May 13, 2013 ***<u>Via E-mail</u>***

Securities and Exchange Commission
100 F Street, N.E.
Washington D.C. 20549

RE: File Number 4-661
Credit Ratings Roundtable

Ladies and Gentlemen:

This letter provides comments on the Securities and Exchange Commission's (the "SEC") Report to Congress on Assigned Credit Ratings, dated December 2012 (the "Report"). The opportunity to contribute thought is most appreciated and I do look forward to participating in the May 14th Roundtable discussion (the "Roundtable").

INTRODUCTION

The objective of these comments is to convey what could be a feasible and effective portion of the regulatory framework for structured products credit ratings. In my view the best framework would be a combination of the numerous proposals covered in the Report. I don't believe all of the issues raised can be solved with legislation and/or regulations. Some reforms require the cooperation of the financial community, good corporate citizenship. There should be low tolerance for parties who choose policy circumvention or compliance obfuscation over sustained compliance with laws and regulatory guidance as well as the spirit, or societal objective, of said statutes. Capital markets participants should be expected to respect these markets as they would the very street where they live. One could reasonably argue that without such honorable citizenship no amount of good policy and regulation would be effective and/or sustainable. We know it is impossible to cease all potentially flawed professional judgment with regulatory policy.[1] Therefore a cornerstone of this message is the need to fund and mandate specialized ethics training in colleges, universities and every level of management in the structured finance banking sector.

In many respects domestic U.S. structured products, bond ratings and capital markets may be considered American brands. Bond credit ratings serve a "bricks and mortar" role in the statistical control of these fixed income and derivatives markets. Much of the extremely high volume data present in fixed income and derivative markets is calibrated by risk level and/or credit rating (i.e., data control element). As such, there should be low tolerance for parties who pollute markets with practices that dishonor our hard earned American brand. Any party,

[1] Please see the last paragraph of page 76 of the Report for an example of logical limits to what can reasonably be achieved.

NRSRO or otherwise, polluting markets and/or mal-affecting ethical and fiduciary trust of capital markets should be examined. It is important that this aspect of regulatory oversight include any parties contributing ratings dependent data to rating agencies. We know any statistical model tends to only be as good as the data it is fed. NRSROs should have a channel to report any potential abuses to the authorities in a manner that does not disincentivize such reporting. And the annual NRSRO examination program should focus very closely on the risk of bad data being fed to NRSROs.

Attempting to solve all of the issues raised in the report with rules, regulation and operational design would likely result in an overly onerous system that smothers innovation and market efficiency. It would be worthy to implement a regulatory regime that solves most matters, does not smother or disincentivize growth and innovation, and employs a strict regulatory examination regime. That examination regime could be mobilized, as needed, if/when market practices are trending poorly (red flags) in areas where reform was needed but moral-suasion was chosen over pointed regulatory rules for fear of smothering markets and/or imposing operationally unsustainable terms.

Another cornerstone of this message lies in protecting free markets. Bond underwriting is a capital and intellectual property intensive discipline. Syndicates are established to deliver competitive and optimal securities distribution strategy. This traditionally calls for syndicates to support liquidity of the securities in the secondary market, which often means providing a bid for the securities, as needed. Bond underwriters traditionally commit capital to these efforts and a poorly received offering can result in extended (time) balance sheet utilization. Credit rating is a major determining factor of bond liquidity marketability. Since the failure to place bonds traditionally results in longer balance sheet (capital) utilization underwriters should maintain the freedom to select an NRSRO and to pay that agency a reasonable fee agreed upon between the underwriter/sponsor and the rating agency, subject to regulatory oversight. The protection of this free market dealing is key. Lack of such protection could be the most weighted factor in a potential smothering of markets outcome.

A PROPOSED FRAMEWORK

The best system may include a combination of the numerous proposals covered in the Report, coupled with potentially new thought. Specifically, an effective system may include:

- A 17g-5 based regime with an NRSRO chosen (for each new issue) by a designated investor trade group.

- No mandate for unsolicited ratings. The option could remain available for qualified parties but the ratings should be assigned after bond closing and based on publically available information. NRSROs' and investment banks' business processes and platforms are costly and proprietary, and should not be forcibly shared freely.

- An integrated stand-alone fee model funded by bond underwriters/issuers/sponsors.

- NRSRO fee vesting over time provided performance criteria is satisfied.
- NRSRO fee vesting cessation based on performance.
- NRSRO fee claw back covenants based on performance.
- Enhanced regulatory examination, oversight and enforcement regime.

In this proposed framework the bond underwriter would select one or more NRSROs to rate the bonds for each new issue. The planned issuance is then listed on a planned issuance calendar at a time no later than three days prior to when the first deal specific information is provided to the NRSRO selected by the bond underwriter. The planned issuance calendar would inform all NRSROs as well as a designated investor trade organization of the coming transaction. Any NRSROs not selected by the bond underwriter and interested in rating the transaction would express their interest electronically in the planned issuance calendar. The designated investor trade organization would then select an NRSRO to rate the new issue.[2]

NRSRO Compensation

One half of each NRSRO's initial rating fee and one half of each NRSROs first year surveillance fee would be paid at or prior to bond closing by the bond underwriter/issuer/sponsor. The remaining balance of the initial rating and first year surveillance fees would be deducted from bond cashflow before any funds are released to investors. The fees would be deducted by the bond trustee on a pro-rata basis from each class of bonds based on initial class principal balance. Every 12 months thereafter one half of the NRSROs annual surveillance fees would be deducted from investor cashflows in an identical manner, based upon remaining class principal balances. The remaining surveillance fee balance would be billed to the transaction sponsor.

The surveillance fees captured from investor cashflow would be held at the trustee level until six months of seasoning occurs in any given 12 month cycle. After six months of seasoning in a given year the annual surveillance fee would be made available for release to the NRSROs. Should the bond issue be fully retired prior to six months of seasoning in a given 12 month cycle the trustee would pro-rate the fee, return the balance to investors and make the appropriate pro-rated amount available for release to the NRSROs.

NRSRO Fee Vesting & Performance Criteria

Each NRSRO would be required to hold one third of all <u>initial</u> rating fees (no surveillance fees) in a segregated account with a "*subject to regulatory enforcement action*" custodial bearing. Those funds will vest to the NRSRO overtime based upon performance and regulatory compliance. Vesting would take place over the life of the investment grade securities, with 10% of the original fees balance deposited to the segregated account vesting annually until the investment grade securities are fully retired. Annual vesting would require authorization from the regulator following performance assessment and completion of annual regulatory

[2] The growth and/or creation of new NRSROs could be assisted with favorable financing and/or incentives being made available to parties who qualify. Parties with strong reputational capital and established institutional footprint may be reasonable candidates (e.g., Bloomberg, PIMCO, General Electric, State Street, Alliance Bernstein, KPMG, etc.)

examination. Once all investment grade securities are fully retired any remaining fees that have not yet vested <u>may</u> vest following performance assessment, completion of the next annual regulatory examination of the NRSRO and authorization from the regulator. NRSRO periodic performance breaches could result in cessation of fee vesting for a given transaction until performance cures, if at all.

Transaction performance should be a loss curve driven methodology. Specifically, if a given transaction deviates (actual) from the NRSRO's deal specific loss curve for 3-4 consecutive quarters and said deviation exceeds a predetermined (by regulators) range of tolerance the rating would be considered potentially in breach of <u>periodic performance parameters</u>. Similarly, if the transaction's actual cumulative losses exceed a predetermined (by regulators) range of tolerance <u>above</u> the NRSRO's lifetime cumulative loss estimate the rating would be considered potentially in breach of <u>lifetime performance parameters</u>. The periodic performance tolerance should become more liberal with deal age, as pro-forma estimates are naturally less bankable with time.

The breaching of performance parameters should necessitate a short-form regulatory review process intended to determine why the breach occurred. This review could be undertaken as part of the annual examination program or via some other abbreviated process. If a periodic breach is confirmed and determined to be a true performance shortfall then said breach would result in fees vesting cessation for that transaction and adverse scoring for the NRSRO. This adverse scoring would be a factor considered by examiners in their annual review of the NRSRO and factor into regulatory decision making. The failure of fees to vest due to periodic performance breach would not remove funds from the segregated account. If a transaction records periodic breaches but the investment grade bonds are retired without a lifetime performance breach then a curing may have taken place and fees <u>may</u> then vest with authorization from the regulator following the annual examination.

Lifetime performance breaches occurring prior to retirement of the investment grade securities may result in fee recovery by the regulator from the NRSRO's segregated account. The fee recovery rate (*for lifetime performance breaches*) should become less punitive with deal age. One half of fee recoveries should be used to fund ethics training in colleges, universities and structured finance divisions of financial institutions. The remaining half of fee recoveries should be directed to fund related regulatory special projects and targeted examinations (not annual examinations).

<u>**ISSUES & PROPOSALS RAISED IN THE REPORT**</u>

The following offers thought relating to select issues and proposals included in the Report.

<u>*Reducing Reliance on Credit Ratings*</u> – While reducing reliance on credit ratings may lead to analytical growth and risk governance improvements on the buy-side, it would also further empower the active bond trading community. Increased empowerment of the active bond trading community may lead to increased market volatility for structured products and potentially expose workers' savings to more risk.

Analytical and risk governance improvements on the fiduciary buy-side can be realized without lessening reliance on credit ratings. These objectives can be achieved via more pointed regulatory action in this specific area.[3]

<u>*Section 15E(w) System*</u> – A Section 15E(w) System would not be feasible primarily because it would likely smother market activity. Since bond underwriting is a capital intensive discipline and bond ratings are major determining factors of bond liquidity, underwriters should be permitted to choose an NRSRO and to pay that agency a reasonable fee that is agreed upon between the underwriter/sponsor and the rating agency, subject to regulatory oversight.

Additional potentially negative results of 15E(w) may include:

- Bottleneck delays at the CRA Board level.

- Government accountability for outcomes (i.e., moral hazard and Government reputational risk).

- Encroachment upon Investment Banks' intellectual capital (valuable property).

- Endangering research and development investments NRSROs have to make in order to rate instruments.

- Lack of consistency in financings that could otherwise be refined financing programs if transaction parties remained unchanged. This can impact cost of deal execution and bond liquidity (i.e., story bonds vs. proven program bonds).

Reduced bond marketability/liquidity traditionally results in more balance sheet risk for bond underwriters. Forcing bond underwriters to change NRSRO may increase their balance sheet risk, to the extent a new NRSRO's criteria employs different asset treatment and/or confuses investors (i.e., story bonds).

If a 15E(w) system is implemented the following adjustments may be helpful:

- NRSROs expressing interest in rating a specific transaction prior to being selected by the CRA Board.

- Bond underwriters and/or NRSROs retaining the ability to cease the ratings process.

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[3] Highly leveraged, below prime credit quality RMBS issues were widely and profoundly oversubscribed late into the credit and asset valuation cycle (2004-2007). This may call the risk governance of fiduciary investors into question.

Reputational Risk – Reputational risk issues can be effectively addressed with:

- Compensation policies that incentivize ethical practice and bankable transaction performance over time.
- Elevating managers of learned, good character.
- Specialized ethics training to students, early career professionals, middle management and senior structured finance leadership.

All market participants should maintain focus on ensuring the culture of their workforce employs high ethical standards and respect for the institution. This is a free market matter that should not be regulated. Organizations that present systemic risk based on examination findings should be addressed on a case by case basis.

Measuring Accuracy of Credit Ratings – The loss curve should be the primary measure of performance of NRSROs in this regulatory regime. A methodology could be employed that measures actual periodic and life of transaction loss curve variances from the curve employed by the NRSRO at time of rating assignment. Actual performance measurement vs. the modeled curve should inform NRSRO fee vesting and feed a scoring system considered by examiners in the annual examination program.

NRSRO Compensation - The bond underwriter should hire at least one NRSRO and a designated investor led trade group should be encouraged to hire an NRSRO for each offering. The initial rating fees and the annual surveillance fees should be shared equally by bond underwriter/issuer/sponsor and investor (i.e., two contingencies split the ratings fees).

Investor Owned Credit Rating Agency Model – An investor owned credit rating agency model would present a conflict of interest. NRSROs need to be unbiased. Having NRSRO ownership represent the same parties consuming that NRSRO's products violates best practices relating to unbiased financial work products.

Stand-Alone Model – This proposal is partially acceptable and feasible, with the exception of fees being dependent on secondary market transactions. NRSROs realizing fees via secondary market trades would be operationally onerous and may not compensate NRSROs enough to justify sustained quality and breadth of the work products.

Designation Model – This proposal is not feasible and would pose a disservice to the capital markets. Ratings quality would be expected to deteriorate due to NRSROs not being paid for their services. The ratings business requires significant investment in research, administration, new ratings and surveillance personnel and platforms. These cost structures require some form of bankable revenue in order to be sustained.

User-Pay Model – This proposal is not feasible for the following reasons:

- Too operationally onerous.
- Delaying audit opinions on this basis invites systemic issues.
- Complications around the definition of "Auditor's Satisfaction."

Given the large size of the accounting industry trade group, bringing the accounting lobby into this issue in this manner would further complicate matters.

Alternative User Pays Model – Although NRSRO competitive bidding could be employed by the bond underwriter, rating fees need to remain a "free market pricing-bearing" while being subject to regulatory scrutiny. Investment banking and bond underwriting are intellectual property pursuits that are capital intensive. Bankers need the freedom to decide who rates the bonds because their firm's capital and reputation are at stake in the offering.

Issuer Pay Model – In prior structured finance cycles the issuer, bond underwriter and program sponsor have been related entities but there is no guarantee that will continue to be the predominate paradigm going forward. For example, I believe Redwood Trust has sponsored structured products issuance but their securities have been underwritten and distributed by investment banks unrelated to Redwood Trust. Traditionally the bond underwriter selects the rating agency, although the issuer/sponsor is typically charged with the expense of paying the NRSRO fees. Of course the issuer and/or transaction sponsor may endeavor to impose an NRSRO on the bond underwriter, which may or may not be met with acceptance.

The underwriter is charged with optimizing the liquidity of the newly issued securities. Therefore the underwriter should be permitted to select the NRSRO and pay that NRSRO a reasonable fee for the services rendered, subject to regulatory oversight.

Conflicts of Interest – These problems can be greatly alleviated and/or remediated by regulatory performance examination and public results reporting. If an NRSRO's risk forecasting performance is weak relative to other NRSROs, investors will likely ascribe a deeper discount to like securities rated by the weaker NRSRO. This will cause investment bankers/bond underwriters to be less wedded to any single NRSRO relationship.

CONCLUSION

Based on observations cited in the Report there is no debating reform is needed. While much great work has been done by many to bring about improvement and to repair damage to trust in markets, there are limits to what can be achieved with legislation and regulatory oversight. All forms of questionable professional judgment cannot be protected against without employing market smothering regulation. At some point free markets, good corporate citizenship and proactive systemic risk surveillance must be relied upon to remediate parties employing poor judgment. Elements of this reform strategy which may be helpful include:

- Regular inter-agency communication and collaboration.
- Close collaboration with the Financial Stability Oversight Council.
- Specialized ethics training for structured finance professionals and students studying finance related disciplines.
- NRSRO fee vesting over time based on performance.
- Investor empowerment in the ratings process.
- Communication channels for NRSROs to report suspicious activity.
- Surveillance of third parties performing key functions that feed into the ratings and risk analytics practice.

Examination, oversight and enforcement are the most important foundational elements to this new ratings regime. The annual examination program should employ routine rigor as well as be flexible enough to respond to indicators and intelligence, as needed. NRSRO performance, intelligence, ongoing regulatory dialog, issues remediation, etc. should all have the ability to trigger reviews and examinations over and above the annual frequency. The regime should also closely consider imbedding unannounced surveillance at select postings in and around structured assets and securities processing pipelines. This may include third parties that serve systemically important functions within these processing pipelines. Making examination and performance data public should influence the natural order of market flows, thereby motivating lesser performing parties to solve problems.

Empowering investors to hire NRSROs for new issues should deliver a natural tension to the ratings discipline that may convey significantly more risk intelligence to market participants. The efficiency of markets will be challenged by this but the depth and breadth of buy-side analytics should increase. Market participants can be expected to seek rational for gaps between NRSRO ratings, thereby fueling qualitative evolution of fiduciary investing. The decision making behind how savers' funds are invested is expected to be supported by additional thought and analysis, as examiners remain on watch protecting the American brand.

Thank you again for this opportunity to comment.

Sincerely,

/s/ Arthur H. Bolden II
Arthur H. Bolden II