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By E-mail

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

Re: File Number 4-611: Credit Ratings Roundtable Discussion

Dear Ms. Murphy:

The following are the comments of A.M. Best Company, Inc. ("A.M. Best" or "the Company"), a nationally recognized statistical rating organization ("NRSRO" or "NRSROs") currently registered under Section 15E of the *Securities and Exchange Act of 1934* (the "Exchange Act"), regarding the upcoming Roundtable discussion on credit ratings issues ("Roundtable") being held by the Securities and Exchange Commission ("SEC" or "Commission").

I. Introduction

Established in 1899 and headquartered in Oldwick, NJ, A.M. Best is the premier global rating agency and information source for the insurance industry. The Company is best known for providing in-depth reports and financial strength ratings about insurance organizations.

A.M. Best's principal credit rating activity is the issuance of financial strength ratings, which are primarily used by insurance brokers, insurance agents, risk managers, and retail insurance consumers. The Company also issues ratings on debt and debt-like obligations such as bonds, notes, preferred stock, securitization products, and other financial instruments, primarily issued by re-insurance organizations.

A.M. Best appreciates the Commission's willingness to consider comments and ideas from the credit rating industry in connection with the upcoming Roundtable. It is important that the Roundtable discussion incorporate an understanding regarding the variety of practical, competitive, and cost-related concerns for smaller NRSROs such as A.M. Best. In A.M. Best's experience, regulatory and legislative proposals often include provisions that make it even more difficult for smaller NRSROs to compete with the three largest NRSROs that dominate the ratings market. Additionally, it is important that discussion regarding credit ratings sufficiently account for the differences between corporate ratings (such as financial

strength ratings of insurance companies) and ratings of the structured and asset-backed financial products that contributed to the recent economic crisis.

II. The SEC Should Calibrate Regulatory Burden to NRSRO Size to Foster Competition

The NRSRO market demands a regulatory approach that fosters genuine competition because of the dominance of the three large NRSROS. Most analyses of the NRSRO market highlight a functional monopoly controlled by the three largest credit ratings firms, which are estimated to control approximately 98% of the credit rating market.[1] In fact, the new NRSRO rules proposed by the Commission in 2011 even noted that the NRSRO market is dominated by the three largest firms and a key statistical measure—the Herfindahl–Hirschman Index—indicates that there are only three firms of relatively equal size in the NRSRO market.[2]

The lines between small and large in the NRSRO market are clear enough that the Federal Reserve was comfortable classifying only three NRSROs (Fitch Ratings, Moody's Investors Service, and Standard & Poor's) as "major" NRSROs when the Federal Reserve was implementing the Troubled Asset-Backed Securities Loan Facility ("TALF") in early 2009. The remaining NRSROs did not qualify as "major" and hence were not able to participate in the mandatory ratings connected to the TALF program.[3] It is clear that the federal government can distinguish between the market-dominating "major" NRSROs and the remaining NRSROs. The simple fact is that non-"major" NRSROs account for a small amount of the credit ratings market and have to compete in a market dominated by three very large ratings companies.

Protecting smaller NRSROs from disproportionate regulatory burdens that could further reduce competition in the ratings market was a goal underlying the adoption of the *Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010* ("Dodd-Frank").[4] In fact, the language of Dodd-Frank itself recognizes the need to exempt small NRSROs from certain provisions. For example, in §932(a)(8) and §932(a)(5)(B)(2)(B), Congress explicitly referenced the need to protect small NRSROs from unreasonable regulatory burdens. These exemption provisions provide evidence that Congress intended to enable small NRSROs to continue to provide viable alternatives to the large NRSROs and to provide new entrants relief from overly-burdensome regulatory provisions under the new regulatory regime.[5]

Discussions regarding credit rating issues should include a discussion about how to craft a definition of "small" that does not render the Dodd-Frank exemptions largely useless for fostering competition in the ratings market. If the SEC fails to adopt a definition of "small"

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[1] See Frank Partnoy, *Rethinking Regulation of Credit Rating Agencies: An Institutional Investor Perspective* (Apr. 14, 2009) available at: http://www.cii.org/UserFiles/file/CRAWhitePaper04-14-09.pdf

[2] Nationally Recognized Statistical Rating Organizations, 76 Fed. Reg. 33,420, 33,500 (June 8, 2011) (hereinafter "proposed rules").

[3] Controversy over this policy eventually resulted in the Federal Reserve abandoning the requirement that "major" NRSROs be used.

[4] Pub. L. No. 111-203 (2010).

[5] *Id*.

that applies to the seven smaller NRSROs that are forced to compete with three NRSROs that dwarf them in size, then it will undermine competition and result in further concentration in the NRSRO market. Failing to calibrate compliance timelines, policies, and procedures to reflect the uniquely concentrated nature of the market will result in the seven NRSROs that are a fraction of the size of the three largest NRSROs shouldering an identical regulatory burden. This will only exacerbate existing competitive advantages held by the three largest NRSROs because those companies have enormous infrastructure advantages that allow them to more easily absorb compliance costs and burdens.

A.M. Best believes that the SEC should analyze each NRSRO on a case-by-case basis, but given the concentration of the market (98% in three NRSROs), all of the seven smaller NRSROs should be treated as "small" NRSROs for purposes of qualifying to be considered for exemptions targeted at "small" NRSROs. This objective could be accomplished by adopting the definition of "small" that was used in the version of the financial reform legislation initially passed by the U.S. House of Representatives. In § 6002 (a)(5)(1) of H.R. 4173, the SEC was empowered to allow NRSROs to voluntarily withdraw from being a NRSRO if the NRSRO "received less than $250,000,000 during its last full fiscal year in net revenue for providing credit ratings on securities and money market instruments issued in the United States."[6] While Congress ultimately removed the mandatory registration requirement from the legislation during the conference process, at no point did the conference express disapproval of the $250 million threshold. The SEC should view this language as an indicator of what Congress believes a reasonable threshold for "small" is in the context of NRSROs and against the backdrop of the highly-concentrated market.

Defining "small" based on revenue is an approved means under the Small Business Act ("SBA"), which allows the Administrator to develop definitions or standards to determine what constitutes a "small business concern."[7] In so doing, the Administrator may define small business concern according to "number of employees, dollar volume of business, net worth, net income, a combination thereof, or other appropriate factors."[8]
The SEC should utilize the exemption authorities provided in Dodd-Frank, and the SEC's general exemption authority, to craft compliance timelines, policies, and procedures that reflect the unique competitive burdens facing the seven smaller NRSROs. More specifically, in taking any action in connection with the proposals under discussion at the roundtable, the Commission should utilize existing statutory authority to craft a definition of "small" that reflects the uniquely top-heavy nature of the NRSRO market.

III. Differences in Types of Ratings and Concerns about Potential Assignment

It is important that most aspects of the Roundtable agenda are focused on practices surrounding ratings of structured finance products, as these products were central to the recent economic crisis. As Dodd-Frank's legislative findings indicate:

[6] H.R. 4173, 111th Cong. § 6002(a)(5)(1)(2009).

[7] 15 U.S.C. § 632(a)(2)(A).

[8] Id. § 632(a)(2)(B).

> In the recent financial crisis, the ratings on structured financial products have proven to be inaccurate. This inaccuracy contributed significantly to the mismanagement of risks by financial institutions and investors, which in turn adversely impacted the health of the economy in the United States...Such inaccuracy necessitates increased accountability on the part of credit rating agencies.[9]

If the Commission and Congress move forward on the ideas discussed at the Roundtable, it is important that any resulting rules recognize that there are different types of ratings and not all should be subject to the same type of scrutiny. Underpinning this evaluation should be an examination of actual risk. For example, some specialized ratings, such as ratings of insurance organizations, do not pose the same risk as ratings on structured financial products, as recognized by Congress.

This difference was again highlighted during the legislative debate on Dodd-Frank, specifically the Franken amendment that would have mandated an assignment system. The Franken amendment was narrowly-tailored to apply to structured financial products. An assignment system would be particularly harmful if used in the financial strength ratings context and would likely undermine the quality of financial strength ratings.

A.M. Best has developed institutional knowledge and expertise in the area of insurance for over more than a century. Replacing this expertise with an assignment system whereby an NRSRO without knowledge of the insurance industry would rate an insurance company would ill-serve the insurance industry, investors, and the economy. Moreover, an assignment system would sever the relationship between A.M. Best and its customers, and these long-term relationships are necessary for A.M. Best to conduct the ongoing surveillance and reviews critical to financial strength ratings. Accordingly, no matter the outcome of deliberations on assignment systems in general, it is essential that they not be applied to classes of ratings, such as financial strength ratings of insurance organizations, that require specialized knowledge and expertise.

IV. Proposed Changes to NRSRO Compensation Systems

While there has been much discussion about NRSRO compensation systems, it is important to place the current “issuer-pays” model in context. The issuer-pays model was originally adopted in the 1970s in response to confidence crises that arose while "subscriber-pays" models were the norm. Reverting to the subscriber-pays model will only invite a return of the secrecy and resulting lack of confidence that was related to ratings not being generally available to the public.

Moving away from the issuer-pays model does not resolve conflict of interest concerns, because all compensation models can be abused. For example, under the subscriber-pays model large investors, even in small numbers, could form a block and attempt to influence

[9] Pub. L. No. 111-203, § 931(4) (2010) (emphasis added).

ratings. Further, for some types of securities, a small group of investors often purchase the entire offering, so the potential for conflicts of interest remains.

Thus, rather than eliminate the issuer-pays model, policymakers must look to differences within types of issuer-pays systems. Grouping all compensation models into broad categories makes the same mistake as grouping all credit agencies together—it obscures key differences between different business models. Policymakers should view credit rating agencies differently based upon what they rate (e.g., structured assets vs. insurance companies) and how they charge for their services (e.g., one-time fees vs. annual contracts).

For example, rating services fees for obligor ratings are generally much lower than securities rating fees and are paid annually. The vast majority of A.M. Best's rating services revenue is derived from the issuance of financial strength ratings (obligor ratings). This type of fee structure promotes active surveillance of ratings since ratings are formally reviewed at least annually.

For NRSROs such as A.M. Best that rate obligors and use annual fees with continual surveillance the issuer pays model is the appropriate tool to produce high-quality ratings. This is true for a variety of reasons, including:

- Ratings determined under an issuer pays model benefit from using non-public information provided by the rated company, information that would not be available under a subscriber pays model (that relies on public information). Use of non-public information facilitates more thorough ratings than could be determined through other compensation systems that do not establish a relationship between the credit rating agency and the obligor (thus allowing for access to non-public information).

- Under an issuer pays model that includes surveillance and monitoring, credit rating agencies are able to revisit and revise ratings in a timely manner as a part of the services paid for by the obligor. Under other compensation models, the agencies would be dependent on subscribers or the government to fund such revisiting and revisions.

- Information generated by credit rating agencies at the request of, and funded by, issuers is widely available to the market-place and the public free of cost and in real time. The quantity, diversity and easy access to this information creates a level playing field for investors, retail consumers, risk managers, vendors and other interested parties, regardless of their ability to pay, and would be sacrificed in alternative compensation models such as "subscriber pays."

When operating correctly, the issuer-pays model allows credit rating agencies to establish long-term relationships and thorough monitoring as part of the rating process—much like the relationship between an effective third-party accountant and a company—leading to a level of understanding that can produce the highest possible quality ratings. The key is to analyze the specific attributes of a relationship between a credit rating agency and the entity being rated,

not to make broad judgments about the overall compensation model.

IV. Conclusion

A.M. Best appreciates the opportunity to provide these comments in advance of the Roundtable and looks forward to continuing to work with the Commission to analyze these important issues.

Sincerely,

David A. Brey