RapidRatings

U.S. Securities and Exchange Commission Roundtable to Examine Oversight of Credit Rating Agencies

James H. Gellert, Chairman and CEO
and
Dr. Patrick J. Caragata, Founder and Executive Vice Chairman
Rapid Ratings International Inc.

Washington, D.C.
May 14, 2013
File Number 4-661

Contents

1. **Introduction**

2. **The deficiencies of the Franken Amendment based on the GAO's cost benefit analysis criteria**

3. **A comparison of payment options considered in SEC Report**

4. **Conclusion**

Appendix A: Panel 3 — Alternative compensation models Q&A

Appendix B: Testimonies and comments submitted to US Congress and the Securities and Exchange Commission by Rapid Ratings International Inc.

Appendix C: Table: Comparison of payment options considered in SEC Report

1. Introduction

Rapid Ratings is honored to be asked to participate in this Credit Ratings Roundtable. Having also participated in the last ratings roundtable in 2009, and four congressional hearings on ratings, we value the opportunity to contribute to the dialogue on industry reform.

Rapid Ratings is a subscriber-paid firm. We produce Financial Health Ratings (FHRs®) on thousands of public and private companies and financial institutions quarterly utilizing a proprietary, software-based system. We use only financial statements, no market inputs, no analysts, and have no contact in the rating process with issuers, bankers or advisors. Our ratings far outperform the traditional issuer-paid rating agencies in innumerable cases and also typically outperform the prevalent market-based default probability models.

We have not applied for NRSRO status and have no immediate plans to do so. We can be viewed as a player committed to change and innovation in the ratings business but highly skeptical that industry reform is evolving to facilitate our success or to entice us to seek registration. As reinforced by the subject matter in this Roundtable, the costs associated with NRSRO status as well as the uncertainty surrounding the regulation of NRSROs create too many deterrents. In short, it is difficult to quantify the costs and benefits in this analysis. In addition, we do not rate structured products, although we have subscribers who would like us to move into this and other ratings categories.

In December 2012 the Division of Trading and Markets of the U.S. Securities and Exchange Commission ("The Commission") released for public comment a working paper entitled *Report to Congress on Assigned Credit Ratings* ("The Report"). The Report was required by Section 939F of the Dodd-Frank Wall Street Reform and Consumer Protection Act (2010) ("Dodd-Frank"). The Report was a summary of earlier submissions from interested parties on the Sen. Franken *Restore Integrity to Credit Ratings* **(Dodd-Frank, 2010: Section 15E(w) System,)** amendment ("Franken Amendment") for creating a CRA Board to assign ratings for structured finance products as a substitute for normal market-based selection. The proposal arose because of legitimate concerns that the process of rating structured finance products in the lead up to the Global Financial Crisis in 2008 was riven with conflicts of interest among the rating agencies.

The Report uses the Government Accountability Office ("GAO") cost benefit analysis[1] ("CBA") framework (p. 35) of seven decision criteria to examine the costs and the benefits of the Franken Amendment. The SEC asked interested parties commenting on the proposals to apply the same CBA framework. Those criteria are (1) independence, (2) accountability, (3) competition, (4) transparency, (5) feasibility, (6) market acceptance and choice, and (7) oversight. However, we note that this list of decision-criteria (inputs in the decision-making process) does not represent a comprehensive cost benefit analysis framework because it excludes the criteria of fairness, effectiveness and net benefits (or net costs). These are explored in the following pages.

The Report details advantages and disadvantages of the Franken Amendment, the Exchange Act Rule 17g-5 and a variety of other prospective compensation models for the ratings industry.

[1] Government Accountability Office, 2012, Report to Congressional Committees, CREDIT RATING AGENCIES Alternative Compensation Models for Nationally Recognized Statistical Rating Organizations.

While the goals of these models, and indeed of the Franken Amendment itself, are laudable in their intent to end the Issuer-Paid conflicts of interest, they are all significantly flawed. In general we agree with the conflicts highlighted in the Report and do not see the justification for any of the proposed models if the goal is to have a "better" ratings market as a result.

Perhaps most importantly, the Report fails to provide consistency with policies established in the Credit Rating Agency Reform Act of 2006 ("CRA Act") and Dodd-Frank. These legislative initiatives intended for increased competition and reduced reliance on ratings in the market to be central tenets of reform. In other words, allow for more players to emerge to reduce the impact of the oligopoly represented by Standard and Poor's (S&P), Moody's Investor Services ("Moody's) and Fitch Ratings ("Fitch") and remove references to Nationally Recognized Statistical Rating Agencies ("NRSROs") from federal regulations to reduce the structural support of these firms. While neither the CRA Act nor Dodd-Frank accomplished these goals comprehensively or effectively, the spirit was clear. The Report and the initiatives it proposes for consideration, ranging from the Franken Amendment to new payment models, run counter to the central tenets of prior legislation; they will support the incumbent Big Three firms and further imbed government bureaucracy and imprimatur in the ratings industry.

The Franken Amendment and proposed new compensation models carry a range of direct, often inter-connected and unintended consequences. In particular, the Franken amendment:

- Undermines rating agency independence by increasing the government role in CRA selection, payment and performance review
- Creates new conflicts of interest
- Undermines rather than strengthens CRA accountability
- Promotes a convoluted selection, payment and performance review process that will reduce rather than enhance transparency, and also reduce rather than enhance simplicity and therefore increase costs (compliance costs and transaction costs etc), and reduce effectiveness
- Further entrenches the dominance of the largest NRSROs
- Further disadvantages competition by strengthening existing barriers to entry and creating new ones
- Undermines product and process innovation
- Does nothing to address some of the most fundamental problems with asymmetric information access in the industry
- Offers no focus on promoting and improving the "subscriber paid" model (as though it has been written off) despite all the new revenue model suggestions
- Offers continued focus on increasing non-Big Three NRSRO access to "new" ratings at the expense of any attention on existing and outstanding ratings in need of alternate opinions
- Disregards non-NRSRO CRAs and the role they can play as potential new entrants
- Ignores the deficiencies of the Credit Rating Agency Reform Act (2006) such as the requirement for new NRSRO applicants to rate in an asset class for three years prior to application. Given various payment model restrictions, only NRSROs will be considered as structured product raters, effectively shutting out competitors from gaining three years of qualifying ratings history

- Ignores the reality that governance of many public and private pension funds and other institutional asset managers dictate that NRSROs be used in investment decision making, and often name S&P and Moody's outright

In the Report, there is another serious omission that needs to be highlighted, both in terms of government policy and what are considered to be the available alternatives in the market for ratings payment. Ironically, that omission is the subscriber-paid model, the only current alternative to the issuer-paid model in use. The subscriber-paid model gets short shrift. It is mentioned in reference to also having conflicts of interest (which we contend are significantly overstated) and then no real focus on it returns in the Report amongst the myriad business model propositions.

The advantages that the subscriber-paid model has are manifold: (1) the subscriber paid model dominated the ratings industry from its inception over 100 years ago until 1975, and during that time there were no conflict of interest scandals involving the rating agencies;[2] (2) S&P, Moody's and Fitch still earn a large share of revenue each year from their rating subscription services; and (3) despite attempts by some of the issuer-paid rating agencies to characterize the subscription-based model as subject to serious conflict of interest, the truth is that that ploy is mere rhetoric designed to create a red herring to distract attention from the conflicts of interest embedded in the issuer-paid model.

The potential for conflicts in subscriber-paid firms is close to zero and thus the conflict of interest nature of the subscriber–paid firms is not remotely comparable to the inherent conflict in the issuer-paid model. The greater integrity is best exemplified by Rapid Ratings whose ratings are predetermined by the model design and are never, under any circumstances, shaped by random discussions with subscribers, or pressure from subscribers much less issuers themselves.

There is no reason why the subscriber-paid model should be an orphan of government policy, especially when we consider that the subscriber model works, and all of the alternatives being discussed are academic constructs which have never been applied in practice. You are looking at something that already works, and we should focus on ways of improving its viability rather than engineering convoluted structures that are more likely to cause more problems than solutions.

In the following pages we provide thoughts on 1) the Franken Amendment deficiencies; and 2) the strengths and weaknesses of alternative compensation models followed by an Appendix which lists Panel #3 questions and our answers.

2. The Deficiencies of the Franken Amendment based on the GAO's Cost Benefit Analysis Criteria

2.1 Independence:

[2] If it had not been for the credit market freeze in the aftermath of the Penn Central bankruptcy in 1970, that model may very well have continued to dominate or at least not been so radically reduced in favour of the issuer-paid alternative.

While CRA independence is a desirable objective, the interpolation of this Board selection process falls seriously short of meeting that objective for several reasons. First, it undermines CRA independence by creating CRA dependence on government decision-making. Substituting one type of dependence for another is not advisable because it will create new conflicts of interest and distortions, especially given how much concentration of power the CRA Board will have. Second, there needs to be a fair process for selecting each CRA for each job, something the Board will often fail to achieve because Board members would have their own conflicts of interest given their past experience in the investment or ratings industry and their decision-making power on the Board. Third, structured product ratings are complex by nature and myriad structural derivations emerge that board members may be ill-qualified to understand, much less to know which CRA is qualified as a rating mandate designee. Fourth, the large CRAs would still have unregulated paid relationships with the issuers and the investment bank "arrangers" for asset classes other than structured products (e.g. Sovereigns, corporates). This means that the large CRAs would continue to have an incentive to please the payer. Smaller CRAs would not have similar relationships with the large issuers and the arrangers, creating a distinct disadvantage for them. Fifth, it perhaps makes the government a potential co-defendant in future litigation involving the choice of the CRA and the quality of its subsequent rating.

2.2 Accountability

Responsibility comes first and accountability comes second. By way of example, each citizen is responsible for obeying the law, just as the policeman is responsible for defending or upholding the law, yet both the citizen and the policeman are held accountable by law for breaking the law or failing to uphold the law, respectively, and are therefore subject to sanction. In the context of the CRA Board, the correct principle to apply here is effectiveness not accountability: thus the SEC should be asking "*is the compensation model effective in promoting NRSROs' responsibility for the accuracy and timeliness of their ratings?"* If the CRAs misbehave then they would be held accountable and subject to penalties, including being fined or losing their place in a queue. Accountability deals with outputs not inputs. The basis for selection for new jobs will be past performance and analysis during the qualification process. There are several problems:

- For the structured finance models to work takes the right length of time-series data, in-depth monitoring, well-designed models and experienced staff. These will not be in evidence for several years for new entrants *if* they can get initial work without experience. Thus the selection bias will favor the Big Three rating agencies which are already noted for having a poor performance record. This means that accountability will be undermined.

- Conflicts of interest on the Board may interfere with an objective determination of performance. Irrespective of whether conflicts do actually exist at any point in time, one can never know for certain and suspicion cannot be avoided. This would also undermine accountability.

- Assuming the Board could avoid any conflicts of interest, the Board would not have the hands-on ability to set, monitor and evaluate performance quality standards inside CRAs

given skill shortages. This would either undermine accountability or lead to excessive delays in allocating work to CRAs or both.

- Given the history of past disasters in rating structured finance products, this market segment needs more realistic ratings. Such ratings may not arise if there is inadequate competition, notably if the Board creates new and higher barriers to entry.

All of these drawbacks may have a negative effect on the innovation performance of all rating agencies affected. However, the stand-out result of experience in structured product ratings is model manipulation or neglect rather than model innovation and the introduction and use of immature models to undertake professional and demanding tasks. So for the Big Three CRAs to complain about how their innovative potential could be diminished is a bit rich. The most likely result will be a continued dominance by the large rating agencies in the structured finance product market regardless of their performance quality along with bureaucratization of the performance measurement process as the Board struggles with its responsibilities. The result would be delays in appointing new CRAs and complaints from investors about the lack of transparency in the assessment process. These results would not represent an advance in accountability.

2.3 Competition

Overall, the way that the principle of "competition" is framed is not very satisfactory because it fails to take into consideration the impact of the Franken Amendment on barriers to entry (both old ones and new ones created by the amendment). A more detailed critique follows:

- First, there are significant start-up costs for CRAs to enter the market to rate structured products resulting in a limited number of "qualified NRSROs" that rate structured products now or that will rate them in the near future. Thus, the existence of the Board cannot presuppose enhanced competition. The number of qualified NRSROs at present is greater than the Big Three, but there is only a handful, meaning the current pool of potential raters is only a mild expansion from the status quo.

- Second, it will be difficult for the CRA Board to remove any NRSRO for rating inaccuracy without diminishing the credibility of the assignment system because so few CRAs rate structured products. The Board could easily be a toothless tiger.

- Third, what happens to the demands of issuers of complex securities who are not satisfied because the Board has chosen a new entrant that has little or no experience with rating complex structured products and does not want a new or inexperienced entrant to do the rating? Thus, what if an issuer/arranger objects to an assigned CRA? What conflict resolution steps would be resolved? Any experiences along these lines are likely to reinforce the Board preference for using the larger CRAs.

- Fourth, the Board assignment system will entrench the existing dominant CRAs and strengthen the barriers to entry, whereas under the current non-interventionist system, a CRA that is entering the structured finance area can negotiate with one or more issuers/arrangers to provide a second (or, in theory a first) opinion on structured products, i.e it does not have to go through an intermediary screening process to gain

credibility. Thus, under the proposed system a Catch 22 will develop: new entrants will have the door shut on them because they have little or no experience and because the door is shut they cannot get experience. Under the Franken system the new entrants are unlikely to get past first base, whereas under the current system they can.

- Fifth, these barriers to entry will only add to those already generated by the Credit Rating Agency Reform Act of 2006, one of whose major objectives was to enhance competition and accuracy in the ratings industry in order to minimize the risks of Enron-type ratings surprises. Those barriers to entry are reported as follows: "since 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" [DBRS Letter]. There is thus mounting evidence that the regulatory interventions of the past decades are back-firing. Surely, this is sufficient warning of the risks of poorly planned regulatory interventions.

- Sixth, the CRA Act requires an aspiring NRSRO to rate in an asset class for three years as an approval criterion. Under the Franken Amendment, only firms that are already NRSROs would be eligible for rotation. Moreover, under 17g-5, only NRSROs have access to information used by paid for NRSROs in order to perform unsolicited ratings. If one is locked out of the current (17g-5) and proposed (Franken) systems, one cannot qualify to become an NRSRO. If one cannot qualify as an NRSRO, one cannot avail oneself of any benefits these market reforms may hold. This conflict in regulation/legislation and asymmetric access to information needs resolution or it is another example of unintended consequences undermining the policy intention to increase competition.

- Seventh, the argument[3] that Fitch, as the newcomer, was inflating corporate bond ratings in the 1990s and 2000s and therefore that we should conclude that new competition does not improve the quality of ratings is a misleading argument that lacks relevance for several reasons: (1) Fitch is not a newcomer; in fact it was launched 100 years ago this year but the study from which the argument arises only covered corporate bond ratings in the 1990s and early 2000s. Market participants know that Fitch, and its acquired companies such as Duff & Phelps, aggressively pursued corporate ratings, particularly in the private placement markets. They were early players in the "ratings shopping" and "regulatory arbitrage" games where higher ratings from a second tier ratings firm were easier and cheaper to achieve than from S&P or Moody's and would satisfy the National Association of Insurance Commissioners (NAIC) capital designation equally. (2) Nevertheless, it was S&P and Moody's, the dominant

[3] Based on the following paper: "How Did Increased Competition Affect Credit Ratings?, Bo Becker, Harvard Business School; National Bureau of Economic Research (NBER) and Todd T. Milbourn, Washington University in Saint Louis - John M. Olin Business School, September 21, 2010, *Harvard Business School Finance Working Paper No. 09-051:* **"**The credit rating industry has historically been dominated by just two agencies, Moody's and S&P, leading to longstanding legislative and regulatory calls for increased competition. The material entry of a third rating agency (Fitch) to the competitive landscape offers a unique experiment to empirically examine how in fact increased competition affects the credit ratings market. Increased competition from Fitch coincides with lower quality ratings from the incumbents: rating levels went up, the correlation between ratings and market-implied yields fell, and the ability of ratings to predict default deteriorated. We offer several possible explanations for these findings that are linked to existing theories.**"** This is not the only test that can be used.

oligopolists, that were the main perpetrators of ratings inflation in the structured finance market, and not Fitch, and that is the subject at hand not ratings in general. (3) But if non-structured finance product ratings are to be introduced into the debate we should note that Fitch has had a reputation for years of downgrading sovereign ratings before Moody's but more slowly than S&P[4], and (4) the argument fails to take the flaws of the issuer-pays model into account (notably the presence of ratings inflation which stems from rating companies who pay you) relative to the subscriber-pays model, the latter being the model which S&P, Fitch and Moody's used from inception till 1975.[5] Overall, the argument that Fitch Ratings as the newcomer inflates ratings is an argument out of context and not relevant to the concerns in the structured finance market.

With respect to the principle of **competition,** the Franken Amendment strengthens existing barriers to entry and creates new barriers to entry. As a result it undermines the requirement for more competition by failing to minimize new barriers to entry and reduce existing barriers to entry by essentially shifting market share amongst a slightly broader group of players that the Big Three. This is not what was intended by CRA Act. That Act mandated the promotion and protection of choice in the market by opening up opportunities for a greater number of ratings agencies, and by promoting more accurate and reliable ratings than in the past where the major CRAs had let the market down by failing to warn of impending crises.

2.4 Transparency

The complexity of the proposed Board-driven ratings assignment system is likely to seriously frustrate the demand for transparency. In particular, because market mechanisms would be replaced by bureaucratic intervention, the market participants (the issuers/arrangers and the rating agencies) would no longer make the decisions that drive the outcomes for investors and therefore uncertainty and information distortion will increase. Both the CRA selection process and the performance measurement process are likely to be opaque to the market.

2.5 Feasibility

The concept of "feasibility" subsumes the principle of simplicity and the principle of cost minimization (compliance costs, transaction costs including start-up costs) as subcategories of feasibility, whereas both simplicity and these costs involve trade-offs between them (i.e. simple systems have low costs while complex systems entail high costs); thus, for the sake of clarity it would have been preferable if the two were analyzed independently.

The Franken Amendment may be simple to conceptualize but it will not be simple to implement, operate and manage because of its inherent conflicts of interest, accountability problems, transparency problems and effectiveness problems etc. Given its complexity, the Franken Amendment does not pass the simplicity test. In terms of costs, there will be significant compliance and transaction costs: (1) the cost of hiring highly skilled personnel by the Board, (2) the cost of developing practical selection criteria and accurate performance measurement by the CRA Board, all of whose costs may very well be paid by the eligible rating

---

[4] IMF, 2010, Global Financial Stability Report: Sovereigns, Funding and Systemic Liquidity, October.

[5] The authors also accept the following argument: "Industry sources confirm this logic. According to a Bear Stearns & Co equity analyst in June 2007, S&P claimed that "reputation is more important than revenues". Bloomberg news cites Moody's CEO Raymond McDaniel stating that "we are in a business where reputational capital is more important". But these are assertions that were contradicted by the October 2008 ratings hearings wherein ex-employees stated that the pursuit of revenue over-rode model quality and concern for reputation."

agencies, (3) the potential threat to an individual CRA's intellectual property because of forced disclosure of methodology to the CRA Board , (4) the cost consequences of any new conflicts of interest, (5) start-up costs for the CRA Board and (6) the start-up cost for any small CRA that wants to compete, which would be a disincentive for some smaller CRAs to get involved in structured finance ratings. All of these would significantly add to the cost of doing business and the cost of investing and lending related to structured finance. More complexity leads to higher costs for every participant.

2.6 Market Acceptance And Choice

There are several important consequences of preventing issuers/arrangers from selecting their preferred CRA for a structured finance product: (1) it could lead to work being given to inexperienced CRAs that could have a negative effect on investor interest and demand who might accept only securities rated by larger well-known CRAs; thus, if their expectations were undermined, it could undermine public confidence in the market which in turn could drive up the cost of capital, engender discounted ABS prices, reduced yields and reduce the volume of securities processed, and (2) it could encourage investors to seek ratings from the larger CRAs to substantiate or challenge the ratings from new entrants, further adding to costs. Overall, the market reaction to the Franken Amendment is likely to be negative. Market acceptance is likely to be minimal to weak because of all the foreseen negative consequences arising from the potential implementation of the Franken Amendment as well as fear of the accumulation of negative unintended consequences. In particular, there is good reason to be concerned that:

- The independence of participating CRAs will be compromised by significant dependence on government decision-making
- Accountability will not be even-handed[6]
- Transaction costs will be higher for larger CRAs while small CRAs will experience high start-up costs
- The market will face frustrating delays in CRA Board decision-making
- Transparency will not be optimal because of the new layer of screening and decision-making
- Smaller CRAs will face new barriers to entry (e.g. a second level of eligibility screening after NRSRO eligibility screening) and higher existing barriers to entry (because of the inability of the CRAs to negotiate for business directly with issuers) seriously compromising the goals of the Credit Rating Agency Reform Act of 2006 to enhance competition and accuracy in the ratings market

2.7 Fairness

The Franken Amendment omits reference to the fairness principle (or equitability) which is a standard cost benefit analysis principle. Proposals are fair if they do not selectively impose any unnecessary or harsh burdens on any of the participants. The Franken proposed system has many flaws but one of its most egregious flaws is unfairness to small CRAs and new entrants, as discussed above.

2.8 Effectiveness

[6] Because the pool of CRAs that rate structured finance products is so small the elimination of participants that do a poor job would seriously undermine confidence in the structured finance products. So poor-performing firms would be retained.

The Franken Amendment omits the principle of ***effectiveness*** which is a standard decision criterion in cost benefit analysis: does the proposal address and resolve the problem or problems that gave rise to this and related regulations and legislation. Furthermore, to what extent (how effective is it?) does it resolve those problems and at what cost for progress? Legislators in the CRA Act intended that their intervention would lead to greater competition in the ratings market from new entrants and smaller companies as well as encourage more accurate and reliable ratings. Legislators in Dodd-Frank (2010)[7] intended that their legislation reduce the legal and regulatory references to the use of credit rating agencies and hence curtail market dependence on credit ratings and credit rating agencies. But the Franken Amendment will make the market more dependent on rating agencies as an unintended consequence and discourage competition for various reasons including the fact that it will add a second layer of screening on top of NRSRO registration that will make it more difficult for companies to enter and compete in the market. Hence, at a strategic level, the Franken Amendment is out of step with the spirit and the substance of existing government legislation affecting credit ratings and credit rating agencies.

2.9 Net Benefits/Net Costs

The Franken Amendment omits Net Benefit as a decision criterion: does the proposal create more benefits than costs (in terms of frequency and value)? And in assessing all decision-criteria (or inputs), in terms of total value, does it solve more problems than it creates? If the measure barely adds value or adds no value, why is it being done and why is an effective alternative not being presented? In brief, while the government is trying to be helpful in this intervention it will make matters much worse than they are now. A better, simpler and fairer system that results in enhanced competition is preferable. The Franken Amendment is likely to fail tests with respect to independence, accountability, competition, transparency, feasibility, fairness and effectiveness etc.

2.10 Oversight

If the Franken Amendment works as intended it will entrench market dependence on credit ratings in the structured finance market, while increasing CRA dependence on government. This objective directly contradicts the intent of Dodd-Frank which aims to reduce market dependence on credit rating agencies. Hence, the concept of "oversight" needs to be re-thought so that it is consistent with Dodd-Frank if the Franken Amendment is eventually adopted. At a more generic level of analysis, "oversight" is a *post-facto* tool, or governance tool not an *ex ante* tool designed to assess the costs and benefits of projects before they are inaugurated.

An *ex ante* assessment of the degree to which a proposal or project will meet its goals is what is referred to as *cost effectiveness* by CBA specialists. Simply announcing an oversight component to a proposal or a project is a confidence-building measure but not an *ex ante* analytical exercise. Only once the project has been commenced will "oversight" tell us whether or not

[7] "Passage of the Dodd-Frank Act precipitated a comprehensive approach to the removal of ratings from SEC regulations. In response to the perceived over-reliance on credit ratings, the Dodd-Frank Act: (1) deleted assorted statutory references to credit ratings and NRSROs; (2) ordered federal agencies to review their regulations within one year and to substitute alternative standards of creditworthiness for all references to credit ratings; and (3) required each agency to prepare a report describing resulting modifications to its regulations." http://www.cov.com/files/Publication/57976284-bd18-4806-9e2f-1616333ee2af/Presentation/PublicationAttachment/833c3fba-2f79-4925-b748-1aef415a30d7/Rating%20Agency%20Regulation%20After%20The%20Dodd-Frank%20Act%20-%20A%20Mid-Course%20Review.pdf

the project is living up to expectations, and as we have already noted, those goals need to be designed to be consistent with existing policy. As discussed above, oversight for the Franken Amendment will distort Dodd-Frank goal of reducing reliance of credit ratings and will be an expensive interference in the market that will produce many negative unintended consequences.

Table 2: Summary of Cost Benefit Analysis of the Franken Amendment

	Cost Benefit Analysis Criteria	**Does the Franken Amendment meet these cost benefit analysis criteria?**
1	**Independence**	• ***No.*** *It undermines CRA independence* by creating CRA dependence on government decision-making that can undermine objectivity and it does not end the other strong relationships that large CRAs have with issuers and arrangers (nor should it).
2	**Accountability**	• **No.** *Selection bias will operate to favor the Big 3 rating agencies which created the crisis in structured finance ratings in the first place.* So if accountability means what it is supposed to mean, it will not hold much meaning here because the Big Three will not lose much business and pay for their past mistakes. This outcome will likely be reinforced by potential conflicts of interest on the CRA Board or if the proposal and Board create new barriers to entry.
3	**Competition**	• **No**. The principle of "competition" employed in the GAO Cost Benefit Analysis format is not framed in a satisfactory way because it fails to take into consideration the impact of the Franken Amendment on barriers to entry (both old ones and new ones) created by the Franken Amendment: (1) start-up costs, (2) the need for new entrants to go through a second approval process (NRSRO designation is the first level of approval), (3) the Board's difficulty in removing any NRSRO for rating inaccuracy without diminishing the credibility of the assignment system because so few CRAs rate structured products. Under the proposed system a *Catch 22* will develop: new entrants will have the door shut on them because they have little or no skills and experience and because the door is shut they cannot get experience and skills. This will be a major contravention of the Credit Rating Agency Reform Act of 2006 which specifically sought to enhance competition and the accuracy and reliability of credit ratings as well as a major contravention of Dodd-Frank which clearly intended to reduce market reliance on credit ratings.
4	**Transparency**	• **No**. The market comments in the SEC paper on the Franken Amendment reveal that there is a serious transparency problem because of the many unintended consequences of the proposal.

5	**Feasibility**	• **No**. Less Simplification means more Costs. More Simplification means less Costs. But to introduce a complex design with complex and, in many cases, unintended negative consequences, means that the simplification variable is not being treated seriously. And that is usually a sign of future difficulties, in this case, serious future difficulties.
6	**Fairness**	• **No.** The Franken Amendment will be blatantly unfair to small CRAs and new entrants to the structured finance market.
7	**Effectiveness**	• **No**. The Franken Amendment will be ineffective in realizing its goals.
8	**Net Benefits/ Net Costs**	• **No.** Not undertaken by the SEC. But an assessment of the factors outlined above suggests strongly that there will be large costs and limited benefits leading to large net costs.
9	**Market Acceptance and Choice**	• Market acceptance is likely to be minimal because of all the foreseen negative consequences arising from the potential implementation of the Franken Amendment as well as fear of the accumulation of negative unintended consequences.
10	**Oversight**	• Not applicable because this is an ex post governance tool not an ex ante cost benefit analysis tool. It is premature to pass judgment on this criterion and as currently calculated the proposal poses a direct contradiction to the Dodd-Frank goal of reducing market dependence on credit ratings and the CRA Act of enhancing competition and improving ratings accuracy and reliability.

Conflict of interest is a serious issue in the issuer-paid rating agency business model, but it cannot be resolved by introducing regulations that undermine existing government priorities in legislation to lessen market dependence on credit ratings and to enhance competition and improve accuracy in the ratings industry. As a result of this analysis we conclude that the Franken Amendment is not viable. This means that other options need to be considered.

3. A Comparison of Payment Options Considered in or Omitted from the SEC Paper

In addition to the Board assignment model proposed by Sen. Franken, several other models were identified by the GAO (2012)[8] as potential alternatives to the existing "issuer-pays" model, but "**none has been implemented**." The GAO's list of *Alternative Compensation Models for NRSROs* is presented below:

- **Investor-owned:** Institutional investors create and operate an NRSRO. Issuers are required to get two ratings, one from the investor-owned NRSRO and one from an NRSRO of their choice.

- **Stand-alone:** NRSROs choose which issues to rate. A transaction fee for original issuance and fees from secondary market transactions pay for the ratings.

[8] Government Accountability Office, 2012, Report to Congressional Committees, CREDIT RATING AGENCIES Alternative Compensation Models for Nationally Recognized Statistical Rating Organizations.

- **Designation:** NRSROs choose which issues to rate and securities holders designate which NRSRO(s) would receive the fees they pay for rating(s). A third party collects and distributes fees.

- **User-pays:** Third-party auditors determine who is "using" ratings and require that all "users" pay the NRSROs.

- **Alternative user-pays:** Creditors' resources are pooled and a government agency or independent board uses these resources to solicit ratings. NRSROs bid on the right to rate products.

- **Issuer and investor-pays:** Issuers and investors pay a fee on the issuance of new debt and secondary market trades. NRSROs are placed in a continuous queue and assigned to rate issues as their number comes up. Assignment eventually is based on an NRSRO's performance.

A few of the options depend on open access to information from rating agencies which rate structured finance products. This potentially valuable web-based system is already in operation, but it is currently not very actively utilised:

> "The Commission also requested comments on how the Rule 17g-5 Program currently is being used to determine credit ratings for structured finance products. 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. A few commenters state that the program, in its current form, is not effective. 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. 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. 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. 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. The commenter explains that this makes it difficult for smaller NRSROs to take advantage of the Rule 17g-5 Program. The commenter also contends that NRSROs do not receive information under the Rule 17g-5 Program in time to market unsolicited ratings to investors." (p. 58)

Even so, this legislated transparency is a good foundation; however it is only a partial measure as it pertains only to new issues and is focused exclusively on structured products. In order to be a comprehensive solution, 17g-5 would need to provide, and should provide, access to existing issues as well as new issues. Issuer-paid NRSROs balk at the idea of providing others with access to data used for existing issues ("maintenance ratings") but the fastest way for a new market entrant to make an impact is to provide an alternate opinion and analysis on outstanding issues. There are a significantly greater number of outstanding issues than there

are ratings of new issuance and this can distinguish a new player much faster than one that can only fight for market share of new volume.

Table 3 presents a summary analysis of the status quo, the Franken Board assignment proposal and the six alternative options identified by the GAO for compensating rating agencies (CRAs) in the structured finance product area. Those options include: (1) the status quo, (2) the Franken Amendment, (3) investor-owned CRAs, (4) stand-alone model, (5) the designation model, (6) user-pays model, (7) issuer and investor pays model, (8) alternative user-pays model.

Unfortunately, the fact that a key option, the subscriber paid model, was left out means that this analysis below is incomplete. Ironically, all the options considered in **Appendix C** do not operate in reality, whereas the subscriber-paid model, which has been in place for over 100 years, has been left out.

Based on the analysis presented in **Appendix C**:

- five models are unviable: (2) the Franken Amendment, (5) the designation model, (6) the user-pays model as presented (7) issuer and investor pays model, and (8) the alternative user-pays model

- also likely unviable, but nonetheless somewhat more attractive than models (2), (5), (6), (7) and (8) are: (3) the investor-owned credit rating agency model, (4) the stand-alone model

Questions posed to Panel Three by the Commission, and answers thereto, can be found as **Appendix A.**

4. Conclusion

The Franken Amendment is a poor choice for improving the ratings market. 17g-5 is a partial measure that has potential to improve information access for competitors to the Big Three and other issuer-paid firms, but it doesn't go far enough. The other proposed revenue models run the gamut of very complicated to exceptionally overcomplicated. All will have unintended consequences and will produce more problems than they solve.

There are several key lessons that arise when examining the Franken amendment and alternative ratings compensation models:

- Keep designs for reforming the credit rating industry simple, notably the payment system; introducing or imposing complex payments systems to solve conflict of interest problems in the ratings industry does little to solve old problems and a lot more to create new ones; this means that feasibility (simple system with low costs) is a key cost benefit criterion
- Ensure that the reforms are consistent with laws and government policy in related areas (enhance competition, improve accuracy and reduce dependence on rating agencies); this means that effectiveness is a key cost benefit criterion

- If the issuer has lost the ability to choose the rating agency, it does not matter if the issuer pays the rating agency
- Minimize existing barriers to entry and avoid building new barriers to entry; this will increase CRA accountability in the market and promote innovation and accuracy
- A more thorough analysis of the costs and benefits of these alternative options at this time is not possible because these proposals have never been put into practice
- Reduce rating agency dependence on government, don't increase it
- Spend more time thinking about how a market driven ratings compensation option ("subscriber paid") can be adapted to solve the crisis of confidence in the structured finance ratings market rather than relying on untested academic options that have never been reality tested
- Spend more time thinking about how to deal with non-regulatory private legal barriers in contracts or mandates that entrench the position of the Big Three CRAs

The CRA Act and Dodd-Frank, while both highly imperfect pieces of legislation, are thematically correct – create an environment that fosters, not hinders competition (as well as innovation) and reduce the reliance on the Big Three and on NRSROs in general. If these two tenets can be guiding principles for reform, there is hope.

Appendix A

Panel 3 — Alternative Compensation Models
This panel will discuss other potential alternatives to the current issuer-pay business model. The questions that the panel could consider include:

Q: What are other potential alternatives to the current issuer-pay business model?

A: The Report does a good job of laying out a variety of alternative ratings business models. For the most part, however, none of them are really viable. They are alternatives for alternatives' sake as opposed to being practical solutions. Most have vast unintended consequences of actually thwarting or undermining competition and further reinforcing the dominance of the Big Three incumbent players. Also, some, like the investor owned options, are academically interesting but practically speaking highly unlikely.

The most disappointing feature of The Report in our minds is the disregard for the only current alternate model in the market, "subscriber-paid" ratings. No proposed model is a real variation or even modification of the current subscriber-paid paradigm. It is almost as though the model has been written off as unviable when the empirical evidence suggests otherwise. We are aware that many say that institutional investors do not want to pay for ratings, but Rapid Ratings is paid by institutional investors. We contend that no one wishes to pay for something they can get for free, but that people pay for value when (and if) they see it. It's also worth noting that each of the Big Three NRSROs currently have data subscription businesses that are highly profitable and rarely discussed. In their case, the purchasing habits are driven more by necessity to have the ratings en mass from these shops than an endorsement of the value of any one rating or firm, but they are purchased nonetheless. It's also worth recalling that the large CRAs were exclusively subscriber-paid business models until the mid-1970s.

We contend that, absent an imposed structural change like one of the business models contemplated in the Report, ultimately the market will choose winners and losers in the ratings business if there is a level playing field. A level playing field means competitor CRAs can grow unimpeded, have realistic and definable cost structures and have access to data/information on an equitable basis. Granted changes outside of the Commission's purview would be necessary, such as changing public fiduciaries' hard coding S&P and Moody's into their investment guidelines. But in a perfect world where competition is granted a flat, not uphill, road, we are confident that the subscriber-paid business model can support many new market entrants. Even without these changes, and with a hill of structural impediments, Rapid Ratings is selling subscriptions to hedge funds, funds of funds, public and private pension funds, insurance companies, banks, broker dealers, corporations and others.

If you want competition, tear down the walls and don't erect new ones. End the three year eligibility requirements for NRSROs in the CRA Act so more non NRSRO CRAs can avail themselves of 17g-5 and any new initiatives that allow for greater access to data used for rating new structured products (or other asset classes, for that matter). Increase the scope of 17g-5 to the real opportunity for new entrants – outstanding issues rather than new issues only. Do not over engineer ratings selection processes and boards that have conflicts and may or may not be able to execute their duties successfully. Begin exploring ways of reducing institutional

investor's investment guideline reliance on ratings. And overall, generally keep the focus on facilitating and not impeding competition. These elements will facilitate innovation, competition and diversification of ratings techniques. Ultimately market players will decide what mix of CRAs' products best suit their needs and will subscribe and support accordingly.

Q: **What potential advantages and disadvantages would come from establishing a licensing and certification requirement for NRSRO analysts?**

A: In concept there is nothing wrong with having a certification/licensing program for analysts. The challenge for traditional CRAs, those that generally speaking rely on qualitative, human analysts as opposed to quantitative methodologies like Rapid Ratings, is that there is competition for good talent. There was a golden era for ratings analysts in the 80s and 90s when there was strong cache to being a career analyst. Even today, the alumni of Moody's and S&P tend to be quite close and fraternal. But in more recent years there has been a real talent drain. Analysts who cut their teeth at an agency early in their career could make significantly more moving to banks or buy-side shops. Even in the 90s all the top and mid-level banks staffed "rating agency advisory" departments filled with ex-Big Three staff. Their roles have been to advise bank clients on how to manipulate the rating agencies to achieve the best ratings possible from ex colleagues. With the exceptional reputational damage the Big Three have brought on themselves as a result of the financial crisis, the hiring and retention problems for the agencies continue today. So, training and certifying is one thing, attracting and retaining the talent who want to be in a traditional agency in the first place is another thing entirely.

As for newer entrants into the market, certainly there are new and already experienced analysts who wish to blaze a new path as ratings entrepreneurs. The challenge for any certification program is to make sure that the certification qualities for being a ratings analyst do not become prescriptive to the point of homogenizing the end product. In other words, new entrants should be encouraged to bring innovation to ratings, not to approach the ratings business with the same engine in a different chassis. Creating a licensing and certification requirement for ratings analysts will make it harder for new CRA entrants to compete. Let the industry create certification standards. The government should stay out of it. At Rapid Ratings we have no analysts because our ratings process is automated, so we have no vested interest in arguing this position. Our message is: keep it simple and minimize barriers to entry.

Q: **Would a system of NRSRO rotation be workable?**

A: It depends on the design. For all the reasons highlighted in the preceding pages, NRSRO rotation is problematic. With the current NRSRO designation requirements under the CRA Act, and the types of proposals currently under review for alternate payment models, we see rotation benefiting the status quo in the following order: The incumbent Big Three, the small group of other NRSROs licensed for structured product ratings, and in a distant third, new competitors. Given this is essentially the current market dynamic, adding bureaucracy, opaque and potentially conflict filled boards to govern rotational process to achieve little change is a massive wheel spinning exercise.

Q: What would be the effects of requiring NRSROs to use compensation systems other than the issuer-pay model?

A: We are not sure on what basis a revenue model (issuer-paid) can be banned or on what basis another can be required. We point out that the top issuer-paid agencies are in reality also subscriber-paid as they have significant subscription based businesses.

Q: Should the SEC require issuers to hire at least one smaller NRSRO to rate each structured finance issuance? Would opinions of these smaller NRSROs help to mitigate any conflicts of interest in the issuer-pay model of the larger NRSROs? How should "smaller NRSRO" be defined? Would such a requirement cause a race to the bottom among the smaller NRSROs? Would it increase costs to issuers?

A: Requiring an issuer to use any firm presupposes that the requiror can justify the designee firm as being qualified. Whether by rotation or other means, the firm assigned to rate needs to be qualified and the board or mechanism to select them will need to be experienced sufficiently to opine on that qualification. This is a tall order. If the issuers may pick a small firm at their discretion, this problem is eliminated but all the traditional conflicts of interest in the issuer-paid ratings paradigm simply get spread to a broader universe of raters.

Opinions of the smaller firms will only marginally help to eliminate the conflicts of the larger NRSROs. The reputation of the large NRSROs will erode over time but given the revenue jump of the Big Three since the global financial crisis it would seem that it is not reputation that drives revenue, rather it is generic market demand combined with regulatory protection that does that job. It is a challenge for any small firm that relies on traditional analysts to gain the scale and to rate the volume necessary to meaningfully move the needle. However, for certain the market can benefit from having alternate opinions and analytics and smaller firms can make an immediate impact on deal by deal bases because they have greater accuracy or flexibility and speed. Thus, arrangers and issuers may be encouraged to pick a smaller rating agency for each structured finance product rating, but this move should be accompanied by eliminating regulatory barriers to entry for small CRAs. Additionally, this initiative cannot be accompanied by a massive allocated cost for participant firms or it will inadvertently discourage the small CRA participant.

Below the scale of dominant CRAs such as S&P and Moody's there is a lot of flexibility on where the line of "small" is drawn given how much larger they are than any other firms.

A requirement to use a smaller firm does not necessarily cause a race to the bottom. We believe there is too much concern paid to this concept. New entrants and young firms need to compete by innovating and providing good product but they can only grow and prosper if regulatory barriers to entry are minimal. S&P, Moody's and Fitch were able to compete in the RMBS and CMBS ratings boom by aggressively competing for market share at the expense of quality ratings. But they were ultimately only able to get away with this behavior because they are part of a tight oligopoly and the other market players (bank arrangers, law firms, regulators, investors) enabled their behavior. Any young firm competing today needs to provide quality analytics or they will be rejected by the investment community. They may be able to convince

a handful of issuers to hire them, but they will ultimately survive on the quality of their product and if government reduces or eliminates the regulatory barriers to entry.

If required to hire a small firm, the cost to the issuer will rise unless the small firm rates for free. The only way a small firm can afford to do such a thing is if it has an incredibly low cost model and is predominantly or completely subscriber-paid. Barring this, yes issuance costs will rise.

Q: Should issuers be required to provide credit enhancement that is no lower than the second lowest quote it receives from NRSROs? Should the issuer be permitted to hire any NRSRO it chooses, as long as it provides enhancement no lower than an amount equal to the second lowest quote? Would this method help to satisfy investor guidelines and mitigate ratings "shopping"?

A: This seems to only further enforce the concept of ratings shopping. Credit enhancement will increase issuance costs. Higher issuance costs may, in the extreme, stymie new issuance. The best antidote to ratings shopping is to require an issuer to disclose any CRA it approaches on even a preliminary basis and to have any preliminary rating also disclosed by both the issuer and corroborated by the ratings firm.

Q: Should issuers be required to disclose which rating firms they have solicited for feedback, regardless of which firm or firms, if any, they engage to issue a rating?

A: Yes, see above.

Q: Are investors' voices being heard in the rating selection process and in the terms of structured finance transactions? If not, how could investors have more input?

A: The investment community has long been one of the three legs of the stool in the ratings paradigm. Issuers, rating agencies and investors have lived in a dynamic that is mutually beneficial at times yet with natural tension at others. So many institutional investors have embedded "NRSROs" or S&P and Moody's specifically by name in their investment guidelines that they have by definition spoken on the ratings selection process. It should also be noted that many investors support the current ratings paradigm because inefficient and slow to change ratings indeed provides monetizeable arbitrage opportunities. This says a lot about a conflict of interest which is seldom discussed.

Q: Would a compensation scheme that required NRSROs to charge a flat fee reduce the potential for inflated ratings?

A: Yes fixed fees would assist at the margin. Competing for issuer-paid business is less about the absolute dollar fee and more about winning the business first, and revenue second. This is not to say firms are callous about their fees. Rather, because most deals will have one, two or maybe three ratings, the principal goal is to be one of those firms fees notwithstanding. A fixed fee would eliminate this variable from a CRA's competitive toolset.

Q: Are there any other potential alternatives that the Commission has not yet considered?

A: Please see comments above regarding the existing subscriber-paid model.

Appendix B

Testimonies and Comments Submitted to US Congress and the Securities and Exchange Commission by Rapid Ratings International Inc.

Opening Remarks and Testimony Concerning: "The Collapse of MF Global". Before US House Representatives Committee on Financial Services and Subcommittee on Oversight and Investigations. February 2, 2012

Opening Remarks and Testimony Concerning: "*Oversight of the Credit Rating Agencies Post Dodd-Frank*". Before US House Representatives Committee on Financial Services and Subcommittee on Oversight and Investigations**.** July 27, 2011

Testimony Concerning: "*Transforming Credit Rating Agencies*". Before the United States House of Representatives Committee on Financial Services and Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises**.** September 30, 2009

Testimony Concerning: Proposals to Enhance the Regulation of Credit Rating Agencies. Before the US Senate Committee on Banking, Housing and Urban Affairs**.** August 5, 2009

Opening Remarks and Submission to the US Securities and Exchange Commission Roundtable to Examine Oversight of Credit Rating Agencies. April 15, 2009

Appendix C: A Comparison of Payment Options Considered in the Report

		OWNERSHIP			DOES THE OPTION MEET THE DECISION CRITERION?							
	OPTION: Model Type[i]	Investor-owned	Independ-ent	Issuer-owned	Enhances independence	Promotes Accountability	Promotes competition	Transparency	Feasibility: simple with low costs	Effectiveness	Fairness	Net Benefits
1	STATUS QUO (CRARA 2006)	No	More than 2	No	More than 2	Better than 2	Better than 2	Better than 2	Better than 2	Better than 2	Better than 2	Better than 2
2	Franken CRA Board assignment	No	Yes	No	No	No	No	No	No	No	No	No
3	investor-owned credit rating agency model* (IOCRA)[ii]	Yes	No	No	More than 2 but can still exhibit conflicts of interest[iii]	Yes (one IOCRA rating and one NRSRO rating)	Yes but might edge out small CRAs	It depends on the design	Could be expensive to develop but better than 2	It depends on the design	Might edge out small CRAs	It depends on the design
4	stand-alone model[iv]	No	Yes	No	Doubtful. CRA still selected by issuers	It depends on the design	Payment delays will deter smaller CRAs from entry	Good securities info but poor payment info	Payment system likely expensive to develop & maintain	Likely payment system problems[v]	It depends on the design	Doubtful
5	designation model[vi]*	No	Yes	No	Unlikely. Payment system through 3rd party is not sustainable	Doubtful	Motivation to compete is weak since CRAs must do the work without assurance of payment	No; too much un-certainty	No	No	No	No
6	user-pays model[vii]	No	Yes	No	Unlikely. Complex payment & audit system not sustainable	Doubtful	The convoluted payment system will deter entry	No; too much un-certainty	Complex & Expensive payment and audit system	No	No	No
7	issuer and investor-pays model[viii]*	No	Yes	No	Unlikely. Complex payment & mgmt system not sustainable	Doubtful	Not if the payment system is deficient; this option introduces a queue and a per-formance review	No; too much un-certainty	Payment system likely expensive to develop & maintain	No	No	No

8	**alternative user-pays model**	No	Yes	No	Unlikely. Complex payment & mgmt system not sustainable	Doubtful	The convoluted payment system will deter entry	No; too much un-certainty	Payment system likely expensive to develop & maintain	No	No. Bidding system would lock out small CRAs	No

*- Free to the Public

---

[i] SEC4, 2012, Report to Congress on Assigned Credit Ratings

[ii] Either for-profit or not-profit entities. No limit on the number of INOCRAs permitted.

[iii] Because investors have a strong interest maintaining high ratings, just as do issuers and hence may pressure their IOCRA to conform to confirm to their view.

[iv] "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."

[v] Much of the incidence of payment may fall on the issuer in any case, leaving little gain for this high cost exercise.

[vi] "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. 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." (p, 66).

[vii] "Under the user-pay model, issuers would not pay for ratings. 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." (p.68). Capturing free riders goes too far. A less ambitious target would make this model work better, as would eliminating the audit. CRAs should be allowed to compete in the market for investor clients. This is such a badly designed model that it colors opinion about any model which is a user-pays model. A more simple requirement is to have the issuer pay for a rating from a traditional rating agency and also for a rating from a subscriber-pays CRA.

[viii] The queuing system proposed in this model has a number of deficiencies: "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." (p. 69). The principal deficiencies with the queuing system are: (1) it provides no rationale for the initial position allocation (if it is random then how will inadequately skilled CRAs do the work, (2) it makes inadequate allowance for fluctuations in CRA scale and capabilities in the structured finance product area, and (3) it makes inadequate allowance for issuer and investor objections.