on the "Section 15E(w) System" in Section II.A. We also comment on the likely impact of what we believe are certain key definitions (*e.g.*, the meaning of the term "accurate credit rating") in Section II.B. In Section III, we comment on existing rule 17g-5[18] under the Securities Exchange Act of 1934,[19] which we believe addresses the risks associated with potential conflicts of interest in the issuer-pays model, with suggested enhancements that could improve the effectiveness of rule 17g-5. Finally, the Roundtable concludes this letter with our views on the remaining alternative rating agency compensation structures the Commission presented in the Release.

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15 *See, e.g.*, MOODY'S INVESTORS SERVICE, *Code of Professional Conduct* (June 2011); STANDARD AND POOR'S, *Ratings Policies and Code of Conduct* (2011).

16 *See*, *supra* note 1.

17 SEC. & EXCH. COMM'N, *Proposed Rules for Nationally Recognized Statistical Rating Organizations*, Exchange Act Release No. 64514, 76 FR 33420 (June 8, 2011).

18 Rule 17g-5 under the Exchange Act [17 C.F.R. § 240.17g-5 (2011)].

19 15 U.S.C. § 78a *et seq.* (2010).

II. The "Section 15E(w) System" would not eliminate conflicts of interest and could instead result in greater potential conflicts of interest and distortions in credit ratings than are present under the "issuer-pays" model.

A. The "Section 15E(w)[20] System"[21] would not be an effective regulatory or policy response to credit agencies' potential conflicts of interest in ABS transactions.

Although the potential for conflicts of interest are inherent in the issuer's selection of one or more credit rating agencies to rate ABS transactions, the Roundtable is not convinced that the "Section 15E(w) System" (the "credit rating assignment system") is the solution—or even an improvement. *It merely replaces one set of potential conflicts with another*. The credit rating assignment system also would be unsound public policy because it would distort the securitization markets.

i. Potential conflicts would not be eliminated—just shifted to governmental or quasi-governmental authorities.

Considering the well-documented recent "failings" of credit rating agencies in the rating of collateralized debt obligations and sub-prime securitizations generally,[22] it is unclear why the U.S. Government—acting by or through the Commission or any quasi-governmental entity or board—would risk entanglements in private contracts between issuers, credit ratings agencies, and investors. Indeed, the U.S. Government risks replacing one type of potential conflicting interest with another: the inevitable political pressure on rating agencies due to the direct impact of ratings on the cost of capital for both governments and their taxpayers.

[20] *See* Section 939F(d)(1) of the Dodd-Frank Act, Pub. L. No. 111-203, § 939F(d)(1), 124 Stat. 1889-90 (2010).

[21] *See* Release, "Section II.B."

[22] *See*, "Subtitle C—Improvements to the Regulation of Credit Rating Agencies," Pub. L. No. 111-203, § 931(5), 124 Stat. 1872 (July 21, 2010); THE FINANCIAL CRISIS INQUIRY COMM'N, *The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States* at 126 (Jan. 2011) ("Moody's . . . relied on flawed and outdated models to issue erroneous ratings on mortgage-related securities, failed to perform meaningful due diligence on the assets underlying the securities, and continued to rely on those models even after it became obvious that the models were wrong."). Criticism of credit rating agencies was not limited to their performance with structured finance products. Credit rating agencies were faulted for their failures to warn investors prior to the collapse of Lehman in 2008, WorldCom in 2002, and Enron in 2001. *See*, White, *supra* note 7 at 218 (noting the "tardiness" of rating agencies to change their investment-grade ratings on these companies).

The potential impact of this approach could affect the rating of structured finance products issued or guaranteed by municipal or governmental issuers (including private activity bonds). For example, if a politician's voters are in a state or municipality on which "Rating Agency X" has a negative view, any appointee influenced by that politician would have an incentive to avoid any rating by "Rating Agency X" because a negative rating would impact adversely the cost to borrow for that politician's constituents. Similarly, if the politician represents voters for whom credit cards, automobiles, or farm equipment are an important sector of the local economy, the politician would have an incentive to pressure selection committee members to avoid any rating agency that holds a negative view of the credit card, automobile, or farm equipment industry, because a negative rating would impact adversely the cost to borrow for his constituents. Furthermore, any member of a rating agency selection committee that would have enough expertise and insight into the ratings process to contribute to the credit rating agency selection process in a meaningful way would most likely be deemed to have a conflict of interest—either because the member is currently or formerly was affiliated with the financial services industry.

Thus, while private-sector issuers have incentives to maximize proceeds *via* better ratings, politicians have incentives to lower the cost to borrow for their constituents, which is directly enhanced by better ratings.

ii. Moral hazards would become embedded in ABS transactions.

Although the Commission has taken steps to eliminate references to credit ratings in its rules and regulations,[23] as required by section 939A of the Dodd-Frank Act,[24] the role of the governmental entity or quasi-governmental entity in the Section 15E(w) System would undermine that goal. The Section 15E(w) System would for the first time in our nation's history intertwine the U.S. Government—acting by and through the Commission—in the credit ratings' determinations for ABS transactions at all stages of the process. Section 939F(b)(2)(c) of the Dodd-Frank Act[25] requires that the Commission's study of the credit ratings assignment system also consider the extent to which the system's creation "would be viewed as the creation of moral hazard by the Federal Government."

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[23] *See*, SEC. & EXCH. COMM'N, *Security Ratings*, Securities Act Release No. 9245, 76 FR 46603 (Aug. 3, 2011) (Final Rule); SEC. & EXCH. COMM'N, *Removal of Certain References to Credit Ratings under the Securities Exchange Act of 1934*, Exchange Act Release No. 64352, 76 FR 26550 (May 6, 2011) (Proposing Release); SEC. & EXCH. COMM'N, *References to Credit Ratings in Certain Investment Company Act Rules and Forms*, Securities Act Release No. 9193, 76 FR 12896 (Mar. 9, 2011) (Proposing Release).

[24] Pub. Law No. 111-203, § 939A, 124 Stat. 1887 (July 21, 2010).

[25] Pub. Law No. 111-203, § 939F(b)(2)(c), 124 Stat. 1889 (July 21, 2010).

It is clear that the very design of the Section 15E(w) System would create a moral hazard. For example, the Commission ultimately bears responsibility for every aspect of that the Section 15E(w) System through the Commission's power to establish and regulate any "public or private utility" or "self-regulatory agency" that assigns rating agencies and monitors their ratings of ABS transactions.

We believe that market participants (including sovereign wealth funds) are likely to view the power of the *public or private utility* or *self-regulatory organization* to assign particular rating agencies to rate specific ABS transactions as the U.S. sovereign's *imprimatur* of the credit ratings assigned to those ABS transactions. This propensity of market participants raises a concern about the moral hazards of governmental regulation envisioned by the credit rating assignment system. If one considers the level of involvement with the Federal Mortgage Association and the Federal Home Loan Mortgage Corporation, there is a substantial risk that investors and market participants will believe that the governmental or quasi-governmental entity makes qualitative judgments on credit ratings notwithstanding disclaimers to the contrary. The Roundtable believes the implied, government-endorsed credit ratings on ABS transactions ultimately would encourage over-reliance by market participants on credit ratings. We also are concerned that the process for monitoring the "accuracy" of credit ratings assigned to ABS transactions would devolve into a one-size-fits-all "U.S. government-approved" model to which all credit ratings would be required to conform.[26]

iii. The Section 15E(w) System would impose a further tax on U.S. capital formation.

The imposition of a statutorily authorized governmental or quasi-governmental entity to regulate both the designation of initial credit ratings on ABS transactions, and monitor ratings assigned to ABS transactions would require substantial resources to implement properly. For example, the regulatory entity would need to attract and retain competent staff (including those with expertise in ratings analyses and methodologies), build and maintain adequate systems, and monitor *in real-time* the credit ratings on hundreds of thousands of securities.

Credit ratings agencies expend substantial amounts on their initial review and on-going review of ABS transactions. Under the current issuer-pays model, these costs may be paid by issuers, but in all instances are effectively passed through to consumers in their costs to finance homes, automobiles, education, *etc*. Any governmental or quasi-governmental entity charged with monitoring the accuracy of credit ratings of ABS transactions would need to expend resources

26 *See*, Section II.B., *infra*.

comparable to the resources credit rating agencies currently dedicate to this process.

These costs are not insubstantial, and ultimately will be borne by consumers.[27] Upon completion of economic analyses[28] of the Section 15E(w) System, we believe the Commission will find that the substantial costs of the Section 15E(w) System do not provide any benefit to consumers and market participants of replacing the current processes with one that would not guarantee "more accurate" credit ratings or foster materially fewer conflicts of interest in the ratings' assignment and monitoring processes.

Rather than look for novel regulatory burdens to impose on U.S. markets and market participants,[29] Congress and financial regulators should draw substantial comfort from the fact that market participants <u>already</u> have the basis for a cost-effective way to address potential conflicts associated with the issuer-pays model: rule 17g-5 under the Securities Exchange Act of 1934, and instead look to support this system.

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27 Our estimates for the costs to monitor ratings accuracy are based on approximate rating agency fees to monitor the deals themselves. Assuming the average asset backed securitization costs $200,000 per deal, the average commercial mortgage backed securitization costs $700,000 per deal and the average residential mortgage backed securitization costs $175,000 per deal, if one assumes the average volumes of securitization transactions seen during the first decade of this century, the cost for a governmental or quasi-governmental entity to monitor "ratings accuracy" could easily be anywhere from approximately $250,000,000 to $500,000,000 per annum.

28 When the Commission is engaged in any rulemaking that requires it "to consider or determine whether an action is necessary or appropriate in the public interest" or for the protection of investors, the Commission also must consider "whether the action will promote efficiency, competition, and capital formation." *See*, section 3(f) of the Exchange Act [15 U.S.C. § 78c(f) (2010)].

29 In considering the impact on competition, the Commission must make a determination that any "burden on competition" is "necessary or appropriate." *See*, section 23(a)(2) of the Exchange Act [15 U.S.C. § 78w(a)(2)(2010)] (prohibiting the Commission from adopting any rule or regulation that "would impose a burden on competition not necessary or appropriate in furtherance of the purposes of [the Exchange Act]"). The Commission also must determine the impact of its regulations on small entities. *See* Regulatory Flexibility Analyses, 5 U.S.C. §§ 603-04 (2010). Finally, the Office of Management and Budget must determine if any proposed rule or regulation would constitute a "major rule" within the meaning of the Small Business Regulatory Enforcement Fairness Act of 1996, Pub. Law. No. 104-121, Title II, 110 Stat. 857 (Mar. 29, 1996). Generally, a major rule is one that results in (1) an annual effect of at least $100 million on the economy; or (2) a major increase in costs or prices for consumers, individual industries, governmental agencies, or geographic regions; or (3) significant adverse effects on competition, employment, productivity, or innovation. Pub. Law No. 104-121, § 804(2), 110 Stat. 873 (Mar. 29, 1996). Major rules are subject to Congressional over-ride within sixty (60) days of adoption. Pub. Law No. 104-121, § 801 *et seq.*, 110 Stat. 868 (Mar. 29, 1996).

iv. *The Section 15E(w) System also would subject issuers to an arbitrary process where issuers lack any means of assuring either the quality of the designated rating agency's performance or the acceptability of the rating by potential investors. Moreover, the exercise of any right to appeal to a governmental or quasi-governmental entity would likely result in the issuer's inability to finance its capital requirements in a timely manner*.

The appointment of a credit rating agency is only one part of the equation; the issuer and the government-appointed rating agency still would have to agree to contractual terms for the provision of ratings services. While the Section 15E(w) System would compel an issuer to use the government-appointed rating agency, the issuer and rating agency would still need to negotiate the terms and conditions of the rating agency's engagement. Under this system, what leverage would an issuer have to insist that the government-appointed rating agency accept on fair and reasonable contractual terms? Or, to state it another way, would the government-appointed rating agency see any need to concede terms or conditions that weigh heavily in its favor? Would the rating agency <u>ever</u> have an incentive to provide any level of customer service or extend any courtesy to issuers?

Will the governmental or quasi-governmental entity force the issuer to accept an engagement agreement that includes indemnification provisions that the issuer believes are unreasonable? For example, will the issuer be forced to agree to indemnify the rating agency for its negligence, gross negligence, or willful misconduct in issuing a rating that the issuer did not want in the first place, and from a rating agency that its investors will not accept?

Will the governmental or quasi-governmental entity force the issuer to agree that it will provide to the government-appointed rating agency all information ever requested by the rating agency for any purpose without any guarantee of confidentiality? Or would the issuer be forced to engage a rating agency that regularly distributes confidential information concerning the issuer's origination strategies and other competitive advantages that the rating agency derives from its due diligence of the issuer's ABS transactions?[30]

Ultimately, if the issuer and the appointed rating agency are unable to agree to the terms of the engagement, will the governmental or quasi-governmental entity force the issuer to accept terms and conditions that the issuer ordinarily would reject if it were free to negotiate in its best interest? Will engagement

[30] Similarly, would an issuer be compelled to share private borrower information upon the demand of the rating agency, even if the issuer determined that withholding that information was appropriate to protect the borrowers from identity theft?

letters become the new "shrink-wrap" agreements that require the issuer to accept unconditionally whatever terms and conditions (including indemnification) the government-appointed rating agency sets forth? Or, will the government also become more intertwined in the process and prescribe standard terms and conditions for engagement letters?

These are examples of issues that are presently being addressed in the issuer-pays model. These issues also would exist in the Section 15E(w) System; however, issuers would have no practical recourse to address them. The Roundtable believes this is a fundamental defect of the Section 15E(w) System.

The Roundtable also is concerned that the credit rating assignment system inevitably will devolve into an arbitrary process, because issuers will be subject to the further risk that investors will not buy their bonds because they refuse to accept credit ratings provided by the government-appointed credit rating agency. Under the current issuer-pays model, the issuer can make certain that it engages a rating agency acceptable to investors. From a practical perspective, if an issuer were assigned a rating agency that is not acceptable to the investor, the issuer is not likely to go forward with the transaction. Also, if an issuer chooses not to go forward with the transaction because it has been assigned a rating agency that is not acceptable to the investor, it is not clear what will happen the next time the issuer structures a transaction. Is the issuer assigned the same rating agency and, by default, is not able to engage in ABS transactions on a going forward basis?

The following illustrates the potential adverse impact of the credit rating assignment system:

Before the issuer sets and locks the borrowing rate, it must determine both the basis in the loan and the most efficient execution for financing the loan. Financing options include (1) keeping the loan in its portfolio (banks only, whereby they measure return on the asset against sale), (2) selling the loan into a private label securitization, or (3) selling the loan as a whole loan.

The issuer then takes the financing option yielding the highest return (or proceeds), either adds fees or increases the borrower's interest rate to meet its required return on equity, overhead costs, *etc*., and then sets the loan rates.

Because the various rating agencies have varying criteria, the credit enhancement levels they ascribe (which directly impacts the proceeds received from any securitization) will vary amongst them, as well as other intangibles that determine proceeds received *via* securitization. Those variables include (1) what investors will pay for bonds rated by any one of these agencies, (2) whether investors will buy securities rated by a particular rating agency at all, and (3) true intangibles with costs ascribed to them, including any indemnification required by a rating agency, *etc*.

The credit enhancement levels and the variable outlined above will affect the total net proceeds received on the sale of securitized assets, directly affecting the cost of capital *via* securitization, and ultimately the pricing of loans to consumers. In order to be competitive and make the most attractive loans (*i.e.*, those with the best rate), the issuer ordinarily would select the rating agency that provides the best execution and set loan rates accordingly. We strongly object to a system where issuers are subject to arbitrary decisions made by a government or quasi-governmental entity that will subject certain issuers to higher cost of funds than their competitors.

If the issuer cannot make this fundamental business decision, and a governmental or quasi-governmental entity makes the actual selection of the rating agency in accordance with the credit rating assignment system and only do so after the loans have been closed and submitted for a potential securitization, the issuer will need to assume worst execution in all instances. The result of this *assumption of the worst execution* inevitably would harm consumers because they would not receive the benefit of the lowest cost of financing on their home mortgage, automobile loan, student loan, *etc*.

Further, should a rating agency be assigned that would allow the issuer to get best execution, it will just result in found profits *via* securitization arbitrage, because the loan would have already been closed with a rate assuming a worst case securitization execution. This would completely undermine structured finance's highly efficient system of *passing through the lowest cost of capital* to borrowers. Of course, it is possible that the issuer would lose because it was assigned a rating agency that <u>none</u> of its investors will accept—so investors refuse to buy the issuer's bonds. This would have the perverse effect of the lender's profitability not being driven by its business practices, but instead by chance or the decisions of an "impartial" governmental or quasi-governmental entity or officials. This control over a lender's profitability also would bring its own conflicts of interest.

v. The Commission would be taking a step back from recent initiatives to reduce inordinate reliance on credit ratings.[31]

Our members have noted a welcome change in market practice: Many institutional investors are dispensing altogether with reliance on third-party credit ratings on ABS transactions in favor of *assessing credit-worthiness for themselves*.

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[31] *See* H.R. REP. NO. 111-517 at 871 (2010) (Conf. Rep.).

The Roundtable believes the Section 15E(w) credit rating assignment system undermines, and is inconsistent with, efforts to reduce over-reliance on credit ratings by investors. One concern is that notwithstanding the disclaimer required by the Section 15E(w) system, investors may believe that credit ratings coming from this assignment system have been vetted and approved by a government-appointed and regulated entity. Also, by creating this rating agency assignment system, a limited number of credit rating agencies will be further entrenched in the securitization market, in conflict with Section 939A's goal of eliminating what some have referred to as a "sanctioned oligopoly."[32]

vi. The Commission's regulations should not interfere with the prerogative of market participants to determine for themselves both the usefulness of credit ratings for their investment analysis of specific ABS transactions, and the particular agency or agencies that they desire to provide those ratings.

The Roundtable urges the Commission to develop regulatory responses that to the greatest degree possible allow market participants—rather than governmental or quasi-governmental entities or officials—to determine whether credit ratings add value to their due diligence on ABS transactions. The Roundtable also asks the Commission to develop and implement regulatory policies that allow market participants—rather than governmental or quasi-governmental entities or officials—to determine which rating agency's opinion(s) on credit-worthiness are most relevant for their uses.

Since ratings impact the cost to borrow or profit for all capital markets participants (borrowers, originators, securitizers, ratings agencies, and investors), no one is neutral. Therefore, *freedom of choice* is the best protection for market

[32] *See* Section 939A of the Dodd-Frank Act, Pub. L. No. 111-203, § 939A, 124 Stat. 1887 (July 21, 2010). *See also*, SEC. & EXCH. COMM'N, *Security Ratings*, Securities Act Release No. 9245, 76 FR 46603 (Aug. 3, 2011) (Adopting Release) (replacing "rule and form requirements . . . for securities offering or issuer disclosure rules that rely on, or make special accommodations for, security ratings . . . with alternative requirements"); SEC. & EXCH. COMM'N, *Re-proposal of Shelf Eligibility Conditions for Asset-Backed Securities*, Securities Act Release No. 9244, 76 FR 47948 (Aug. 5, 2011); SEC. & EXCH. COMM'N, *Removal of Certain References to Credit Ratings Under the Securities Exchange Act of 1934*, Exchange Act Release No. 64352, 76 FR 26550 (May 6, 2011) (proposing amendments to Exchange Act rule 15c3-1 (the "Net Capital Rule"), Appendices A, E, F, and G of the Net Capital Rule, rule 15c3-3, rules 101 and 102 of Regulation M, and rule 10b-10); SEC. & EXCH. COMM'N, *References to Credit Ratings in Certain Investment Company Act Rules and Forms*, Securities Act Release No. 9193, 76 FR 12896 (Mar. 9, 2011) (proposing amendments to Company Act rules 2a-7 and 5b-3, and Company Act forms N-MFP, N-1A, N-2, and N-3); OCC, FEDERAL RESERVE SYSTEM, FDIC, AND OTS, *Advance Notice of Proposed Rulemaking Regarding Alternatives to the Use of Credit Ratings in the Risk-Based Capital Guidelines of the Federal Banking Agencies*, 75 FR 52283 (Aug. 25, 2010); and OCC, *Alternatives to the Use of External Credit Ratings in the Regulations of the OCC*, OCC-2010-0017, 75 FR 49423 (Aug. 13, 2010). *See generally*, SEC. & EXCH. COMM'N, *Report on Review of Reliance on Credit Ratings As Required by Section 939A(c) of the Dodd-Frank Wall Street Reform and Consumer Protection Act* (July 2011).

participants—and that is what rule 17g-5 offers. At its core, rule 17g-5 enables any investor to hire the credit rating agency of its choice, and the investor-designated rating agency has access to the information it would need to rate transactions. Because no party can truly be neutral, the solution is to allow and encourage each market participant to make independent decisions based on its self-interest.

There are no simple performance measures that are accepted across the financial markets for investors. Investors effectively show their vote of confidence based on their choice to buy or not buy securities rated by particular credit ratings agencies. Investors also voice their preferences directly to broker-dealers and issuers. A system that would allocate the development and maintenance of credit rating performance measures to a governmental or quasi-governmental entity could result in a divergence from the market's assessment of a rating agency's performance or "accuracy" of its ratings. This divergence *from the real world* could occur for any number of reasons—from inherent conflicts of interest to insufficient staff or other resources to oversee an enormous, complex, and constantly moving market.

In our view, no governmental or quasi-governmental entity could ever act as swiftly *or as harshly* as the capital markets already do. The market is more prone to note and react to concerns immediately due to the immediate and direct financial implications, and will always be more severe, choosing to completely shun a rating agency with recent poor performance. Because a governmental or quasi-governmental entity could never replicate this immediate market discipline, we question why a new regulatory system would be imposed that is slower to act than the system already in place—a system that is driven by investor demand.

Furthermore, should investors and the governmental or quasi-governmental entity's perceptions of any particular credit ratings agency deviate under the Section 15E(w) System, the consequences would be dire. Issuers would be stuck with bonds investors refuse to buy, and investors would be restricted from buying assets they would otherwise purchase but for the particular assigned rating agency. In a situation where the market does not approve of credit ratings agencies that are being assigned, how would this problem be corrected, or would investors and issuers be forced to accept the governmental or quasi-governmental entity's assessment in place of their own? Why has the judgment of an "impartial" entity completely replaced the judgment of those who actually use the ratings?

B. The Commission should solicit public comment on definitions and interpretative statements issued to implement the Study's findings.

It would be essential for the Commission to clearly define "accurate credit rating," "quality rating," and "poor performance," for purposes of the credit rating assignment system. Accuracy does not just mean never having a bond perform worse than expected. Anyone can be overly conservative and set ratings that will not be downgraded. Rather, accuracy involves striking a balance: not being overly optimistic or overly pessimistic. This would be a daunting task for a governmental or quasi-governmental entity to monitor. Depending on market size, this potentially would involve monitoring tens of thousands of ABS transactions and hundreds of thousands of securities.

Leaving aside the cost of adequately staffing and maintaining the technology and other resources necessary to monitor properly the "accuracy" of ABS ratings, true accuracy in ABS ratings (especially the credit events necessary to test "AAA" securities credit enhancement) only reveals itself over several decades. Therefore, a governmental or quasi-governmental entity would only likely be able to judge meaningfully any single credit rating agency once it is too late. Due to the sheer size of the market and the range of ABS products, most monitoring of ratings in both the long and short term will be based on a government-approved model. Since accuracy would be determined relative to this model and business awarded based on accuracy, ratings agencies will be incentivized to all conform to the then-current government-approved model. This will actually have the unintended consequence of reducing diversity of opinion and ensuring that all ratings conform to the standard set of assumptions set forth in the government-approved model.

III. Rule 17g-5 offers investors a superior means to address potential conflicts of interest inherent in the "issuer-pays" ratings agency business model.

A. Rule 17g-5 provides market participants with the tools to protect themselves from the risks of potential conflicts of interest in the ratings of ABS transactions.

Today, rule 17g-5 offers investors the means to protect themselves from the risks of rating agencies' potential conflicting interests. <u>First</u>, any credit rating agency that was not selected by the issuer to rate its ABS transaction can elect to rate the ABS transaction, because it will have access to the same information the issuer (or other transaction parties) provided to the issuer-designated rating agency.[33] Second, investors can engage another credit rating agency to rate the ABS transaction on their behalf. For example, the investors could use the investor-selected rating agency to *validate* the rating(s) provided by the issuer-designated rating agency.

Rule 17g-5 reinforces the traditional market discipline employed by investors: the leverage to walk-away from a deal unless the issuer meets investors' reasonable demands (including the designation of credit rating agencies). Ultimately, rule 17g-5 allows market participants to retain the power to pick the "winners and losers" among the credit rating agencies, rather than cede that role to governmental or quasi-governmental entities or officials.[34] Moreover, investors always are free to disregard the opinions of issuer-paid rating agencies.

B. Further enhancement of rule 17g-5 would be better than replacing it with a flawed system.

Rather than replacing an existing rule with a wholesale new approach that has its own problems, we believe that the Commission should continue to use the existing rule 17g-5 model, enhanced with changes that would improve the effectiveness of the existing rule. For example, issuers could be required to disclose all credit ratings agencies that they solicited for any particular transaction but did not select to rate the transaction. The Commission also could replace the "unsolicited rating requirement" of the rule with a requirement that a rating agency provide a specified number of "ratings commentaries or other credit quality statements"—rather than an unabridged credit rating. This would bring into the market more "unsolicited" credit-worthiness opinions on ABS transactions, and foster greater competition among credit rating agencies.

Enhanced Issuer Disclosure. By requiring an issuer to disclose all ratings agencies it approached but did not ultimately select to rate any given security, investors and financial regulators will be made aware of any potential "ratings shopping." This enhanced disclosure would benefit investors by providing transparency into the ratings agency selection process. Enhanced issuer disclosure also would avoid concerns raised by the Section 15E(w) System, such as issuers not being able to use a government-assigned rating agency due to fees, poor service, inability to agree on other terms and conditions of the engagement (*e.g.*, indemnification). Investors could factor into their due diligence potential "ratings shopping," and would even be able to identify and contact the non-selected ratings

33 Rule 17g-5(a)(3) [17 C.F.R. § 240.17g-5(a(3) (2011)].

34 *See*, Walker, *supra* note 6 at 1 ("An operating model for [rating agencies] that is less dependent on regulation, and more driven by market needs, is superior and should be identified if possible.").

agencies for their opinions or concerns regarding the securities. This would bolster investors' ability to ensure that they are receiving an opinion from an independent third party.

Ratings Commentaries and other Credit-Quality Statements. The Roundtable believes that investors and other market participant would benefit from rating agencies' distributions of ratings commentaries and other credit-quality statements that would amount to less than a full "rating" on ABS transactions.

Rating ABS transactions involve an in-depth analysis of all aspects of a securitization, from the thousands of pages of contracts that create the securities to the nuances of each of the assets that back the securities. These ratings come at a significant cost, and because they are dynamic and evolve as payments are made on the underlying assets, and the market and the economy ebb and flow (which also affects the assets), rating agencies incur significant costs to monitor and update ABS transactions on a monthly basis (most securitized assets have monthly payment streams and collateral updates). Allowing agencies to provide less than this full analysis would give them the ability to speak without the fear of incurring an obligation to devote the substantial resources required to monitor complex securities (including exposure to liability) on a monthly basis for up to 30 years.

The ability to make these more affordable ratings commentaries and other credit-quality statements also would serve as a form of good will or marketing for the smaller ratings agencies, which would allow them to develop a following in the market and show value. Over time, this should lead to investors seeking out the ratings of these smaller ratings agencies as the primary/initial ratings agencies on ABS transactions.

Moreover, the Commission should consider removing in its entirety the requirement that a rating agency have "determined and maintained ratings for at least 10% of the issuer securities and money market instruments."[35] The alternative that we suggest would allow the "unsolicited ratings" and ratings agency competition/diversity process to be grown organically. As a practical matter, investors drive the ratings agency selection process because issuers will not create securities they cannot sell.

As investors see these diverging opinions and are able to judge them on their accuracy and insight, they will become more likely to require them at issuance. At the very least, investors always have the option to choose any rating agency they want to give an opinion on a security, because of the access afforded

[35] Rule 17g-5(a)(3)(iii)(B)(1) [17 C.F.R. § 240.17g5(a)(3)(iii)(B)(1)(2011)].

to ratings agencies by rule 17g-5.

The Roundtable believes adoption of these enhancements would promote and enable ratings agencies to provide more coverage of ABS transactions in the market, and foster positive competition amongst ratings agencies. Furthermore, because conflicts of interest can never be removed from the ratings agency selection process, these modifications to rule 17g-5 would allow investors to make informed decisions when evaluating securities ratings.

IV. None of the other alternatives presented by the Commission would offer practical or effective solutions to the risks of potential conflicts engendered by the issuer-pays model.

From our perspective, the Investor-Owned Credit Rating Agency Model, the Stand-Alone Model, the Designation Model, and the Subscriber-Pays Model fail to provide investors the breadth of freedom and protection from the risks associated with the issuer-pays model that rule 17g-5 presently provides.

Moreover, the Subscriber-Pays Model raises practical enforcement issues. For example, how *would* the Commission or any governmental or quasi-governmental authority compel investors to pay for credit ratings on bonds? Given the speed with which many financial instruments trade in the market, how would fees be set for investors and securities dealers who held the bonds for milliseconds before they traded it to other investors? What about securities firms and institutional investors who never own the bonds but use the ratings for repo/reverse repo transactions, and to make credit decisions? What about investors who use the rating to decide <u>not</u> to buy the bonds—how would their fees be measured? What about investors who did <u>not</u> use the ratings in their decision-making processes? Ultimately, artificially limiting or increasing the cost for certain issuers to access to ratings would be an incentive for market participants to engage in careless decision-making.

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The Roundtable and its members appreciate the opportunity to offer our perspectives on various alternative credit rating agency compensation models. We commend the Commission for its recent accomplishments in regulating credit rating agencies. As we illustrated in our letter, potential conflicts of interest are inherent in capital markets transactions. While we do not believe that all potential conflicts can be extracted from the marketplace, the Roundtable believes regulatory efforts should focus on appropriate management and disclosure of potential conflicts of interest. If it would be helpful to discuss the Roundtable's specific comments or general views on this issue, please contact me at Rich@fsround.org or Don Truslow at Don@fsround.org.

Sincerely yours,

Richard M. Whiting
Executive Director and General Counsel
The Financial Services Roundtable

With a copy to:

The Honorable Mary L. Schapiro, Chairman
The Honorable Elisse B. Walter, Commissioner
The Honorable Luis A. Aguilar, Commissioner
The Honorable Troy A. Paredes, Commissioner

Robert W. Cook, Director
Randall W. Roy, Assistant Director
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