August 5, 2011

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

Re: *Proposed Rules for Nationally Recognized Statistical Rating Organizations*, File No. S7-18-11

Dear Ms. Murphy:

AFSCME is pleased to comment on "Proposed Rules for Nationally Recognized Statistical Rating Organizations" (the "Proposed Rule") issued by the Commission in Release No. 34-64515 (the "Release"). The American Federation of State, County and Municipal Employees ("AFSCME"), is the largest union in the AFL-CIO representing 1.6 million state and local government, health care and child care workers. AFSCME members participate in over 150 public pension systems whose assets total over $1 trillion. In addition, the AFSCME Employees Pension Plan (the "Plan") is a long-term shareholder that manages $850 million in assets for its participants, who are staff of AFSCME and its affiliates. Through public policy advocacy and company-specific initiatives, AFSCME and the Plan have long championed transparency and accountability in the capital markets.

We appreciate the complexity of the Commission's task in implementing the provisions of Dodd-Frank aimed at reforming Nationally Recognized Statistical Ratings Organizations (NRSROs). In some areas, the Commission has proposed changes that will provide meaningful benefits to investors. The bulk of the Proposed Rule, however, defers too much to the NRSROs, leaves key terms undefined (thus dooming enforcement efforts) and proposes measures that will not change NRSRO behavior. In short, much of the Proposed Rule simply will not accomplish the objectives set out in Dodd-Frank.

The major shortcomings of the Proposed Rule are that it:

- Abdicates responsibility for supplying substantive content for Dodd's Frank's requirement that NRSROs establish, maintain, enforce and document an effective internal control structure governing ratings determinations;

American Federation of State, County and Municipal Employees, AFL-CIO
TEL (202) 429-1000 **FAX** (202) 429-1293 **TDD** (202) 659-0446 **WEB** www.afscme.org 1625 L Street, NW, Washington, DC 20036-5687

- Ignores abundant evidence of pervasive conflicts of interest affecting ratings methodologies and decision, choosing to define a prohibited conflict of interest so narrowly as to be useless; and
- Renders Dodd-Frank's universal ratings provisions meaningless by allowing NRSROs to define ratings symbols differently as applied to different ratings classes.

Introduction

Broad agreement exists that the NRSROs played a key role in causing the financial crisis. "It has escaped almost no one's attention," Columbia Professor John Coffee testified in March 2009, "that the credit rating agencies bear much responsibility for the 2008 financial crisis . . . ."[1] The Report of the Permanent Senate Subcommittee on Investigations into the causes of the financial crisis stated that "[t]he investigation found that the crisis was not a natural disaster, but the result of high risk, complex financial products; undisclosed conflicts of interest; and the failure of regulators, the credit rating agencies, and the market itself to rein in the excesses of Wall Street."[2] Michael Barr, Assistant Secretary for Financial Institutions, testified in August 2009: "Ultimately, this led to serious overreliance on a system for rating credit that was neither transparent nor free from conflict. And when it turned out that many of the ratings were overly optimistic, to say the least, it helped bring down our financial system during the financial crisis."[3]

By 2010, Moody's and S&P had downgraded to non-investment-grade status over 90% of subprime residential mortgage-backed securities (RMBS) issued in 2006 and 2007 originally rated AAA. [4] This extraordinarily poor performance was driven by a combination of factors, including poorly-designed and out-of-date ratings models, frequent departures from ratings methodologies, a marked decrease in due diligence performed on assets underlying rated securities and inadequate resources for rating and surveillance functions.[5] These phenomena were logical consequences of an obsessive focus on market share and the absence of countervailing incentives to prioritize ratings

---

[1] Testimony of Professor John C. Coffee, Jr. Before the U.S. Senate Committee on Banking, Housing and Urban Affairs, "Enhancing Investor Protection and the Regulation of Securities Markets," at 10 (Mar. 10, 2009).

[2] U.S. Senate Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, "Wall Street and the Financial Crisis: Anatomy of a Financial Collapse," at 1 (Apr. 13, 2011) (hereinafter, "Levin Report").

[3] Testimony of Michael Barr Before the U.S. Senate Committee on Banking, Housing and Urban Affairs, "The Examination of Proposals to Enhance the Regulations of Credit Rating Agencies," at 6 (Aug. 5, 2009) (available at http://www.gpo.gov/fdsys/pkg/CHRG-111shrg55739/pdf/CHRG-111shrg55739.pdf).

[4] Levin Report, supra note 2, at 267.

[5] See id. at 267-310; see also sources cited infra notes 6-12.

quality or mechanisms for holding NRSROs accountable for willfully or recklessly poor performance.

The Commission's own 2007 examination of the NRSROs found that they:

- Rated deals despite unresolved issues, resource constraints and incomplete methodologies;[6]
- Deviated from the ratings processes and methodologies disclosed pursuant to Commission rule and failed to document the reason for ratings model "adjustments";[7]
- Did not maintain written procedures for rating certain kinds of securities;[8]
- Failed to document "significant steps in the rating process" including the reason for ratings committee actions and decisions and the identity of significant participants in the ratings process;[9]
- Appeared not to perform adequate and timely surveillance of previously-rated securities;[10] and
- Maintained policies that allowed significant conflicts of interest to exist, including participation in fee discussions by analytical personnel and influence on ratings or ratings criteria of considerations of market share and other business interests;[11] the Office of Economic Analysis noted that the conflicts of interest inherent in the "issuer pays" model were exacerbated in the context of RMBS and CDO offerings because there were a limited number of arrangers who underwrote these deals, heightening the influence a particular client could wield.[12]

Congress responded to the overwhelming evidence of dysfunction by including a number of reforms targeted at NRSROs in the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). Section 931 of Dodd-Frank contained a Congressional finding that the inaccuracy of credit ratings on structured products "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 and around the world."[13] The purposes of the Dodd-Frank reforms were to ensure

---

[6] Staff of the Office of Compliance Inspections and Examinations, Division of Trading and Markets and Office of Economic Analysis, Summary Report of Issues Identified in the Commission's Staff's Examinations of Select Credit Rating Agencies, at 12 (July 2008) (hereinafter, "SEC Examination Report").
[7] Id. at 13-14.
[8] Id. at 16.
[9] Id. at 19-20.
[10] Id. at 21-22.
[11] Id. at 24-26.
[12] Id. at 31-32.
[13] Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111-203, (July 21, 2010) (available at http://www.gpo.gov/fdsys/pkg/PLAW-111publ203/pdf/PLAW-111publ203.pdf) (hereinafter "Dodd-Frank").

that conflicts of interests did not affect credit ratings; impose accountability on NRSROs through private litigation; reduce reliance on credit ratings in law and regulation; and improve the transparency of credit ratings and the ratings process.[14]

As an initial matter, we acknowledge that the Commission has been asked in Dodd-Frank to proceed along multiple tracks with respect to the NRSROs. Most of the Dodd-Frank reforms dealing with the NRSROs assume that the current "issuer-pays" business model, in which issuers, underwriters or sponsors of securities offerings engage NRSROs to provide credit ratings, continues to dominate the credit ratings market. The Proposed Rule, to a large extent, reflects this assumption. But Section 939D of Dodd-Frank requires the Government Accountability Office to study alternative business models for NRSROs and Section 939F requires the Commission to study "the feasibility of establishing a system in which a public or private utility or a self-regulatory organization assigns nationally recognized statistical rating organizations to determine the credit ratings of structured finance products . . . ."

In our view, meaningful exploration of alternatives to the issuer-pay business model is of critical importance. Many of our concerns about the Proposed Rule stem from a belief that conflicts of interest under the issuer-pay model resist effective management. Although an investor-pay or utility model is not free from problems, we believe they would be less acute. We recognize that business model reform in the near term has not been specifically mandated, however, and that strong rules governing the NRSROs under the current model are necessary to protect investors. Our comments below on the Proposed Rule are offered with these considerations in mind.

Internal Controls

Section 932(a) of Dodd-Frank amended section 15E of the Securities Exchange Act (the "Exchange Act") to require each NRSRO to establish, maintain, enforce, and document an effective internal control structure governing the implementation of and adherence to policies, procedures and methodologies for determining credit ratings, "taking into consideration such factors as the Commission may prescribe, by rule." That section of Dodd-Frank also required an attestation by the NRSRO's CEO as part of annual reports to the Commission. Dodd-Frank thus authorized, but did not require, the Commission to specify factors NRSROs must take into account in designing, maintaining and enforcing internal controls.

In the Proposed Rule, the Commission declined to use this authority, proposing instead to "defer prescribing factors an NRSRO must take into consideration with respect to its internal control structure."[15] We believe this would be a mistake. Because there is

---

[14] See Congressional Research Service, "The Dodd-Frank Wall Street Reform and Consumer Protection Act: Title IX, Investor Protection," at 5 (Nov. 24, 2010) (available at http://www.llsdc.org/attachments/files/260/CRS-R41503.pdf).

[15] Release, at 7.

ample evidence of the NRSROs' internal control failings, both in the SEC Examination Report and reports on other investigations, we strongly object to deferring rulemaking on this issue.

Successful implementation of many elements of the Proposed Rule—those addressing conflicts of interest, training and credit rating methodologies, for example—will not happen without effective internal controls. Effective internal controls require a framework against which controls can be benchmarked. When the Committee on Sponsoring Organizations (COSO) set out to develop the Internal Control—Integrated Framework in 1992, it recognized this, stating:

> Internal control means different things to different people. This causes confusion among business people, legislators, regulators and others. Resulting miscommunication and different expectations cause problems within an enterprise. Problems are compounded when the term, if not clearly defined, is written into law, regulation or rule.[16]

If history is any guide, allowing the NRSROs to design internal controls without any Commission guidance will result in weak internal control structures. The Commission supplied no guidance on what constitutes effective internal controls over financial reporting for many years, despite the Foreign Corrupt Practices Act's requirement that public companies maintain such controls; many observers believe this lack of a framework contributed to the financial reporting scandals at Enron, WorldCom, Adelphia and many other firms in 2001-2003.

Moreover, without concrete considerations, the internal controls requirement will be unenforceable. The Commission's Staff will find itself in the position of negotiating with the NRSROs without any credible threat of enforcement action. Accordingly, we do not believe that the objectives of the self-executing requirement in Section 15E(c)(e)(A) of the Exchange Act can be adequately achieved by NRSROs if the Commission does not do the following:

- Provide a basic definition of internal controls to be used by the credit rating agencies and the Commission staff in its inspections;
- Define what would constitute a "material weakness"—a serious deficiency in internal controls that would or did prevent the internal controls from achieving their objective;
- Specify the objectives of internal controls;
- Identify the level of assurance internal controls are expected to provide;
- Describe the basic components of internal control; and
- Set forth the fundamental steps for managing internal controls.

---

[16] Committee of Sponsoring Organizations of the Treadway Commission, "Internal Control—Integrated Framework," Sept. 1992, at 1.

Although the COSO framework was not developed for internal controls over credit ratings, the basic principles provide a useful reference for the Commission in connection with the steps described above. They could also be used as an interim framework until the Commission proposes rules tailored to ratings agencies. The five components of internal control identified by COSO are:

1. The control environment, including such factors as incentives, integrity and ethical values, management's philosophy and operating style, and organizational structure.

2. Risk assessment: measuring and analyzing risks facing the company.

3. Control activities, which encompass a wide range of activities including approvals, authorizations, verifications, reconciliation of data and segregation of duties. Control activities include the fundamental, documented policies and procedures, controls over information technology systems and a process for ensuring that the risk assessment affects the design, implementation and operational effectiveness of the control activities.

4. Information and communication within the organization, including communication with regulators, users of credit ratings and data suppliers.

5. Monitoring, which includes supervisory activities, management of processes and controls and board oversight. Monitoring ensures that internal controls deficiencies are identified and reported up to appropriate personnel and that serious and material weaknesses in internal controls are reported directly to upper management and the board.

We favor the requirement in the Proposed Rule for NRSROs to document their internal control structures. Investigations into the NRSROs' conduct during the years leading up to the financial crisis were hampered by the lack of documentation of key processes.[17]

The Commission must, however, set minimum standards for internal controls documentation. The Commission should prescribe that documentation should be sufficient so that a "reasonable experienced person" could review the documentation of the internal controls or the testing of those controls and reach similar conclusions with respect to:

---

[17] See, e.g., Levin Report, supra note 2, at 310 ("When asked to produce contemporaneous decision-making documents indicating how and when ratings were selected for downgrade, neither S&P nor Moody's produced meaningful documentation."); SEC Examination Report for Moody's Investor Services, Inc., at 5 (undated; examination initiated on Aug. 31, 2007) (available at http://fcic-static.law.stanford.edu/cdn_media/fcic-testimony/2010-0602-sec-ocie-report.pdf) ("Moody's does not consolidate its methodologies for rating subprime or CDO transactions in one location. As such, the Staff had difficulty locating the disclosure of certain aspects of Moody's ratings process.").

- The design of the system of internal controls;
- The evidence obtained, and conclusions reached, during the testing of the operational effectiveness of the internal controls;
- Material weaknesses in internal controls that were identified and their remediation;
- The oversight by the board of directors;
- Significant matters that arose in the design, operation or monitoring of internal controls and how they were resolved; and
- The basis for reports to the Commission on the operational effectiveness of internal controls and the internal control structure.

The Commission's minimum standards on documentation should require that the documentation be accessible to the Commission regardless of where the credit rating is produced. The Commission should specify a retention period for the documentation as well.

The Commission should also bolster the contents of the reports on internal controls to be provided to the Commission by NRSROs. In addition to including a description of the responsibility of management for establishing and maintaining an effective internal control structure and assessment of the internal control structure, the Commission should require reporting on:

- The period of time to which management's assessment relates—to wit, it should relate to the entire year and not just year-end, since ratings are issued throughout the year;
- The benchmark or framework used in assessing internal controls, as well as the definition of internal control used;
- A statement that the board of directors is responsible for overseeing the system of internal controls;
- If a material weakness was detected during the year, a description of that material weakness and whether it has been remediated (and how) as of the end of that year; and
- Non-compliance with applicable laws and regulations that have been identified, consistent with the Yellow Books standard of the Government Accountability Office.

It is important to recognize that by supplying guidance now, the Commission does not relinquish the right to adjust its rules in the future. If examinations of NRSROs yield information that informs refinement of the Commission's rules regarding internal controls, those rules can be amended.

Finally, we do not believe that there is any inconsistency between the requirement of Section 15E(t)(3)(C) of the Exchange Act that an NRSRO's board of directors shall "oversee" the "effectiveness of the internal control system with respect to the policies and procedures for determining credit ratings" and the Proposed Rule's requirement that management have primary responsibility for designing and maintaining an effective internal control structure. Boards have similar responsibilities with respect to internal controls over financial reporting—indeed, the boards of the two largest NRSROs by market share, Moody's and Standard and Poor's, both publicly-traded, have experience with such oversight—and there is no reason to believe that board oversight will be any more problematic in the NRSRO context.

Conflicts of Interest

Section 932(a) of Dodd-Frank directed the Commission to issue rules "to prevent the sales and marketing considerations of a nationally recognized statistical rating organization from influencing the production of ratings . . . ." Dodd-Frank required those rules to provide for exceptions for small NRSROs "with respect to which the Commission determines that the separation of the production of ratings and sales and marketing activities is not appropriate."

The Proposed Rule would add to existing Rule 17g-5 a prohibition on an NRSRO issuing or maintaining a credit rating where a person within the NRSRO who participates in the sales or marketing of a product or service of the NRSRO also participates in determining or monitoring the credit rating, or developing or approving procedures or methodologies used for determining the credit rating. Although this prohibition is unobjectionable, in our view it reflects a simplistic and narrow conception of the conflicts of interest that operated within the NRSROs during the years leading up to the financial crisis. As such, it will not prevent the recurrence of harmful conflicts.

Conflicts of interest had profound effects on the development of ratings methodologies and the ratings process itself. A recent study confirmed that the practice of NRSROs allowing "adjustments" to their models was widespread and that it had the effect of increasing the size of the highest rated and most marketable AAA tranche of collateralized debt obligations (CDOs). Griffin and Tang found that if NRSROs had adhered to their own models, only 1.3% of AAA CDOs closed between January 1997 and March 2007 would have been rated AAA.[18] Another study by the Federal Reserve Bank found that risk-adjusted subordination, a form of credit enhancement, declined significantly in subprime and Alt-A mortgage-backed security deals between the start of 2005 and 2007. The authors concluded that their findings supported the prediction in

[18] John M. Griffin and Dragon Yongjun Tang, "Did Subjectivity Play a Role in CDO Credit Ratings," at 4 (working paper 2010) (available at http://ssrn.com/abstract=1364933).

recent theoretical literature that ratings standards will decline when security issuance volume and revenues are high compared with reputational costs of mistakes.[19]

A consensus has developed that such decisions by NRSROs were motivated by a desire to accommodate investment banker clients in asset-backed security deals and increase or preserve market share. Evidence indicates, however, that direct pressure on ratings analysts by individual sales/marketing personnel—the only conflict prohibited by the Proposed Rule--was only one of many ways in which conflicts of interest undermined the integrity of the ratings process. Such explicit intervention was often not necessary.

Investigations produced evidence that issuer "ratings shopping" among NRSROs was common, so the implied threat of losing business was always present and needed no reinforcement by sales/marketing personnel.[20] Eric Kolchinsky, a former Managing Director at Moody's with responsibility for rating CDOs based on subprime mortgage obligations testified that "It was an unspoken understanding that loss of market share would cause a manager to lose his or her job."[21] Kolchinsky described a Moody's practice of detailing departments' market share to managing directors; if that share "dropped by a few percentage points, managers would be expected to justify 'missing' the deals which were not rated."[22] Mr. Kolchinsky testified that he was asked to leave the CDO group after he went over his manager's head to raise concerns about basing CDO ratings on RMBS ratings that Moody's knew were inaccurate.[23] Sales/marketing personnel and clients themselves had input over the assignment of ratings analysts to deals, and analysts who asked too many questions or were viewed as too demanding were excluded from deals.[24]

Accordingly, simply prohibiting the individual sales/marketing employee of an NRSRO who sold ratings services from participating in determining the rating or having input into the methodology used to determine it is not sufficient to prevent corruption of the ratings process. It is particularly important that the Commission get this right because it seems likely that the issuer-pay model will dominate the credit rating market in the near term. We believe that comprehensive structural reforms are required to ensure that

---

19 Adam Ashcraft et al., Federal Reserve Bank of N.Y. Staff Report No. 449, "MBS Ratings and the Mortgage Credit Boom," at 4 (May 2010) (available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1615613).

20 <u>See</u> Levin Report, supra note 2, at 287 (evidence of ratings shopping).

21 Statement of Eric Kolchinsky Before the Senate Permanent Subcommittee on Investigations, "Wall Street and the Financial Crisis: The Role of Credit Rating Agencies," Apr. 23, 2010, at 1 (available at <u>http://hsgac.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing_ID=5f127126-608a-4802-ba77-d1bdffdfbe9b</u>) (hereinafter, "Kolchinsky Testimony").

22 <u>Id.</u> at 2.

23 <u>Id.</u> at 3.

24 <u>See</u> Levin Report, supra note 2, at 284, 286.

NRSROs using an issuer-pay business model provide ratings untainted by conflicts of interest.

We urge the Commission to require the following measures, which will minimize the risk that ratings will be compromised by business considerations and reassure users of ratings regarding their integrity:

- *Firewall*: All communications between ratings and sales/marketing personnel should be limited and monitored.
- *Compensation*: If incentive compensation is used for upper management, it should be based in significant part on performance metrics related to ratings quality. Incentive compensation for ratings personnel should be based on performance metrics related to ratings quality and individual contributions, and ratings personnel should not be compensated in company stock or options. Sales/marketing personnel should have no input into compensation of ratings personnel. Compensation of ratings personnel should be carefully documented.
- *Personnel matters*: Sales/marketing personnel should not have input into the evaluation of ratings personnel. If client input is taken into account in evaluating ratings personnel, ratings personnel should be given a full opportunity to respond to such input. No adverse employment action should be taken solely as a result of client input.

The Commission also seeks comment on the contours of an exemption for small NRSROs from the proposed new absolute prohibition on participation by sales/marketing personnel in decisions around methodologies and individual ratings. We are mindful of the potential burden involved in separating personnel in a very small organization. We are not convinced, however, that the benefits to investors of encouraging more competition—especially the entrance of more issuer-pay firms—outweighs the need to mitigate conflicts of interest at small NRSROs.

A recent study calls into question the notion that more competition results in more accurate ratings. It found that the growth in market share enjoyed by Fitch Ratings, which emerged shortly after 2000 as a credible competitor to Moody's and S&P, coincided with lower quality ratings, as measured by the correlation between ratings and market-implied yields.[25] The study's authors concluded that increased competition among ratings agencies "likely weakens reputational incentives for providing quality in the ratings industry, and thereby undermines quality."[26] We have not seen evidence, moreover, that the small size of a firm makes conflicts of interest less likely to influence ratings.

---

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

Accordingly, we urge the Commission, as part of the small NRSRO exemption application process outlined in proposed new paragraph (f) of Rule 17g-7, to require small NRSROs applying for an exemption to explain in detail why separation of ratings and sales/marketing is inappropriate and to require concrete evidence, not just assertions, to support claims that an NRSRO has inadequate resources to establish separate functions. An NRSRO should not be able to meet its burden by pointing to a small number of employees; indeed, such an approach could discourage NRSROs from hiring enough employees to separate the ratings and sales/marketing functions.

The Commission should require a small NRSRO that has been granted an exemption from the separation requirement to abide by ongoing conditions aimed at effectively manage conflicts of interest. Such conditions would vary depending on the NRSRO's business model, number of employees and structure and should involve stepped-up scrutiny by regulators of performance disclosures and other data that might provide evidence that conflicts of interest were influencing ratings.

Section 932(a) of Dodd-Frank amended Section 15E of the Exchange Act to direct the Commission to provide for the suspension or revocation of an NRSRO's registration if the Commission finds, on the record, after notice and opportunity for a hearing, that (a) the NRSRO has committed a violation of a rule issued under Section 15E(h) of the Exchange Act; and (b) the violation affected a rating.

In the Release, the Commission expressed a belief that the suspension and revocation authority granted by Dodd-Frank should work in conjunction with existing Commission authority to suspend or revoke a registration, which requires a finding that suspension or revocation is "necessary for the protection of investors and in the public interest." Accordingly, the Commission proposes to engraft such a requirement when implementing Dodd-Frank's provision regard suspension and revocation of registration.

It seems likely that Congress was aware of the findings currently required to suspend or revoke registration for a violation of certain subsections of Section 15E of the Exchange Act. That Congress chose not to require a finding that suspension or revocation was "necessary for the protection of investors and in the public interest" implies that it did not wish to impose such a high threshold in this context. "Necessary for the protection of investors" suggests a level of menace that may be difficult to satisfy in the NRSRO context. Further, the Release does not really explain why the Commission believes this third finding is appropriate in this context, other than that it is consistent with the processes the Commission already follows.

We would not object to some kind of finding that suspension or revocation is "consistent with" the public interest. Such a standard is not as onerous as the "necessary or the protection of investors and in the public interest" standard proposed by the Commission but would still give the Commission some flexibility to make the punishment fit the crime.

Look-Back Review

Section 932(a) of Dodd-Frank required that each NRSRO establish, maintain and enforce policies and procedures triggering a "look-back" review in the event an NRSRO employee goes to work for an entity subject to a credit rating or the issuer, underwriter or sponsor of a product subject to a credit rating, when the employee participated in determining that credit rating one year or less before going to work for the entity, issuer, underwriter or sponsor. Dodd-Frank mandated that if the look-back is triggered, the NRSRO must conduct a review "to determine whether any conflicts of interest of the employee influenced the credit rating" and "take action to revise the rating if appropriate, in accordance with such rules as the Commission shall prescribe."

The Proposed Rule would mandate that that NRSROs establish, maintain and enforce policies and procedures that are reasonably designed to ensure that, if the NRSRO determines that a conflict of interest influenced a credit rating as described above, the NRSRO will (a) immediately place the credit rating on credit watch, (b) promptly determine whether the credit rating must be revised so it no longer is influenced by a conflict of interest and is solely the product of the NRSRO's documented procedures and methodologies for determining credit ratings and (c) promptly publish a revised credit rating or reaffirmation of the original rating.

We agree with the Commission that the proposed requirements related to the look-back review would not constitute Commission regulation of the substance of credit ratings or the procedures and methodologies by which an NRSRO determines credit ratings. The NRSRO would be analyzing the credit rating subject to look-back review for consistency with the NRSRO's own procedures and methodologies. We support placing a credit rating on credit watch immediately upon a finding that it has been influenced by a conflict of interest so that investors (and potential investors) are aware that the rating might be changed. Credit watch is a familiar concept to investors since it is widely used to signal potential ratings changes resulting from various factors.[27]

It is not clear why the Commission appears to believe that it should not or can not require subscriber-pay NRSROs to notify former clients (who were clients when the original rating was issued) of the NRSRO's determination that a rating was influenced by a conflict of interest and of any subsequent changes to that rating. (See Release, at 43 n.91) In our view, such notice would be appropriate to protect former clients who made investment decisions based on the original rating.

The Commission seeks comment on whether it should define what it means to have a conflict of interest "influence" a credit rating. NRSROs will likely be very

---

[27] See, e.g., "S&P Places CME Group debt ratings on CreditWatch," Bloomberg Businessweek, Mar. 3, 2011 (available at http://www.businessweek.com/ap/financialnews/D9LNVSF03.htm) (new class of membership increased operational risk).

reluctant to conclude that a rating has been influenced by a conflict of interest, given the reputational and regulatory consequences. Thus, we believe that more specificity would be useful. Common sense would dictate that a rating should be deemed influenced by a conflict of interest if the NRSRO would have taken a different ratings action, applying the procedures and methodologies in effect at the time the original rating was assigned. We would not support a definition that requires proof of subjective intent or motivation on the part of the NRSRO employee, which would be difficult to discern. (Of course, it would not be improper for an NRSRO to consider communications between the NRSRO employee and personnel associated with the new employer, together with other evidence, in determining whether a conflict influenced a credit rating.)

Similarly, the Commission also seeks comment on whether it should prescribe how an NRSRO would be required to determine whether the current credit rating must be revised so it no longer is influenced by a conflict of interest. NRSROs will likely be very reluctant to revise a rating for this reason, given the stakes. As a result, we urge the Commission to be more prescriptive in this area. We believe it would be appropriate for the Commission to require the NRSRO to apply de novo its procedures and methodologies for determining credit ratings to determine whether a revision is necessary.

Public Disclosure of Information About the Performance of Credit Ratings

Accurate performance statistics are essential to allowing investors to evaluate the trustworthiness of ratings issued by different NRSROs. "Competition will work," Professor Coffee recently concluded, "only when ratings agencies compete based on ratings accuracy, rather than in offering promotional benefits to issuers or legal protections to investors."[28]

Section 932(a) of Dodd-Frank amended Section 15E of the Exchange Act to direct the Commission to require each NRSRO to disclose publicly information on the initial credit ratings determined by the NRSRO for each type of obligor, security and money market instrument, and any subsequent changes to such credit ratings, for the purpose of allowing users of credit ratings to evaluate the accuracy of ratings and compare the performance of ratings by different NRSROs.

Dodd-Frank mandated that the Commission's rules must require disclosures that:
(a) are comparable among NRSROs, to allow users of credit ratings to compare the performance of credit ratings across NRSROs;
(b) are clear and informative for investors having a wide range of sophistication who use or might use credit ratings;
(c) include performance information over a range of years and for a variety of types of credit ratings, including for credit ratings withdrawn by the NRSRO;

[28] John C. Coffee, Jr., "Ratings Reform: the Good, the Bad and the Ugly," Harvard Business Law Review, Vol. 1, 2011, at 235.

(d) are published and made freely available by the NRSRO, on an easily accessible portion of its website, and in writing, when requested;
(e) are appropriate to the business model of an NRSRO; and
(f) require an NRSRO to include an attestation with any credit rating it issues affirming that no part of the rating was influenced by any other business activities, that the rating was based solely on the merits of the instruments being rated, and that such rating was an independent evaluation of the risks and merits of the instrument.

At present, applicants for NRSRO status must submit to the Commission, publicly disclose and update short-, mid- and long-term performance statistics (performance over a 1-year, 3-year and 10-year period) for each class of credit rating for which they are seeking registration as an NRSRO. Specifically, NRSROs must disclose historical transition (comparison of ratings at the beginning of a time period with ratings at the end of the time period) and default (percentage of securities with each rating that defaulted over the time period) rates for each category and notch.

The Proposed Rule would improve on the current regime in three important ways, which we strongly support as promoting transparency and accountability for NRSROs. First, it would prescribe methodologies for calculating transition and default rates.

Currently, there is no standard methodology and NRSROs use different methodologies to calculate these rates.[29] A September 2010 GAO study found four differences among NRSROs in how they calculated transition rates,[30] and five differences among NRSROs in the calculation of default rates.[31] These differences, the GAO found, prevented users from comparing transition or default rates across NRSROs. The Proposed Rule would prescribe a methodology, the single cohort approach, and standardize certain other elements of the performance calculations, thus enabling comparisons among NRSROs, including empirical research by academics and ratings users.

Second, the Commission's current rules do not prescribe how NRSROs should present performance statistics. The GAO study found, for example, that four NRSROs reported their transition and default rates as percentages but did not report the absolute number of ratings in each cohort.[32] These differences also impede comparability. The Proposed Rule would remedy this by standardizing presentation of default and transition rates for each class and subclass of credit ratings, including requiring presentation in tabular form using a standard format. Our experience with N-PX filings in which mutual

---

[29] Government Accountability Office, "Securities and Exchange Commission: Action Needed to Improve Rating Agency Registration Program and Performance-Related Disclosures," at 27-36 (Sept. 2010).
[30] Id. at 27.
[31] Id. at 30-31.
[32] Id. at 36.

fund proxy votes are disclosed is that standardized presentation is critical to researchers' ability to extract and analyze large data sets of this kind.

Third, the Commission's rules do not now limit the type of information that can be disclosed in the exhibit to the filing in which performance statistics must be disclosed. The Release states that some NRSROs have included "substantial amounts" of information in that exhibit regarding performance measurement statistics other than transition and default rates.[33] The Proposed Rule would confine the disclosures in the exhibit to transition and default rates and certain supplemental information. This change would help investors by promoting comparability and eliminating "noise" from the disclosures.

In sum, we strongly support the Proposed Rule's changes to ratings performance disclosure requirements. We urge the Commission to be vigilant about enforcing the standardization of presentation to enable efficient large-scale extraction and analysis of performance data.

Credit Rating Methodologies

Some of the sharpest criticism of NRSROs' performance during the housing bubble focused on inadequacies in ratings methodologies. "[T]he margin by which [NRSROs] did not 'get it right'", Professor Coffee exclaimed in a recent article, "now seems extraordinary."[34] There is abundant evidence that ratings personnel were deprived of the resources necessary to analyze data about assets underlying securities and improve their ratings models, and that securitized products were rated despite serious concerns about NRSROs' abilities to model them.[35] In addition, the Levin Report found that changes in credit rating methodologies were not applied to existing ratings, even though failure to do so created an undisclosed discrepancy in the meaning of a particular rating, and concluded that the decision not to retest was driven by lack of resources and fear of downgrades disrupting the marketplace.[36]

Section 932(a) of Dodd-Frank amended section 15E of the Exchange Act to direct the Commission to prescribe rules, for the protection of investors and in the public interest, with respect to the procedures and methodologies used by NRSROs, including qualitative and quantitative data and models, to ensure that:

---

33 Release, at 60.

34 Coffee, supra note 28, at 232.

35 See, e.g., Levin Report, supra note 2, at 288-89 (describing absence of relevant data for modeling performance of high risk mortgage products), 290 (relating Moody's reluctance to buy new data for RMBS model development for four years); 291 (summarizing testimony of Frank Raiter, head of S&P's RMBS Ratings Group);

36 Id. at 300.

- Credit ratings are determined using procedures and methodologies that are in accordance with the policies and procedures of the NRSROs and approved by the board of the NRSRO;
- Material changes are applied consistently and changes to surveillance procedures are applied within a reasonable period of time and the reasons for the changes disclosed; and
- The NRSRO promptly provides notice of material changes to rating methodologies and the discovery of significant errors in rating methodologies.

The Proposed Rule would require NRSROs to establish, maintain, enforce and document policies and procedures that are reasonably designed to ensure that the above objectives are satisfied and would impose a recordkeeping and document retention requirement to the policies and procedures.

We generally support these elements of the Proposed Rule. With respect to the proposed requirement that material changes to procedures and methodologies are applied to then-current credit ratings within a reasonable period of time, the Commission declined to propose a time frame, and would instead allow each NRSRO to adopt its own policies on the issue. Although we acknowledge the need for flexibility due to differences among issuers or securities, we are concerned that the absence of any Commission guidance will give NRSROs carte blanche to continue to devote insufficient resources to retesting. The Commission will be powerless to hold accountable an NRSRO that has harmed investors through excessive delay, so long as the delay was consistent with the NRSRO's own policies. The Commission is well-situated, given its oversight role, to gather information that would allow it to propose concrete time frames for retesting and we urge it to do so. We encourage the Commission to prescribe considerations that would take into account the extent to which investors would be harmed by allowing time to elapse without restesting.

We support requiring that an NRSRO's board approve credit rating methodologies and procedures. We are concerned, however, that board members may not possess the necessary expertise, particularly in quantitative analysis, to carry out this oversight function. This risk is particularly acute where an NRSRO is one subsidiary of a larger company whose business is unrelated or only tangentially related to credit ratings. In our view, NRSRO boards should be required to include at least one person with expertise in quantitative financial analysis. Such a requirement would be similar to the "financial expert" requirement for public company audit committees.

<u>Standards of Training, Experience and Competence</u>

Section 936 of Dodd-Frank required the Commission to issue rules reasonably designed to ensure that any person employed by an NRSRO to perform credit ratings "meets standards of training, experience, and competence necessary to produce accurate ratings for the categories of issuers whose securities the person rates" and "is tested for knowledge of the credit rating process."

The Proposed Rule would require an NRSRO to:

- Establish standards of training, experience and competence for credit analysts and to determine credit ratings that are reasonably designed to achieve the objective that such individuals produce accurate credit ratings in the classes and subclasses of credit ratings for which the NRSRO is registered;
- Consider certain factors when setting these standards (for example, the complexity of the securities that will be rated);
- Periodically test its credit analysts on the credit rating procedures and methodologies such credit analysts have been employed by the NRSRO to determine; and
- Require that at least one individual with three or more years of experience in performing credit analysis participate in determining a credit rating.

In our view, the requirements contained in the Proposed Rule would not meaningfully improve the competence of NRSROs' ratings personnel. The Commission should expand upon each of the four factors; rather than presenting them as open questions, the Commission should set forth more specific expectations. For example, the second factor asks if the credit rating procedures and methodologies used by an individual involve quantitative analysis. The Commission should provide guidance regarding what kind of technical expertise in quantitative analysis should be required, depending on how the person will be using quantitative procedures and methodologies.

There is no shortage of templates on which the Commission could base more specific guidance regarding training, experience requirements and testing. Credentialing organizations exist for public accountants, actuaries and securities analysts, all of whom are similar in some ways to ratings analysts. They test applicants based on standardized curricula, which evolve according to the needs of the profession. They also impose continuing education requirements, to ensure that skills and knowledge do not become obsolete. Moreover, the Commission itself likely has substantial knowledge of the deficits in training, experience and competence that already exist at the NRSROs, given the Commission's oversight role and the numerous investigations and examinations that have produced evidence regarding the ratings process. We urge the Commission to use these resources to prescribe guidance.

We are disappointed with the Commission's specific requirement in proposed paragraph (c)(2) of new Rule 17g-9 that an NRSRO's standards must include a requirement that at least one individual with three or more years of experience in performing credit analysis participate in the determination of a rating. In our view, three years is a relatively short time, especially when one is rating very complex or rapidly-changing securities. Most credit analyst training programs are at least two years long. For example, Wells Fargo describes its U.S. Corporate and Commercial Banking credit training program as a two- to three-year commitment.[37] Bank lending is undoubtedly more straightforward than structured finance. Thus, we urge the Commission to stiffen this requirement, at a minimum for ratings of more complex securities and ideally for all ratings determinations.

It is worth noting here our belief that a key element of improving NRSRO performance is transforming ratings analysis into a profession. Although it is not a panacea, the sense of being part of a larger profession with standards that go beyond the demands of a particular employer helps to foster ethical behavior and promote skill development. To that end, AFSCME looks forward to a robust discussion on the merits and feasibility of creating an independent professional organization for ratings analysts once the Comptroller General issues its report on the matter.[38]

Universal Rating Symbols

Section 938 of Dodd-Frank required the Commission to issue rules requiring NRSROs to have policies and procedures that are reasonably designed to:

- Assess the probability that an issuer of a security or money market instrument will default, fail to make timely payments, or otherwise not make payments to investors in accordance with the terms of the security or money market instrument;
- Clearly define and disclose the meaning of each symbol in the NRSRO's rating scale; and
- Apply any such symbol in a manner that is consistent for all types of securities and money market instruments for which the symbol is used.

The language of the Proposed Rule falls short of achieving the objectives behind Section 938. The Report of the Senate Committee on Banking, Housing and Urban Affairs indicates that Section 938 of Dodd-Frank was intended to address the problem of NRSROs applying stricter standards to municipal debt than to corporate debt, raising the cost of capital for governments already struggling with reduced tax revenues. The Report stated, "The Committee believes that an NRSRO's credit rating symbol should have the same meaning about creditworthiness when it is applied to any issuer—the same symbol should not have different meaning depending on the issuer."[39] In other words, a AAA

---

[37] See https://www.wellsfargo.com/careers/mbas_undergrads/undergrads/programs/corporate.

[38] See Section 939E of Dodd-Frank (requiring that GAO study feasibility and merits of creating an independent professional organization for ratings analysts, due not later than one year after the Commission issues final rules pursuant to Section 936).

[39] Committee Report, U.S. Senate Committee on Banking, Housing and Urban Affairs, Report No. 111-176, The Restoring American Financial Stability Act of 2010, at 124 (Apr. 30, 2010) (available at http://www.gpo.gov/fdsys/pkg/CRPT-111srpt176/pdf/CRPT-111srpt176.pdf).

rating assigned to a corporate bond should indicate the same likelihood of default as a AAA rating assigned to a municipal obligation.

The Proposed Rule, however, allows NRSROs to define each symbol, number or score used to denote a credit rating category (as well as notches within a category) for each class and subclass of credit ratings for which the NRSRO is registered. This language appears to countenance having one definition for AAA for municipal issuers and an entirely different definition of AAA for corporate issuers, as long as the definitions are properly disclosed.

The Proposed Rule is thus inconsistent with Section 938(a)(3) of Dodd-Frank, which states that the Commission's rules should require NRSROs to have policies and procedures that "apply any symbol described [above] in a manner that is consistent for all types of securities and money market instruments for which the symbol is used." The Proposed Rule would allow NRSROs to continue with the very practice that motivated the inclusion of Section 938 in Dodd-Frank.

We urge the Commission to adopt language that would clearly require NRSROs to apply symbols consistently across classes and subclasses of credit ratings. An AAA rating for a municipal bond should indicate the same likelihood of default or non-payment as an AAA rating for any other kind of security. Failure to do so would eviscerate Section 938 and continue to burden municipal issuers unfairly.

* * * *

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

Sincerely,

Gerald W McEntee

GERALD W. McENTEE
INTERNATIONAL PRESIDENT