United States Senate

COMMITTEE ON
HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS
WASHINGTON, DC 20510-6250

August 8, 2011

VIA EMAIL (rule-comments@sec.gov)

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

RE: Proposed Rules for Nationally Recognized Statistical Rating Organizations; Release No. 34-64514; File No. S7-18-11, RIN 3235-AL15

Dear Ms. Murphy:

The purpose of this comment letter is to express support for and offer recommendations to strengthen rules proposed by the Securities and Exchange Commission (SEC) to increase the transparency and integrity of credit ratings. These rules would implement several provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) and improve the SEC's existing rules governing credit ratings and Nationally Recognized Statistical Rating Organizations (NRSROs), which are more commonly known as credit rating agencies.

The proposed rules are intended to promote the integrity and transparency of credit ratings and facilitate SEC oversight of NRSROs. They represent a necessary response to industry practices that permitted droves of inaccurate ratings to undermine the securities market and integrity of the credit rating industry. Effective regulation of NRSROs is critical to ensuring accurate ratings and the return of investor confidence in our markets.

To further enhance the accuracy of credit ratings and reduce systemic risk, the proposed rules should establish mandatory minimum standards for NRSRO internal controls, require standardized forms for initial credit rating actions, and require the annual compliance reports to be subject to a third party audit. In addition, in accordance with several bipartisan recommendations set out in a report released by my Permanent Subcommittee on Investigations on the financial crisis,[1] the SEC should use its authority to rank the performance of the credit rating agencies in terms of accuracy, and ensure that the credit rating agencies assign higher risk to financial instruments whose performance cannot be reliably predicted due to their novelty or complexity.

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[1] 4/13/2011 Senate Permanent Subcommittee on Investigations, "Wall Street and the Financial Crisis: Anatomy of a Financial Collapse."

Subcommittee Investigation

Earlier this year, the Permanent Subcommittee of Investigations, which I chair, released a 635-page bipartisan report on the key causes of the financial crisis. A chapter of the report was dedicated to the role played by credit rating agencies in the financial crisis, using case studies involving the nation's two largest NRSROs – Moody's Investors Service, Inc. (Moody's) and Standard & Poor's Financial Services LLC (S&P). Using emails, memoranda, and other internal documents, the report detailed how inflated credit ratings contributed to the financial crisis by masking the true risk of many mortgage-related securities.

Between 2004 and 2007, Moody's and S&P issued credit ratings for tens of thousands of U.S. residential mortgage backed securities (RMBS) and collateralized debt obligations (CDOs). A majority of the products received AAA and other investment-grade credit ratings despite their risky features. In the first half of 2007, despite increasing evidence of falling home prices and delinquent mortgages, Moody's and S&P issued a surge of new ratings, granting AAA status to a large number of new RMBS and CDO securities. Then, in July 2007, as mortgage delinquencies intensified and more securities began incurring losses, both companies abruptly reversed course and began downgrading at record numbers their existing ratings of mortgage-related securities. Within months, both the RMBS and CDO markets collapsed.

Although AAA-rated securities have historically had a less than 1% probability of incurring defaults, in 2007, the vast majority of RMBS and CDO securities with AAA ratings incurred substantial losses. Some failed outright. Over 90% of the AAA ratings given to subprime RMBS securities originated in 2006 and 2007 were later downgraded by the NRSROs to junk status.

The Subcommittee investigation uncovered a host of factors responsible for the inaccurate credit ratings issued by Moody's and S&P. The first of these was the inherent conflict of interest arising from the "issuer-pays" model – a model that is still permitted by the SEC – where the party planning on issuing a financial instrument pays the NRSRO to analyze the credit risk and assign a rating. This model not only encourages NRSROs to give favorable ratings to attract business, it also encourages 'ratings shopping' by the investment banks designing and issuing the securities. At a Subcommittee hearing in April 2010, senior executives at both Moody's and S&P confirmed the existence of ratings shopping as well as its negative effect on ratings quality.

Compounding these problems were federal regulations that required the purchase of investment-grade securities by pension funds, insurance companies, and others, or that allowed financial institutions to maintain smaller capital reserves when holding investment-grade securities, creating further incentives to produce inflated ratings. Moody's and S&P employees told the Subcommittee and internal records confirm that in the years leading up to the financial crisis, gaining market share, increasing revenues, and pleasing investment bankers bringing business to the firm assumed a higher priority than issuing accurate RMBS and CDO credit ratings.

Another factor behind the inaccurate credit ratings was the failure of the NRSROs to include adequate mortgage performance data in their ratings models. Instead, they relied on historical data that did not sufficiently account for the subprime and other high-risk mortgages that proliferated in the housing market in the years leading up to the financial crisis. Moody's and S&P also failed to provide adequate staffing and to devote the resources necessary to improve their modeling, despite record revenues. In addition, they failed to adjust already issued ratings to reflect increasing mortgage market risks, despite imposing substantial charges on financial firms to oversee their rated securities. Finally, the companies failed to provide their ratings personnel with clear, consistent, and comprehensive criteria to evaluate the complex securities and permitted the subjective judgment of analysts and their supervisors to overly influence the rating results.

Evidence gathered by the Subcommittee shows that Moody's and S&P were aware of problems in the mortgage market, including the high risk nature of the loans being issued, lax lending standards, and rampant mortgage fraud. They were also aware of unsustainable housing price increases and growing mortgage delinquencies. If the NRSROs had issued ratings that accurately reflected the growing risk in the RMBS and CDO markets and adjusted outstanding ratings to reflect that reality, they might have discouraged investors from continuing to invest in high risk RMBS and CDO securities and slowed the pace of securitizations. Instead their actions contributed to the financial crisis. Issuing more accurate ratings was not in the short term interest of the NRSROs, since that would have led to fewer AAA ratings, greater client dissatisfaction, and less ratings revenue.

The proposed rules and any subsequent proposals should be designed to address the credit rating industry shortcomings identified in the Subcommittee's investigation. While many of the measures represent a substantial improvement over the status quo – including proposals pertaining to NRSRO internal controls, credit rating methodologies, due diligence providers, employee conflicts of interest, and transparency and disclosure – additional internal controls and standards are needed.

Proposed Rules

(1) Reporting on Internal Controls

(a) Eliminate Deferral

Section 932(a)(2)(B) of the Dodd-Frank Act requires NRSROs 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 my prescribe, by rule." Section 932(a)(4) requires each NRSRO to file an annual report assessing its compliance with the statutory and regulatory requirements and its own policies and procedures related to credit ratings.

Under the current proposal, the SEC proposes deferring the identification of any "factors" that NRSRO internal control structures should take into account until after the SEC has conducted additional NRSRO examinations and reviewed NRSRO annual compliance reports.

This proposal would postpone for an unspecified period of time – likely a year or longer – the issuance of any standards for NRSRO internal control structures, even though NRSRO internal controls clearly need improvement. The proposed rule indicates deferral is needed to gather additional information and conduct additional reviews, but credit rating problems have already been a subject of study for years.

The SEC first solicited public comment on "the need to establish formal procedures for recognizing and monitoring the activities" of credit rating agencies in 1994, seventeen years ago.[2] Eight years ago, in 2003, the SEC released a comprehensive report on the credit rating industry and included results from "formal examinations of credit rating agencies."[3] Four years ago, in 2007, the SEC conducted formal examinations of the major credit rating agencies, focusing on "practices ... surrounding the rating of RMBS and CDOs."[4] Three years ago, the examination results were summarized in a 2008 SEC report that identified many of the same problems discussed in the report released by the Subcommittee earlier this year.

Because the SEC already has significant information about the weak internal controls at the NRSROs and has already identified a number of factors critical to an effective internal control system, it is time to stop studying the problem and start issuing minimum standards for an effective internal control system. Additional standards or refinements can follow the planned examinations and required annual reports. Postponing the issuance of any standards will result in the NRSROs developing different internal control structures, making oversight and the implementation of minimum standards more difficult, time-consuming, and expensive down the line.

(b) Issue Minimum Standards for Internal Controls

NRSROs, as part of their applications, are required to provide the SEC with "the procedures and methodologies that the applicant uses in determining credit ratings" and to update that information.[5] Prior to the financial crisis, the NRSROs maintained internal control and audit programs designed to provide verification that the NRSROs and their employees were complying with the firms' internal policies and procedures. Work by the Subcommittee and the SEC itself has shown, however, that both the internal controls and audit programs did not work as intended and failed to identify significant flaws in the ratings process.

The Subcommittee's work uncovered a host of troubling practices that should have been prevented by an effective internal control system. Evidence indicated, for example, that NRSROs were susceptible to pressure to weaken standards to maintain "market share." It showed that the NRSROs had unclear and subjective criteria to rate structured products and failed to include in their models relevant mortgage performance data for high-risk residential mortgages. Evidence further showed that they failed to provide adequate staffing to perform

[2] 1/2003 SEC "Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets," at 5.
[3] Id. at 4.
[4] 7/2008 SEC "Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies," at 1.
[5] 15 USC 78o-7(a)(1)(B)(ii) and (b).

rating and surveillance services and intentionally decided not to apply new and improved rating models with more restrictive criteria to existing rated transactions. Effective internal controls would have cured most if not all of these deficiencies.

To ensure effective internal control structures for credit rating agencies, it is critical for the SEC to establish a framework against which the relevant internal controls of a specific NRSRO can be measured. Ideally, this framework would identify the objectives to be achieved by the internal controls, a set of mandatory minimum components, and how a material weakness – a serious deficiency in an internal control that would prevent it from achieving its objective – would be handled. Without such a framework, NRSRO boards of directors would have no federal guidance when evaluating and approving a proposed internal control structure, SEC personnel would have no benchmarks for evaluating effectiveness and identifying material weaknesses, and investors would have a difficult time understanding what a NRSRO is doing. In addition, without this framework, each NRSRO would formulate its own approach, making oversight by SEC personnel more time consuming, subjective, and expensive, and inviting misunderstandings, disagreements, and conflicts between NRSRO and SEC personnel over acceptable practice.

The proposed rule would be strengthened if it were to establish, first, the objectives that an NRSRO internal control structure for issuing credit ratings should be aimed at achieving. Those objectives could include, for example, the issuance of accurate and reliable credit ratings; the disclosure of information related to each ratings action in a timely, useful, and organized way; the monitoring and updating of existing ratings in a timely and effective fashion; and the avoidance of conflicts of interest that undermine ratings accuracy. Emphasizing the importance of accurate ratings in these objectives would help carry out our report's recommendation that the SEC "use its inspection, examination, and regulatory authority to ensure credit rating agencies institute internal controls, credit rating methodologies, and employee conflict of interest safeguards that advance rating accuracy."

Second, the proposed rule should identify the minimum components of an effective credit ratings internal control structure. The prescriptive "factors" set out in the proposal provide a useful starting point to carry out the statutory requirements in the Dodd-Frank Act. For example, the proposal identifies controls that would be designed to ensure that new methodologies or proposed updates for methodologies for determining credit ratings are subject to an appropriate review process and to board approval. Another effective factor offered is that methodologies being used for determining ratings need to be periodically reviewed to analyze if the methodologies should be updated, and that quantitative models are validated prior to use and are periodically reviewed and back-tested.

What is of paramount importance, however, and which is not currently addressed in the proposal, is that these factors should be issued, not as voluntary guidelines or best practices to which an NRSRO should aspire, but as mandatory minimum standards for establishing an effective internal control structure. Unless the specified factors are issued as mandatory minimum standards, history has already shown that NRSROs are likely to ignore or reject them in response to competitive pressures to win market share and please clients by issuing inflated ratings.

The proposed rule would also be strengthened if it clarified how the internal control structure mandated by the Dodd-Frank Act is intended to interact with the internal control requirements of the Sarbanes-Oxley Act, with one aimed at supporting accurate credit ratings and the other at accurate financial reporting.

The following comments discuss some of the key factors that ought to be included in a set of mandatory minimum standards for an effective internal control system for credit ratings, not only responding to those presented in the proposed rule for comment, but also offering several suggestions for additional standards based upon the Subcommittee's investigation.

Rating Exotic and Customized Products. Among the most important of the proposed internal controls are those that would require an NRSRO to determine if it has sufficient competency and access to information before commencing the rating of either a class of financial product that that it has not previously rated, or before commencing the rating of an "exotic" or "bespoke" product. "Bespoke" products are products that have been customized for a particular financial firm or transaction and are not routine or common.

The Subcommittee found evidence that ratings analysts were being given insufficient time, resources, and information to properly analyze the new and increasingly complex financial instruments produced by the investment banks. For example, in 2006, one Moody's analyst wrote:

> "I am worried that we are not able to give these complicated deals the attention they really deserve, and that they (CS) [Credit Suisse] are taking advantage of the 'light' review and growing sense of 'precedent.'"[6]

An S&P analyst offered the cynical comment: "[W]e rate every deal[.] [I]t could be structured by cows and we would rate it."[7]

The NRSROs' failure to address the complexity and unpredictable performance of new structured products was evident in the 2007 mass downgrades. The imposition of internal controls to ensure that adequate expertise, resources, and time are devoted to analyzing unusual and complex financial products is critical in preventing innovative, high-risk financial products from being issued AAA-ratings and passed off as safe investments.

The proposed rule should be further enhanced by making it plain that NRSROs must assign higher risk to financial instruments whose performance cannot be reliably predicted due to their novelty or complexity. To counter the competitive pressures on NRSROs to rate new financial products quickly and grant investment-grade ratings, the proposal would benefit from a rule and minimum internal control standard automatically requiring the assignment of a larger financial cushion or greater credit enhancements for novel and complex products, with the size of the financial cushion corresponding to the extent to which the particular product lacks reliable performance data. This enhancement to the proposed rule would carry out our report's

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[6] 5/1/2006 email from Richard Michalek to Yuri Yoshizawa, Hearing Exhibit 4/23-19.

[7] 4/5/2007 instant message exchange between Shannon Mooney and Rahul Dilip Shah, Hearing Exhibit 4/23-30a.

recommendation to "ensure credit rating agencies assign higher risk to financial instruments whose performance cannot be reliably predicted due to their novelty or complexity."

Finally, the proposed rule should consider avoiding the use of esoteric terms such as "bespoke" when simpler, more direct terms, such as "customized," are available, in order to promote compliance and public understanding.

Compiling Criteria. The proposed list of factors should also be strengthened by establishing as a mandatory minimum standard that NRSROs compile and maintain a comprehensive list of their rating criteria and written guidance on how those criteria are to be applied in the overall ratings process.

The Subcommittee investigation found that neither Moody's nor S&P had an accurate list of the internal criteria used for rating RMBS and CDOs, nor did they have a clear process for how those criteria would be used in their overall ratings process. When asked by the SEC in 2007, for example, to provide a list of its rating criteria, the head of the S&P structured finance department wrote in an email to his colleagues:

> "[O]ur published criteria as it currently stands is a bit too unwieldy and all over the map in terms of being current or comprehensive. ... [O]ur SF [Structured Finance] rating approach is inherently flexible and subjective, while much of our written criteria is detailed and prescriptive. Doing a complete inventory of our criteria and documenting all of the areas where it is out of date or inaccurate would appear to be a huge job."[8]

This email, as well as other evidence collected by the Subcommittee and the 2008 SEC report, indicates that neither credit rating agency had a complete list of their ratings criteria.

In addition, the Subcommittee investigation found that both credit rating agencies had undocumented procedures for applying specified criteria in their "inherently flexible and subjective" ratings process. Moody's Chief Credit Officer observed:

> "Methodologies & criteria are published and thus put boundaries on rating committee discretion. (However, there is usually plenty of latitude within those boundaries to register market influence.)"[9]

An S&P analyst put the problem even more bluntly:

> "[N]o body gives a straight answer about anything around here .... [H]ow about we come out with new [criteria] or a new stress and ac[tu]aly have clear cut parameters on what the hell we are supposed to do."[10]

[8] 3/14/2007 email from Clavin Wong to Tom Gillis of S&P, Subcommittee hearing exhibit 4/23-29.
[9] 10/21/2007 Moody's internal email, Hearing Exhibit 4/23-24b. Although this email is on its face addressed to and from the CEO of Moody's, the Chief Credit Officer told the Subcommittee that he wrote the memorandum attached to the email.
[10] 5/8/2007 instant message exchange between Shannon Mooney and Andrew Loken, Hearing Exhibit 4/23-30b.

To clarify the ratings procedure, the proposed rule should require NRSRO internal controls not only to ensure that NRSROs maintain a comprehensive, updated list of rating criteria in an organized and accessible format, but also include written procedures addressing how those criteria are to be combined with more subjective considerations in the rating process.

Ensuring Adequate Staffing. The proposed rule should also consider requiring internal controls that would ensure NRSROs provide adequate staffing, not only to produce new ratings, but also to conduct surveillance of existing ratings and adjust them as needed. Evidence from the Subcommittee's investigation demonstrated severe understaffing and insufficient resources relative to the growing level of business at both Moody's and S&P, despite record revenues. In a 2006 email, for example, the head of the S&P CDO Ratings Group described the situation as follows:

> "While I realize that our revenues and client service numbers don't indicate any ill [e]ffects from our severe understaffing situation, I am more concerned than ever that we are on a downward spiral of morale, analytical leadership/quality and client service."[11]

At a Subcommittee hearing, Moody's CEO, Ray McDaniel, readily acknowledged that "[p]eople were working longer hours than we wanted them to, working more days of the week than we wanted them to."[12] Because the firms' profits were not dependent upon the accuracy of their credit ratings, the NRSROs had little incentive to increase staffing levels or resources, even when ratings quality deteriorated. Internal controls specifically designed to ensure that NRSROs evaluate and ensure adequate staffing to produce high quality analysis and accurate ratings would help alleviate these problems.

(2) Strengthening Credit Rating Methodologies

Section 932(a)(8) of the Dodd Frank Act provides that the SEC shall prescribe rules with respect to the procedures and methodologies used by NRSROs to determine credit ratings. Under the proposed rules, NRSROs would be required to, among other things, ensure that the procedures and methodologies, including qualitative and quantitative data and models, used to determine credit ratings are approved by their board of directors or another similar body; that when material changes are made to rating procedures and methodologies, the changes are applied consistently to all credit ratings to which they apply; and to the extent that changes are made to surveillance procedures they are applied to existing ratings within a reasonable period of time. The proposed rules would also require that the NRSRO promptly publish notice of material changes to rating methodologies and of the discovery of significant errors in rating methodologies.

The Subcommittee's investigation provides strong support for imposing rules that strengthen rating methodologies. Ambiguity and inconsistency in the application of the ratings criteria, methodologies, and models were a vulnerability in the system that allowed conflicts of interest to undermine the integrity of credit ratings in the years leading up to the recent crisis.

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[11] 10/31/2006 S&P internal email, "A CDO Director resignation," PSI-S&P-RFN-000001.
[12] 4/23/2010 Subcommittee hearing at 97.

Although both Moody's and S&P published a number of criteria, methodologies, and guidance on how to handle a variety of credit risk factors, the novelty and complexity of the RMBS and CDO transactions, the volume and speed of the ratings process, and inconsistent applications of various internal rules, meant that ratings analysts were continuously faced with issues that were difficult to resolve about how to analyze a transaction and apply the company's standards. Evidence obtained by the Subcommittee indicates that, at times, ratings personnel acted with limited guidance, unclear criteria, and a limited understanding of the complex deals they were asked to rate.

The Subcommittee also found that by 2006, Moody's and S&P had revised their rating models to produce more accurate ratings concerning subprime residential mortgage backed securities, but then failed to use the revised model to retest previously rated subprime rated securities. Had they retested the existing rated securities and issued appropriate rating downgrades starting in 2006, the credit rating agencies could have signaled investors about the increasing risk in the mortgage market, possibly dampened the rate of securitizations, and probably reduced the impact of the financial crisis.

The ambiguity and opaqueness of the NRSROs' approaches to the ratings process was a weakness that was exploited by investment banks. Documents obtained by the Subcommittee indicate that investment bankers who complained about rating methodologies, criteria, or decisions were often able to obtain better ratings or other favorable treatment. At times, analysts were pressured to apply older, more lenient models over newer, more conservatives ones. In many cases, close calls were made in favor of the client.

The proposed rules would strengthen the ratings process by fostering more open, uniform, and predictable application of rating criteria, methodologies, and modeling. They would help ensure that improvements are applied consistently to existing as well as new ratings, and that the NRSROs' senior management and board members make deliberate decisions to adopt new criteria, methodologies, and guidance in their ratings. They would also reduce the extent to which NRSRO ratings criteria, methodologies, and modeling are susceptible to improper influence, and thus serve to advance rating accuracy and promote sounder markets.

Requiring Prompt Retesting. The proposed rule should be strengthened by specifying a maximum amount of time, such as 60 days, during which NRSROs must retest existing ratings after making a material change to new or existing rating and surveillance criteria, methodologies, or procedures. A material change to a ratings model may be a significant indicator that existing ratings are inaccurate. If the change also requires higher levels of credit enhancements, NRSROs may be reluctant to downgrade existing ratings, which is what happened in the years leading up to the financial crisis. As previously noted, if the NRSROs had promptly retested existing ratings when they made material changes to their ratings models in 2006, they would have likely reduced the impact of the financial crisis. To ensure retesting is performed promptly, the proposed rule must be clear that retesting is required after a material change in either a new ratings or surveillance criteria, methodology, or procedure, and specify a specific time period during which that retesting must be completed.

Taking into Account Track Records. The proposed rule should also be strengthened by explicitly requiring NRSROs to assign higher risk to products issued by financial institutions with a track record of issuing poor quality assets. The Subcommittee's work showed that some financial institutions were known in the industry for issuing poor quality mortgage backed securities whose loan performance was below average. While one of the NRSROs took into account the track record of those issuers, the other did not until after the financial crisis. The proposed rule should make it mandatory for NRSROs to take into consideration an issuer's past track record when rating its products. Enhancing the proposed rule in that way would carry out the recommendation in our report to "ensure credit rating agencies assign higher risk to financial instruments ... that rely on assets from parties with a record for issuing poor quality assets."

(3) Third-Party Due Diligence.

The proposed rule would require that due diligence providers for asset-backed securities provide a written certification to any NRSRO that rates the securities. The certification would describe the due diligence undertaken and the resulting findings and conclusions. This information would then be made public by the NRSRO or the issuer or underwriter of the securities.

Required third-party due diligence reviews would produce material information that NRSROs need to know to produce accurate ratings. The disclosure of that information fills a conspicuous gap left open by the credit rating agencies, since NRSROs neglected to perform their own due diligence review of the loan data in the period leading up to the financial crisis. In fact, the Subcommittee's investigation showed that NRSRO employees were discouraged from conducting such reviews, despite being aware that significant problems may have existed with the loan data. Published reports of systemic mortgage fraud and internal emails discovered by the Subcommittee demonstrated that analysts within both Moody's and S&P were aware of the seriousness of the problem.

In late 2007, when Fitch Ratings decided to conduct a review of some mortgage loan files to evaluate the impact of poor lending standards on loan quality, the extent of the problem was finally laid bare. Fitch issued a report entitled, "The Impact of Poor Underwriting Practices and Fraud in Subprime RMBS Performance." After reviewing a sample of 45 subprime loan files, Fitch explained: "[t]he result of the analysis was disconcerting at best, as there was the appearance of fraud or misrepresentation in almost every file."

Requiring disclosure of due diligence reports that are certified by third-parties should significantly improve the quality of due diligence and better inform the rating process. The publication of due diligence reports, similar to Fitch's 2007 report, can help expose red flags which could otherwise be ignored by the credit rating agencies.

(4) Preventing Conflicts of Interest Relating to Sales and Marketing

Section 932 of the Dodd-Frank Act seeks to prevent an NRSRO's "sales and marketing" considerations from influencing the NRSRO's credit ratings. The proposed rule would prohibit an NRSRO from issuing or maintaining a credit rating where an employee who participated in its sales or marketing also participated in determining or monitoring the credit rating. Under the rule, mechanisms would be established to permit exceptions for small NRSROs and to create penalties for non-compliance.

Placing a division between marketing and ratings analysis is a necessary measure to prevent the conflicts of interest which led to the proliferation of inaccurate ratings. As stated previously, the direct lines of communication between investment banks and NRSRO employees made it easier for investment bankers to pressure the NRSROs into granting exceptions and providing preferential treatment. While the primary concerns remains the large-scale conflicts of interest arising from the "issuer-pays" system, the rule amendments proposed here provide a springboard for addressing that greater problem. Establishing internal controls to prevent individuals from participating in both the sales and ratings processes will aid in the goal of keeping the overall company's drive for market share and profits distinct from the professional responsibilities of individual ratings analysts.

Smaller NRSROs. Given the obvious conflicts of interest, the justification for exempting smaller NRSROs from having to separate their sales and marketing personnel from the analysts conducting the ratings process is unclear. If a credit rating agency is too small to separate its rating process from its marketing process, it should not qualify as an NRSRO. Allowing the same personnel to perform both functions is inviting the conflicts of interest and inflated ratings that helped generate the financial crisis. It is respectfully recommended that the proposed exception for small NRSROs be eliminated from the proposed rule.

Client Pressure. This part of the proposed rule could also be strengthened by barring NRSRO management from taking negative actions against analysts due to client complaints seeking better ratings, more lenient treatment of their products, or relief from providing information about a product being rated. The Subcommittee investigation exposed several instances in which rating analysts were removed from projects, berated, or instructed to be more deferential toward clients, because of investment banker complaints or pressure. One Moody's senior manager testified at a Subcommittee hearing that she had barred certain analysts from rating certain banks' transactions, because the relationship between analysts and investment banks "could get very contentious and very abusive." When asked whether she had ever protected her analysts by instead banning an abusive bank employee, she could not recall taking that action. The proposed rule should acknowledge and prohibit such improper NRSRO personnel actions which inevitably lead to inaccurate and inflated credit ratings.

(5) Ratings Action Forms

Section 932(a)(8) of the Dodd-Frank Act requires the SEC to develop a form to be used by NRSROs upon taking a ratings action to disclose, among other information, the main presumptions, principles, and models used to determine the rating; the potential limitations and uncertainty of the rating; whether third-party due diligence services were used; as well as an overall assessment of the quality of the data used to support the rating. The NRSRO would also be required to provide an explanation of the potential volatility of the credit rating, including any factors that might lead to a change in the rating.

Standardized Form Needed. While the proposed rule contains important provisions that would increase the transparency of credit ratings by requiring specific disclosures for each ratings action, the SEC should go a step further and create a form that standardizes the required information disclosures across all NRSROs. As currently drafted, the proposed rule requires the NRSROs to standardize disclosures across types of financial products, but leaves at the NRSROs' discretion the format of the disclosure form. Without a standard template, the NRSRO disclosure forms are likely to diverge significantly, creating confusion and an unnecessary barrier to investor and SEC efforts to compare ratings actions taken by different NRSROs. A standardized form, similar to that employed by the SEC for NRSRO registration, would simplify oversight as well as investor analysis and comparisons.

Ratings Duration. The proposed rule would be further strengthened if it required NRSROs to include in the form a projected time period during which the given rating was expected to be valid. Alternatively, the form could provide a check-the-box approach indicating whether the rating was expected to be valid for less than one year, more than one year, or for the life of the product being rated. The Subcommittee investigation found widespread confusion among investors, investment banks, and others regarding how long a particular rating was intended to be effective.

Other Information. The form should also include a standardized, easy-to-follow section presenting the ratings history of a product receiving a new ratings action, including requirements for specific dates to be provided for each past ratings action and any default or withdrawal of a rated product from the market. The proposed rule could be further strengthened by including a check-the-box feature making it easier to understand the product being rated, such as a field indicating the type of product being rated, whether it is synthetic, whether it includes or references previously rated products, and whether it is a standard, customized, or novel product. In the case of a novel product, the form could also require the NRSRO to identify the key novel features as part of its explanation of the rating's potential limitations, uncertainty and potential volatility. Still another useful feature would be to require the NRSRO to list, in a standardized format, the type and extent of credit enhancements being included in the rated product to protect investment-grade ratings.

A standardized ratings action form has the potential to increase significantly the transparency, comparability, and correct usage of credit ratings. If properly designed, the form can also become a useful vehicle for evaluating the volume and types of products being rated, the types and usefulness of the credit enhancements being provided, and the accuracy of the ratings over time. To ensure their value to investors, the form should be standardized and streamlined to the greatest extent possible, and tested with an appropriate focus groups of investors.

(6) Ratings Performance Record

Section 932(a)(8) of the Dodd-Frank Act requires NRSROs to publicly disclose information, not only in connection with each initial ratings action, but also with respect to any subsequent changes to those ratings, so that investors can evaluate the accuracy of the ratings over time and compare the overall performance of different rating agencies. To facilitate investor comparisons and SEC oversight, the proposed rules and rule amendments would standardize the way an NRSRO calculates and presents aggregate information about how its ratings change over a period of years and how often a rated entity or product subsequently defaulted. Disclosure would be required to be comparable among NRSROs, provide understandable information for investors with varying levels of sophistication, and appear on an "easily accessible" portion of an NRSRO's website without charge to the viewer.

The report released by the Subcommittee on the financial crisis included a recommendation to strengthen credit rating disclosures as a way to improve the accuracy of credit ratings and reduce systemic risk. The standardization and transparency required by this portion of the proposed rule represent critical improvements that would help regulators and investors evaluate the relative long-term ratings accuracy of the different credit rating agencies, while helping to expose deficiencies in their ratings process.

Accuracy Rankings. Another recommendation in our report was that the SEC "use its regulatory authority to rank [NRSROs] in terms of performance, in particular on the accuracy of their ratings." This ranking system could use the standardized aggregate information required in this part of the proposed rule to produce an annual report ranking the NRSROs according to one or more measures, with the aim of further encouraging accurate ratings.

(7) Audited Annual Compliance Reports

Although many of the rules and internal controls outlined in the proposal hold promise for curing deficiencies in the ratings process that contributed to the financial crisis, they are only a starting point. Equally important is that the specified rules and internal controls are adhered to by the NRSROs. As currently drafted, the proposed rule would require a "designated compliance officer" to be responsible for administering the policies and procedures required by the Dodd-Frank Act and the SEC, and submit to the NRSRO an unaudited annual report on its compliance with securities laws and its own internal policies and procedures. Additionally, the NRSRO would have to submit the annual compliance report to the SEC, with the compliance officer certifying that the report is accurate and complete and the chief executive officer (CEO) or equivalent officer attesting to responsibility for the report's contents.

The proposed annual compliance report, together with the compliance officer and CEO certifications, would promote NRSRO accountability, transparency, and compliance with relevant statutes and regulations, and facilitate effective SEC oversight.

These measures would also be significantly strengthened if the annual compliance report were subjected to a third-party audit attesting to the report's reliability. It was only after such an audit requirement was imposed by the Sarbanes-Oxley Act that corporations began devoting significant resources to ensuring the adequacy of their internal controls for financial reporting. That history suggests the same approach is needed here.

Given the importance of NRSROs to the U.S. financial system, their complex work, their history of poor compliance with their own ratings criteria, and the devastating impact of inaccurate credit ratings on the U.S. and world economy, an audited annual report certifying compliance with the Dodd-Frank statutory requirements, the SEC's implementing regulations, and the NRSRO's own internal control requirements is warranted. An audited report would not only alert the NRSRO to any internal control deficiencies or other compliance problems, but would also provide the SEC with greater confidence in the annual report as a useful tool for evaluating the adequacy and effective implementation of a particular NRSRO's internal control structure and compliance efforts.

(8) **Establishing an Intermediary System**

The proposed rules on reporting internal controls, strengthening credit rating methodologies, preventing conflicts of interest, enhancing disclosure information about credit ratings and leveraging due diligence requirements will significantly enhance the SEC's ability to oversee the NRSROs. These rules provide stronger measures to eliminate the inflated credit ratings that contributed to the financial crisis. They stop short, however, of resolving the industry-wide conflict of interest caused by allowing the issuer of a financial product to pay for its rating. To address that larger, more fundamental problem, the SEC should adopt the intermediary system proposed in the Franken-Wicker amendment for assigning credit rating agencies to provide the initial ratings for structured finance products. Related studies and rulemakings are still underway addressing that method of eliminating the conflicts of interest arising from the issuer-pay model.

Thank you for the opportunity to comment.

Sincerely,

Carl Levin

Carl Levin
Chairman
Permanent Subcommittee on Investigations