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By E-mail

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

Re: File Number S7-18-11: Comments on Proposed Rules for Nationally Recognized Statistical Rating Organizations

Dear Ms. Murphy:

The following are the comments of A.M. Best Company, Inc. ("A.M. Best" or "the Company"), a nationally recognized statistical rating organization ("NRSRO" or "NRSROs") currently registered under Section 15E of the *Securities and Exchange Act of 1934* (the "Exchange Act"), on the proposed rules regarding NRSROs set forth by the Securities and Exchange Commission ("SEC" or "Commission").[1]

I. Introduction

Established in 1899, A.M. Best is the premier global rating agency and information source for the insurance industry. Headquartered in Oldwick, NJ, with offices in London and Hong Kong, the Company is best known as an insurance-rating and information agency with over 100 years of experience providing in-depth reports and financial strength ratings about insurance organizations.

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

The SEC's recently proposed rules raise a wide variety of practical, competitive, and cost-related concerns for smaller NRSROs such as A.M. Best. The proposals include mandates that will require changes to virtually every aspect of how NRSROs conduct their businesses,

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

and the compliance obligations associated with these changes will make it even more difficult for smaller NRSROs to compete with the three largest NRSROs that dominate the ratings market. Additionally, the proposed rules fail to sufficiently account for the differences between corporate ratings (such as financial strength ratings of insurance companies) and ratings of the structured and asset-backed financial products that contributed to the recent economic crisis.

A.M. Best believes that the SEC should change the proposed rules to allow for specialized compliance timetables and procedures that would mitigate the burdens associated with the proposed rules, and properly calibrate the burdens of the rules with the risks of the activities being regulated.

These comments address several global problems with the proposed rules and then identify a number of specific issues of concern to A.M. Best.

II. Global Issues

A. The Proposed Rules Fail to Address the Disproportionate Impact of the Resulting Regulatory Burdens on Smaller NRSROs, Which Could Undermine Competition and Create Barriers to Entry.

The NRSRO market demands a regulatory approach that fosters genuine competition because of the dominance of the three large NRSROS. Most analyses of the NRSRO market highlight a functional monopoly controlled by the three largest credit ratings firms, which are estimated to control approximately 98% of the credit rating market.[2] The proposed rules even note that the NRSRO market is dominated by the three largest firms and a key statistical measure—the Herfindahl–Hirschman Index—indicates that there are only three firms of relatively equal size in the NRSRO market.[3]

In fact, the lines between small and large in the NRSRO market are clear enough that the Federal Reserve was comfortable classifying only three NRSROs (Fitch Ratings, Moody's Investor Service, and Standard & Poor's) as "major" NRSROs when the Federal Reserve was implementing the Troubled Asset-Backed Securities Loan Facility ("TALF") in early 2009. The remaining NRSROs did not qualify as "major" and hence were not able to participate in the mandatory ratings connected to the TALF program.[4] It is clear that the federal government can distinguish between the market-dominating "major" NRSROs and the

[2]See Frank Partnoy, *Rethinking Regulation of Credit Rating Agencies: An Institutional Investor Perspective* (Apr. 14, 2009) available at: http://www.cii.org/UserFiles/file/CRAWhitePaper04-14-09.pdf
[3]76 Fed. Reg. at 33,500.
[4]Controversy over this policy eventually resulted in the Federal Reserve abandoning the requirement that "major" NRSROs be used.

remaining NRSROs. The simple fact is that non-"major" NRSROs account for a small amount of the credit ratings market and have to compete in a market dominated by three very large ratings companies.

Protecting smaller NRSROs from regulatory burdens that could further reduce competition in the ratings market was a goal underlying the adoption of the *Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010* ("Dodd-Frank").[5] In fact, the language of Dodd-Frank itself recognizes the need to exempt small NRSROs from certain provisions. For example, in §932(a)(8) and §932(a)(5)(B)(2)(B), Congress explicitly referenced the need to protect small NRSROs from unreasonable regulatory burdens. These exemption authorities provide evidence that Congress intended to enable small NRSROs to continue to provide viable alternatives to the large NRSROs and to provide new entrants relief from overly-burdensome regulatory provisions under the new regulatory regime.[6]

A.M. Best is concerned that the SEC may adopt a definition of "small" that renders these exemptions largely useless for fostering competition in the ratings market. For example, rather than utilize existing statutory authority to craft a definition of "small" that reflects the uniquely top-heavy nature of the NRSRO market, the SEC appears poised to import one general rule from the *Small Business Act* ("SBA") that a business must have total assets of $5 million or less to qualify as "small."[7]

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

The SEC should utilize the exemption authorities provided in Dodd-Frank, and the SEC's general exemption authority, to craft compliance timelines, policies, and procedures that reflect the unique competitive burdens facing the seven smaller NRSROs. And, the SEC should provide those NRSROs with the time and guidance necessary to simultaneously comply with SEC rules while implementing the substantial infrastructure requirements needed to comply with the provisions of Dodd-Frank.

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[5] Pub. L. No. 111-203 (2010).
[6] *Id.*
[7] 76 Fed. Reg. at 33, 427.

B. <u>The Proposed Rules Are Overly Broad in Their Application to Financial Strength Ratings.</u>

It is also important to note that the proposed rules create additional competitive obstacles for companies such as A.M. Best because in most cases, the proposed regulations will impose significant and identical regulatory burdens on all NRSROs, regardless of the specific types of ratings issued by the NRSROs. For example, proposed mandates related to ratings methodologies, due diligence, and internal controls are equally applicable to corporate ratings (financial strength ratings) and ratings of asset-backed securities, even though the recent economic crisis was connected to structured financial products and not financial strength ratings of corporate entities. As Dodd-Frank's legislative findings indicate:

> In the recent financial crisis, the <u>ratings on structured financial products have proven to be inaccurate</u>. This inaccuracy contributed significantly to the mismanagement of risks by financial institutions and investors, which in turn adversely impacted the health of the economy in the United States...Such inaccuracy necessitates increased accountability on the part of credit rating agencies.[8]

In addition to others discussed elsewhere in this submission, examples of provisions that should apply to only asset-backed securities ratings include:

- Changes to Rule 17g-7. Current Rule 17g-7 relates to disclosure requirements relating to representations, warranties, and enforcement mechanisms available to investors in securitization products. Proposed Rule 17g-7 substantially expands the amount of information required to be disclosed with *each* rating action, including corporate (financial strength ratings). We believe that expanding 17g-7 disclosure requirements to non-asset-backed ratings is extremely overly-burdensome and provides little additional information to investors and consumers about non-asset backed ratings that are not already available on the public websites of NRSROs, by legislation, regulation, or rule. We believe that since 15(E)(s) devotes such a substantial amount of text and disclosure requirements to items that relate solely to securitization products that it appears the intent of Congress was to provide investors in such products more information regarding the ratings of these products, which were at the core of the financial crisis.

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

- Changes to "look back" provisions.[9] The proposed look back provisions apply to all ratings of an obligor, security, or money market instruments, and require immediate placement of a rating on credit watch if a conflict is discovered. However, in the context of A.M. Best's financial strength ratings on insurers, and to a broader extent ratings on other financial institutions, this requirement is potentially counterproductive. Requiring immediate placement of the financial strength ratings of financial institutions on credit watch risks injecting unnecessary turbulence into the investment and insurance consumer markets as result of the perception that companies may be financially unsound before a full investigation is completed.

Because the proposed rules do not vary based upon the types of products or entities being rated, the purpose of the ratings, or the risk posed by certain financial products to consumers and investors, the Commission is, in the case of ratings of products or entities other than structured financial products, introducing the potential for unintended "run on the bank" scenarios and the attendant liquidity exposures.

C. The Burden Analysis in the Proposed Rules Is Artificially Low Due to the Failure to Consider Full Compliance Costs and Incorporate the Costs of the Big Three NRSROs.

NRSROs such as A.M. Best provide their expertise and services to customers around the globe. With significant changes occurring in the international regulatory climate, it is critical that the SEC fully appreciate the burdens and costs associated with a credit rating agency's compliance with each regulatory regime and to avoid making it more difficult for smaller NRSROs to compete in the global ratings market. Unfortunately, the burden and cost estimates included in the proposed rules, both in the discussion of the *Paperwork Reduction Act* ("PRA")[10] and the economic analysis[11] are unreasonably conservative, misleading, and neglect to take into consideration not only the cumulative burdens associated with the universe of regulatory actions being pursued by the SEC, but those that have and continue to be undertaken by foreign regulatory bodies.

The burden and cost estimates are flawed because they rely on improper constructs regarding the time and cost associated with the new mandates under the rules. This problem stems from several flaws in the burden analysis, set forth below.

1. The Premise for Calculating the Burden Estimate is Flawed

[9] 76 Fed. Reg. at 33,515.
[10] *Id.* at 33,499.
[11] *Id.* at 33,511.

A key problem with the burden and economic analysis is that it is premised on the argument that the burdens associated with the specific proposals can be measured by evaluating the number of "credit ratings outstanding or the number of credit analysts employed" by a given NRSRO.[12] This metric is flawed because it results in a burden analysis that camouflages the costs and strain on resources that result from systematic overhauls and the blizzard of simultaneous changes to regulatory standards. In order to properly evaluate the actual burden of the rules, particularly as they relate to the seven NRSROs that must compete with the largest three NRSROs, the burden analysis must take into account not only the number of ratings or analysts in isolation, but also must include the amount of legal and compliance resources necessary to implement systemic and simultaneous changes.

Including an evaluation of the legal, training, and other compliance costs associated with the systemic overhauls required by the proposed rules would also allow the SEC to better evaluate the differential impact of the rules on the smaller NRSROs. This is information that the Commission should already possess as result of the extensive document requests and analysis already being conducted in connection with examinations. The Commission's experience likely indicates that the three largest NRSROs have immense legal and compliance resources at their disposal, which is due to the fact that they are parts of much larger multinational companies. Those resources can be tapped to expedite SEC examinations and requests allowing these NRSROs to absorb more smoothly increased compliance costs. In contrast, smaller NRSROs have more limited compliance staff who handle a wider variety of compliance-related tasks than are staff at entities with more resources. As a result, each additional burden under the proposed rules is magnified within these smaller NRSROs, and the burdens and costs associated with the proposals can be larger in terms of their relative impact on business operations than the burdens on the three largest NRSROs.

The problems associated with the use of the number of credit ratings and credit analysts as the key metric for measuring paperwork burdens under the proposed rules are also present in the SEC's approach to measuring the economic costs of the proposed rules. While the proposal does state that the proposed rules will likely cost each NRSRO approximately $1 million in the first year of implementation and over $600,000 annually for each year after,[13] these numbers are flawed because these estimates, like the paperwork estimates, are based on the number of ratings and analysts.[14] Additionally, these estimates also exclude the costs to

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[12] *Id.* at 33,500.
[13] *Id.* at 33,511-16.
[14] *Id.*

the three largest NRSROs from the averages included in the analysis.[15] This means that the estimates are fundamentally flawed for at least two reasons:

- Relying on only the number of ratings and analysts is an improper metric. Ensuring compliance with most aspects of the proposed rules will not be more or less difficult based upon the number of credit ratings or analysts because the proposed rules require that smaller NRSROs adopt systematic and complex procedural changes designed for ratings of structured products and apply those procedures to completely different types of ratings. The time, legal advice, and new resources (such as new computer systems and paperwork processing and retention infrastructure) required to take these actions is difficult to estimate with precision. It is clear, however, that the investments will not be diminished relative to financial resources because an NRSRO may have fewer analysts or credit ratings issued.

- The estimated averages exclude the large NRSROs. While the SEC may have excluded the largest NRSROs with the intention of preventing undue inflation of the economic impact averages, the combination of excluding those NRSROs and using the number of ratings and analysts works together to produce unrealistically low estimates. First, this exclusion leaves the SEC with too small of a sample size to make reliable estimates because only two percent of ratings remain to be evaluated after the ratings of the three largest firms are excluded, thus, by using only the number of ratings and analysts as the key metric, the averages cannot account for the cumulative impacts of the proposed rules. Second, the fact that it is doubtful that any smaller entity, with a limited compliance staff and budget, will be able to simultaneously satisfy all of the mandates in the proposal within the timeframes used in the economic impact analysis.

2. The Estimates Fail to Address Cumulative Regulatory Burdens.

On January 18th of this year, President Obama announced a new initiative designed to encourage agencies to promulgate "cost-effective, evidence-based regulations that are compatible with economic growth, job creation, and competitiveness."[16] In connection with this initiative, the President issued two documents that are relevant to the request, a new executive order and a memorandum related to small businesses.

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[15] *Id.* at 33,512.
[16] White House, Fact Sheet: The President's Regulatory Strategy, available at: http://www.whitehouse.gov/the-press-office/2011/01/18/fact-sheet-presidents-regulatory-strategy

Executive Order 13563, entitled "Improving Regulation and Regulatory Review" ("the Executive Order"), was issued by the President on the same day that his regulatory initiative was announced. The Executive Order directs all federal agencies to use the "least burdensome tools for achieving regulatory end," that "take into account benefits and costs, both quantitative and qualitative."[17] The Executive Order further provides that "each agency must...tailor its regulations to impose the least burden on society...taking into account...the costs of cumulative regulations."[18] In evaluating costs, the Executive Order directs agencies to consider unquantifiable issues such as "equity" and "fairness."[19]

The arguments made in the Executive Order were further bolstered by a Presidential Memorandum, issued in conjunction with the Executive Order, entitled "Regulatory Flexibility, Small Business, and Job Creation" ("the Memorandum").[20] The Memorandum explains that regulatory burdens must be "designed with careful consideration of their effect, including their cumulative effects, on small businesses," and restates the language of an earlier Executive Order directing all agencies to "tailor [their] regulations to impose the least burden on society, including...businesses of differing sizes, and...taking into account...the costs of cumulative regulations."[21] Accordingly, the Memorandum directs all executive agencies, and requests from independent agencies, "to give serious consideration to whether and how....to reduce regulatory burdens on small businesses, through increased flexibility."[22] Examples of actions that the Memorandum recommends include "extended compliance dates that take into account the resources available to small entities...simplification of reporting and compliance requirements...different requirements for large and small firms; and partial or total exemptions."[23]

The fact that both the Executive Order and the Memorandum unequivocally call for regulations to be applied in the least burdensome manner in order to reduce unnecessary regulatory obstacles to "innovation" and "competitiveness," argues persuasively that agencies should implement regulations in a manner that avoids placing barriers to competition in front of smaller participants in any particular industry sector. It is important to note that neither the Executive Order nor the Memorandum is restricted to entities that meet the definition of "small business" used in contexts such as the regulations promulgated by the Small Business Administration. The Memorandum appears, through its use of relative language such as the contrast between "large and small firms," to embrace an evaluation of size that fully accounts

[17]Exec. Order No. 13563, 76 Fed. Reg. 3821 (Jan. 21, 2011) at § 1(a).
[18]*Id.* at § 1(b).
[19]*Id.* at §1(c).
[20]76 Fed. Reg. 3827 (Jan. 21, 2011).
[21]*Id.*
[22]*Id.*
[23]*Id.*

for the relative size of businesses involved in a particular market sector—rather than an approach that looks at the size of an individual business in a vacuum. In fact, the language of the Executive Order, which uses the same language regarding cumulative costs as the Memorandum, is not restricted to small businesses in any manner.

While the mandates of the Executive Order are not binding on the SEC because it is an independent agency, the Commission has committed itself to the goals of the Executive order and has claimed that the SEC will "take into account benefits and costs in our rulemakings, assess alternative regulatory approaches … and coordinate our rulemakings with other agencies to harmonize regulations."[24]

The burden estimates in the proposed rules appear to wholly ignore the types of cumulative costs that the President identified in his regulatory orders. For example, the SEC estimate includes no discussion of the cumulative regulatory costs for NRSROs that result from the effort to simultaneously comply with the proposed rules, implement the self-executing aspects of Dodd-Frank, respond to serial inquiries from SEC officials, and participate in annual examinations that require substantial preparation and months of follow-up inquiries. In fact, these burdensome costs were a contributing factor in A.M. Best's recent decision to discontinue its expansion into bank and hospital ratings.

Further, it is not appropriate for the SEC to require the regulated community to calculate these burdens in a vacuum because it is impossible to estimate the burdens associated with future actions from the SEC that are within the sole control of the SEC. For example, individual NRSROs cannot reasonably estimate the cumulative burdens associated with actions such as the duration of examinations and the number of redundant document requests, because NRSROs cannot accurately predict the length of examination follow-up and the frequency and nature of document requests.

Until the SEC develops cumulative burden estimates that take into account all of the strains being placed on smaller NRSROs such as A.M. Best in the U.S. and internationally, it will be impossible to accurately determine the real burdens and costs of the proposed rules. A.M. Best is deeply concerned that the SEC burden and economic impact analysis, by using improper metrics, excluding the three largest NRSROs from the economic impact analysis, and by not considering cumulative impacts, disguises the actual competitive harm likely to result from the proposal, and thus does not satisfy the statutory mandate that the SEC not adopt rules that impose unnecessary competitive burdens.[25]

[24]*See* http://www.sec.gov/spotlight/regulatoryreviewcomments.shtml
[25]15 U.S.C. § 78w(a)(2).

III. Issues Related to Specific Provisions of Dodd-Frank

Preparing comments on every rule contained in the SEC's 500-page rule proposal is a significant burden for a small company like A.M. Best to undertake. As a result, A.M. Best has chosen to specifically comment on only a few of the proposals. Nevertheless, A.M. Best wishes to apply its general comments above to those rule proposals not commented on below. In addition, to the extent its specific rule proposal comments apply to other rule proposals, A.M. Best wishes to apply those specific comments to those rules as well.

A. "Look-Back" Review Rule Proposal

The SEC's proposed rule 17g-8 would require that NRSROs implement procedures designed to place credit ratings on credit watch *immediately* upon the discovery of a potential conflict of interest involving the rating.[26] The SEC has requested comment on the immediate nature of this requirement.

A.M. Best believes that this mandate exceeds the statutory scope and may cause unnecessary confusion for consumers, retailers of financial products, and investors, and in the case of an extreme scenario, economic loss to consumers and/or investors. Section 15E(h)(4), among other things, requires that if a conflict is discovered, an NRSRO "shall: (1) conduct a review to determine whether any conflicts of interest of the employee influenced the credit rating (a "look-back review"); and (2) take action to revise the rating if appropriate, in accordance with such rules as the Commission shall prescribe." The most reasonable interpretation of this provision is that an NRSRO must promptly analyze whether a conflict actually had any impact on the previous rating. Nothing in the language of this provision says or implies that a conflict should be noted to the public prior to determining whether, in fact, a conflict actually impacted the rating. The SEC's proposal to immediately notify the public—prior to a proper and prompt analysis of the conflict—goes beyond the statutory language[27] and scope and potentially places the public at risk of economic loss.

While the SEC's desire to keep users of ratings informed is understandable, placing ratings on credit watch immediately will create a presumption that a previous rating was compromised by a conflict of interest among users of ratings, even though the potential conflict may not have had a material impact on the previous rating. This, in turn, will discourage investment or patronage of entities or products placed on credit watch, and could induce financial problems for these entities before any corrective action can be taken if the conflict is discovered not to exist or not to have impacted the rating. This is particularly acute for consumers of deposit-type financial products and investors in these institutions.

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[26] 76 Fed. Reg. at 33,430.
[27] Public Law 111–203 at § 932(a)(4).

A.M. Best believes that the SEC should require that a rating be placed on credit watch promptly after an investigation of a potential conflict reveals that the conflict has materially influenced the rating in question. The SEC's proposed rules already require that these investigations occur "as quickly as possible," so there is little risk of undue delay.[28] Allowing an investigation to occur prior to public notification would ensure that conflicts are appropriately identified, examined, and publicized without causing undue market turbulence by requiring immediate notification of conflicts that may not have had material impacts on ratings.

B. Internal Control Structure Rule Proposal

The Commission notes that this provision of Dodd-Frank is self-executing and preliminarily believes deferring prescribing factors that an NRSRO must consider with respect to its internal control structure is appropriate at this time. The Commission further notes that deferral will allow it the opportunity to review annual internal control reports that are required to be submitted by each registered NRSRO under the provisions of 15(E)(c)(3)(B) and to evaluate the programs implemented by NRSROs in conjunction with the annual NRSRO examination process, prior to prescribing rules, if any. A.M. Best strongly agrees with the Commission's preliminary belief that deferral is appropriate.

A.M. Best believes that the Commission could greatly benefit from the review of reports and evaluation of programs implemented by credit rating agencies prior to prescribing any rules, given that business models and the size and scope of credit rating operations vary significantly among credit rating agencies. Should the Commission nonetheless exercise its authority to prescribe rules now, A.M. Best believes the Commission should exercise caution in doing so. Attempting to create a "one-size fits all" rule in such a short time frame could result in the creation of an anti-competitive environment and the attendant unintended consequences.

For example, the proposed rule requests comment on whether an NRSRO should be required to have, "*Controls reasonably designed to ensure that in-use methodologies for determining credit ratings are periodically reviewed (e.g., by persons who are independent from the persons who developed and/or use the methodology) in order to analyze whether the methodology should be updated.*"[29] It appears that the Commission would be creating three separate "independent" functions: methodology users; methodology developers; and methodology reviewers. Regulators, other than the SEC, already require that users of methodology and those approving methodology (developers) be "independent," which for many credit rating agencies is a substantially burdensome structural cost in and of itself.

[28] *Id.*
[29] *Id.* at 33,422.

Adding yet another "independent" body (reviewers), would be extremely overly-burdensome for many smaller NRSROs and likely cost prohibitive for a small credit rating agency considering becoming an NRSRO.

The Commission asks whether it should prescribe specific internal control structure factors. A.M. Best believes this is unnecessary and potentially overly-inclusive. An NRSRO can establish and maintain suitable internal controls without the Commission prescribing specific factors. As we have noted, prescribing specific factors implies that all NRSROs are the same, which they are not. NRSROs vary in size, ownership, business plans, and management. "Specific factors" would undoubtedly be designed to apply to the largest NRSROs—this scenario would create a disproportionate impact on smaller NRSROs, whose internal control structure would be best served by designing and implementing policies and procedures that apply the law to the specific characteristics of the NRSRO.

Further, the Commission should not make its rulemaking determination based solely, or substantially, on the recent examination period and recently filed annual reports. Again, such a determination would weigh heavily toward rulemaking for the three largest NRSROs, disproportionally impacting smaller NRSROs like A.M. Best. In addition, upon the enactment of Dodd-Frank, NRSROs were bombarded with multiple Commission requests, exams, staff visits, and follow-on requests all while attempting to implement the Act with very little substantive guidance from the Commission.

While the Commission will be more informed by NRSROs' recent exams and filings, reliance on this information for rulemaking purposes could skew the Commission's perception of the extensive efforts undertaken by NRSROs in the past year—efforts that will realistically differ given the various size and resources available to respond to the Commission's requests during that the past year.

The Commission's proposals also seek extensive documentation of an NRSRO's internal controls. The proposed requirements are expensive, time consuming, and administratively daunting, particularly for smaller NRSROs. A.M. Best believes documentation policies and procedures naturally coincide with the establishment of a properly functioning internal controls structure, which an NRSRO should be allowed to establish according to its own business characteristics and resources. In addition, when or if the Commission decides to prescribe factors, we urge the Commission to exclude extensive or overly-inclusive documentation requirements. These are expensive and time consuming, yielding little benefit. Rather, the Commission should suggest that documentation efforts coincide with the establishment of a properly functioning internal controls structure. However, an NRSRO should be allowed to establish, according to its own business characteristics, what warrants documentation.

As noted above, A.M. Best does not believe the Commission should or needs to prescribe specific factors. Instead, A.M. Best believes the Commission should focus its efforts on providing some general guidance principles. That is, the Commission could identify some principles that an NRSRO should consider when it establishes its internal controls structure. This type of general guidance would allow A.M. Best to consult and incorporate those principles in accordance with the Company's business and management structure.

C. Conflicts of Interest Related to Sales and Marketing Rule Proposal

1. Proposed Rule 17g-5(c)(8) – Prohibited Conflict

Dodd-Frank added new paragraph (3)(A) to Section 15E(h) of the Exchange Act, and requires that the Commission issue rules to prevent the sales and marketing considerations of an NRSRO from influencing the production of credit ratings by the NRSRO. The Commission is proposing to implement this provision by adding new paragraph (c)(8) to Rule 17g-5.[30] This paragraph would identify as an absolute prohibition any circumstance where an "*NRSRO issues or maintains a credit rating where a person within the NRSRO who participates in the sales or marketing of a product or service of the NRSRO or a product or service of a person associated with the NRSRO also participates in determining or monitoring the credit rating, or developing or approving procedures or methodologies used for determining the credit rating, including qualitative or quantitative models.*"[31] As proposed, the rule is overly-restrictive in that it would require smaller NRSROs to dedicate an analytical team(s) to the business development (Sales and Marketing) staff in order to answer potential questions that a prospective client may have regarding A.M. Best methodology and criteria prior to entering into a rating services agreement. The rule, as proposed, would result in grossly inefficient use of the Company's resources and add a substantial amount of infrastructure costs, at little to no benefit.

In its request for comment, the Commission asks: "*How could proposed new paragraph (a)(8) of Rule 17g-5 be modified to retain an absolute prohibition and at the same time not prohibit persons who participate in determining credit ratings or developing or approving procedures or methodologies used for determining credit ratings, including qualitative or quantitative models, to participate in sales and marketing activities that do not expose them to business concerns that could compromise their analytical integrity?*"[32] A.M. Best believes that it is first necessary for the Commission to clearly define the meaning of "sales and marketing activities." Absent a clear definition, NRSROs that establish a conservative

[30] *Id.* at 33,426.
[31] *Id.*
[32] *Id.*

meaning of the term will operate at a distinct disadvantage to NRSROs that define the term more broadly. For example, consider instances where ratings and sales/marketing personnel attend a meeting with a specific client to discuss the rating process, including methodology and criteria, and where there was no intent to discuss during this initial phase a commercial relationship. Depending on the definition of "sales and marketing," an NRSRO could reasonably consider this meeting as either a sales or marketing activity or not.

A.M. Best requests that the Commission consider specifically excluding from the meaning of a sales and marketing activity instances where: 1) ratings personnel attend or make presentations at conferences that describe the analytical process; and 2) rating personnel respond to inquiries from a client with respect to methodology and criteria, provided such responses are subject to the recordkeeping provisions of 17g-2(b)(7).

Further, A.M. Best respectfully requests that the Commission consider adding the statutory requisite[33] of "influence" to the language of the proposed rule: "*NRSRO issues or maintains a credit rating where a person within the NRSRO who participates in the sales or marketing of a product or service of the NRSRO or a product or service of a person associated with the NRSRO* **influenced a person that** *participates in determining or monitoring the credit rating, or* **a person that** *develops or approves procedures or methodologies used for determining the credit rating, including qualitative or quantitative models.*"

We note that 17g-2(b)(7) currently requires that, among other items, an NRSRO must retain all external and internal communications, including electronic communications, received and sent by the NRSRO and its employees that relate to initiating a credit rating. As a result, current sales/marketing recordkeeping policies, procedures and systems are already expected to capture the type of sales and marketing communications that would attempt to "influence" an initial rating. To supplement existing requirements, the Commission could require that an NRSRO that is not exempted under the provisions of 15E(h)(3)(B)(i) establish, maintain, enforce, and document policies and procedures reasonably designed to prevent sales and marketing considerations of an NRSRO from influencing the production of credit ratings and to maintain these records pursuant to a new paragraph (b)(16) of Rule 17g-2. The Commission could further mandate that these policies and procedures contain language requiring that any communications between sales and marketing personnel and ratings personnel are subject to the broader recordkeeping requirements of 17g-2(b)(7), which include communications relating to initiating, determining, maintaining, monitoring, changing, or withdrawing a credit rating.

2. Proposed Rule 17g-5(f) – Exemption for "Small" NRSROs

[33]Public Law 111–203 at § 932(a)(4).

The SEC asks for comment regarding the proposed scope of the definition of "small" in regard to the exemption authority related to the required separation of the production of ratings and sale and marketing activities.[34] Specifically, the SEC has asked how to define a small NRSRO, whether the SEC should use the definition of small used in the Regulatory Flexibility Act ("RFA") analysis, and what factors should be taken into account in regard to the issue of defining small NRSROs.[35]

These questions raise an important issue underlying the SEC's ongoing effort to implement Dodd-Frank. As discussed above, the SEC should endeavor to protect smaller NRSROs from unnecessary burdens while promulgating rules, and utilizing an appropriate definition of "small" could be an important step towards this end.

A.M. Best believes that the SEC should analyze each NRSRO on a case-by-case basis, but given the concentration of the market (98% in three NRSROs), all of the seven smaller NRSROs should be treated as "small" NRSROs for purposes of qualifying to be considered for exemptions targeted at "small" NRSROs. This objective could be accomplished by adopting the definition of "small" that was used in the version of the financial reform legislation initially passed by the U.S. House of Representatives. In § 6002 (a)(5)(1) of H.R. 4173, the SEC was empowered to allow NRSROs to voluntarily withdraw from being a NRSRO if the NRSRO "received less than $250,000,000 during its last full fiscal year in net revenue for providing credit ratings on securities and money market instruments issued in the United States."[36] While Congress ultimately removed the mandatory registration requirement from the legislation during the conference process, at no point did the conference express disapproval of the $250 million threshold. The SEC should view this language as an indicator of what Congress believes a reasonable threshold for "small" is in the context of NRSROs and against the backdrop of the highly-concentrated market.

Defining "small" based on revenue is an approved means under the SBA, which allows the Administrator to develop definitions or standards to determine what constitutes a "small business concern."[37] In so doing, the Administrator may define small business concern according to "number of employees, dollar volume of business, net worth, net income, a combination thereof, or other appropriate factors."[38]

This definition would be far more appropriate than using the $5 million asset threshold used in the RFA analysis. As the SEC notes, that threshold would only allow one single NRSRO

[34]*Id.* at 33,426.
[35]*Id.* at 33,427.
[36]H.R. 4173, 111th Cong. § 6002(a)(5)(1) (2009).
[37]15 U.S.C. § 632(a)(2)(A).
[38]*Id.* § 632(a)(2)(B).

to be considered "small."[39] This result would render the exemption authorities functionally useless as a tool to help avoid further concentration in the NRSRO market resulting from regulatory burdens, and effectively creates a barrier to entry for other small credit rating agencies hoping to diversify the industry. Without the possibility of securing an exemption, instead of competition, the field will likely shrink—smaller NRSROs may not be able to sustain the weight of the regulatory burden and new credit rating agencies will not likely take the chance of entering the market. Essentially, the SEC's proposal is both counter-intuitive and contradictory. The proposal would have the absurd result of treating the NRSRO market as though it is composed of nine large NRSROs and one small NRSRO, while it also acknowledges through its own analysis that the market is almost entirely concentrated in the hands of three large NRSROs.

Accordingly, A.M. Best recommends that the SEC utilize the $250 million revenue threshold, treat the remaining seven NRSROs as small, and design compliance plans and timetables on a case-by-case basis with those small NRSROs. This would allow the SEC and the NRSROs to craft and enforce policies and procedures that reflect both the types of ratings issued and the competitive needs of the smaller NRSROs.

3. Proposed Rule 17g-5(g) – Suspension and Revocation

The Commission has also requested comment on proposed new paragraph (g) of Rule 17g-5.[40] Specifically, the Commission has requested comment on which of the two standards proposed—Sections 15E(h) and 21C of the Exchange Act—should apply when considering suspension or revocation of an NRSRO's registration. Determining a violation of Section 15E(h) should require an official proceeding and findings of whether a rating was indeed affected and whether a suspension or revocation would be in the public interest. A finding of a willful violation is appropriate when considering the length of a suspension or a revocation. Therefore, we believe that Rule 17g-5 would incorporate only Section 15E(d), which has a more appropriate standard because it requires: (1) a willful violation; (2) a public interest finding; and (3) limits the imposition of a suspension to 12 months.

Further, determining whether a violation affected a rating must require extensive analysis of the facts and circumstances surrounding that rating and the allegations of any conflict. Relying on an NRSRO's failure to rely solely on its documented procedures and methodologies for determining a rating is too limiting to an analysis of a potential violation. Suspension and revocation proceedings must take into account all relevant factors of the particular circumstance at issue, just as a credit rating cannot always be appropriately determined by relying on a static list of policies and procedures.

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[39] 76 Fed. Reg. at 33,534.
[40] *Id.* at 33,427.

Section 21C is an inappropriate standard to use when considering suspension or revocation of an NRSRO's registration. Section 21C violation standard is too low and its consequences too high. This section fails to require any purposeful analysis of an alleged violation of Section 15E(h) (*i.e.*, no consideration of the public interest), fails to require any intentionality (*i.e.*, no finding of intentional conduct), and provides no suspension limits (*i.e.*, more than a 12-month suspension is available). It is illogical and improperly punitive to consider revocation or suspension (beyond 12 months) for a non-willful violation that did not affect the public interest.A public interest finding is essential to consider whether, in fact, a violation had any impact on the public.

The Commission asks: "*should the rule provide for the suspension or revocation of an NRSRO's registration solely based on a finding that a violation of a rule affected a rating?*"[41]Whether a rule violation affected a rating is only part of an appropriate analysis for determining suspension or revocation. Again, all the relevant circumstances must be considered. Basing suspension or revocation solely on any one factor is too limiting and potentially too punitive.

D. Fines and Penalties Rule Proposal

Dodd-Frank amended Section 15E of the Exchange Act to add new subsection (p), which provides, among other things, that the Commission establish fines and other penalties applicable to an NRSRO's violation of Section 15E of the Exchange Act and the rules under the Exchange Act. The proposed amendments allow the Commission significant authority to censure or penalize an NRSRO for such a violation—the Commission may censure persons, place limitations on the activities or functions of persons, suspend such persons for a period not exceeding one year, or bar such persons from being associated with an NRSRO.[42]In addition, the Commission now has the authority to temporarily suspend or permanently revoke the registration of an NRSRO in a particular class or subclass of credit ratings if the NRSRO does not have adequate financial and managerial resources to consistently produce credit ratings with integrity.

The Commission may also use Sections 21, 21A, 21B, 21C, and 32 of the Exchange Act to further sanction an NRSRO for violations of Section 15E and the other provisions of the Exchange Act. The Commission asks: "*Are the fines, penalties and other sanctions applicable to NRSROs in Sections 15E, 21, 21A, 21B, 21C, and 32 of the Exchange Act sufficient?If not, what additional fines and penalties should the Commission establish by rule?*"[43] We have already expressed A.M. Best's position (above) regarding the

[41] *Id.* at 33,428.
[42] *See id.* at 33,432.
[43] *Id.* at 33,433.

inappropriate use of Section 21C when considering violations of Section 15E. In regards to the remainder of Section 21 and Section 32 and other violations of the Exchange Act, we do not believe any additional fines or penalties are needed or warranted.

E. Form and Certifications to Accompany Credit Ratings Rule Proposal

Dodd-Frank has amended Section 15E of the Exchange Act to add new paragraph(s), which, among other things, sets forth provisions specifying Commission rulemaking with respect to disclosures an NRSRO must make with the publication of a credit rating. The Commission proposes to implement these provisions by adding new paragraph (a) to Rule 17g-7.Proposed Rule 17g-7(a) would require an NRSRO to publish the following items when taking a rating action: (1) a form with information about the credit rating resulting from or subject to the rating action; (2) any certification of a third-party provider of due diligence services that relate to the credit rating; and (3) attach an attestation to the form that is a signed statement by an NRSRO employee with responsibility for the credit rating that affirms the independent determination of the rating.[44]

"Section 15E(q)(2)(F) of the Exchange Act provides that the Commission's rules must 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."[45] The Commission now proposes that such an attestation be published along with the rating. The language of Section 15E(q)(2)(F) does not, by itself, require an NRSRO to "publish" this attestation along with its rating. Instead, it requires that such an attestation be "included" with any credit rating. Requiring the attestation be published is overreaching, unnecessary, and could have several unintended consequences.

It is unreasonable to essentially assign personal liability to one or more individuals at the NRSRO or on a rating committee. Imposing this type liability and exposure to a particular NRSRO employee or officer could expose that individual, and an NRSRO to third-party lawsuits. It does not appear from the language of Section 15E(q)(2)(F) that the intention was to ensure future class actions which would undoubtedly be filed should such a publication requirement be imposed.

This requirement is further unwarranted because, in the case of A.M. Best, ratings committees fill out a ratings form that reflects their deliberations, attaches the relevant information, and includes the chairperson's signature. In addition, the committee members

[44] *Id.* at 33,463.
[45] *Id.* at 33,464.

rotate—an A.M. Best procedure designed to ensure independence and a candid and thorough analysis of each rating. Every committee chairperson signs the internal rating form, which is itself an attestation to the independence of the rating. Thus, such an attestation is already part and parcel of A.M. Best's ratings package that is recorded and filed within A.M. Best and available to Commission staff during their annual exams, or at any other time. A.M. Best's procedures capture the language and intent of Section 15E(q)(2)(F), and such an attestation is already part of A.M. Best's ratings packages, which are reviewed by Commission staff during its annual exams.

F. Other Amendment Rule Proposals – Classification of Insurance-Linked Securities

The Commission has proposed considerable additional amendments to Form NRSRO. In its proposal regarding Items 6 and 7 of Form NRSRO, the Commission asks "*How should insurance-linked securities be classified? For example, should they be classified as: (1) insurance companies identified in Section 3(a)(62)(A)(ii) of the Exchange Act; or (2) issuers of asset-backed securities identified in Section 3(a)(62)(A)(iv) of the Exchange Act as broadened to include any rated security or money market instrument issued by an asset pool or as part of any asset-backed securities transaction? Is there another more appropriate classification?*"[46]

The term insurance-linked securities covers a broad array of securities, some of which can be rightfully classified as asset-backed securities because they are collateralized by self-liquidating financial assets. For example, insurance collateralized debt obligations and structured settlement securitizations are two insurance-linked transactions that can be legitimately classified as asset-backed security transactions. However, the risks in some insurance-linked securities primarily depend on insurance industry loss events. With these transactions, what are being "securitized" are liabilities as opposed to self-liquidating financial assets.

In this comment, we more narrowly define insurance-linked securities as securities linked to insurance industry loss events. We exclude transactions in the insurance space that meet the statutory definition of asset-backed securities. The most significant recurring transactions in the insurance industry, that involve insurance industry loss events, are catastrophe bonds, which cover low probability, high severity loss events. By explaining the mechanics of catastrophe bonds, it will be apparent that: 1) there are significant differences between insurance-linked securities and asset-backed securities; and 2) in the absence of an entirely

[46] *Id.* at 33,489.

new class of credit ratings, insurance-linked securities can be best classified under a new subclass within the insurance companies class of credit ratings.

Catastrophe bonds are generally issued through special-purpose reinsurance vehicles, which provide fully collateralized reinsurance capacity to their sponsors. The sponsors are normally insurers seeking reinsurance or reinsurers seeking retrocession coverage. Contractually, the sponsors are responsible for paying premiums to the special-purpose reinsurance vehicles, and the vehicles in turn pay the sponsors in the event of insurance losses that exceed agreed-upon attachment levels. In asset-backed securities transactions, the sponsors (*i.e.*, the entities that sell assets to a special-purpose vehicle) normally just service the assets if they remain involved at all after the sale of assets. With catastrophe bonds, sponsors pay premiums to the special-purpose reinsurers pursuant to reinsurance agreements. It is important to note that the sponsors of catastrophe bonds (and indeed, with all insurance-linked securities transactions) are ultimately directly responsible for making claims payments to their policyholders, regardless of their economic arrangements with the special-purpose reinsurance vehicles providing reinsurance.

As alluded to earlier, catastrophe bonds are fully collateralized. This collateralization is provided with the proceeds collected from the bond holders. In the past, catastrophe bond structures employed total return swaps in which rated swap counterparties maintained the value of the collateral associated with the bonds. With the most recent incarnation of these transactions, the collateral investment guidelines have tightened considerably. In most cases, the collateral is in treasury securities, government money market funds and other highly rated securities. In addition, some transactions require frequent mark-to-markets with obligatory "top-offs" designed to maintain the market value of the collateral. Prudent management of the collateral ensures that the most significant risk in these transactions remains the risk of insurance losses.

With catastrophe bonds, the source of funds for interest payments to note holders generally consists of two components—premiums paid to the special-purpose reinsurance vehicles by the sponsors, and interest proceeds associated with the collateral accounts. If qualifying catastrophic events occur before the maturity of the catastrophe bond, the collateral balance is used to satisfy the special-purpose vehicle's reinsurance obligation to its sponsors. In the absence of qualifying catastrophic events, the balances in the collateral account are used to return principal to bond holders. By contrast, asset-backed securities transactions generally rely on excess spread (the difference between the yield on the collateral and the yield on the issued securities) and, in some cases, sale of assets by portfolio managers to amortize obligations to note holders.

It is important to note that the ratings on catastrophe bonds are often constrained by four factors: 1) the ratings of the insurers or reinsurers sponsoring the transactions; 2) the quality of the collateral and the ratings of the associated swap counterparties (if any); 3) the probabilities of the catastrophic events occurring as determined by third-party peril modelers; and 4) the fact that catastrophic risks are binary in nature—either the event occurs or it does not.

While catastrophe bonds are the most common types of insurance-linked securities, other insurance-linked securities are emerging that cover non-catastrophic insurance losses such as those associated with automobile, credit and life/health insurance. Regardless of the type of liabilities involved in such insurance-linked securities transactions, the key point is that these transactions have some common characteristics that make them easier to distinguish from asset-backed securities transactions:

1) Insurance-linked securities are sponsored by insurers or reinsurers seeking protection from insurance risks—the risks are related to the timing and amount of insured losses;
2) Despite the transfer of the insurance risks to investors, the sponsor is still responsible to its original policyholders for any insured losses;
3) Insurance-linked securities transactions normally involve special-purpose reinsurance vehicles under the authority and supervision of insurance regulators;
4) Insurance-linked securities transactions are collateralized;
5) The investment risk is minimal in insurance-linked securities transactions;
6) The agreements between sponsors and the special purpose reinsurance vehicles in insurance-linked securities transactions are similar to the agreements found in traditional reinsurance business;
7) The loss estimates are generally determined by independent third-party entities with modeling expertise in natural catastrophe risks, mortality/morbidity risks and other insurance risks;
8) The moral hazard of ceding the worst risk to investors in insurance-linked securities transactions is minimized—there is no incentive to pass on poorly underwritten business to investors since the sponsors will generally share in the losses in most cases; and
9) The ratings of insurance-linked securities are most often constrained by the ratings of the sponsors and the attachment probabilities determined by independent third-party modelers.

It is A.M. Best's opinion that catastrophe-related insurance-linked securities should not be classified as asset-backed securities due to the features summarized above. However, the entities that issue insurance-linked securities also do not neatly fit into the insurance company category, simply because the securities are generally issued by entities that do not behave like typical insurance companies with multiple lines of businesses and multiple policyholders. For example, the special-purpose vehicles that issue catastrophe bonds have terms of one to three years, whereas traditional insurance carriers are established with no term limitations. Further, there is generally only one policyholder associated with each catastrophe bond issuer—the insurance carrier seeking reinsurance from the special-purpose vehicle.

A.M. Best recommends that the Commission create a new subclass of credit ratings under the current insurance companies class. This would help distinguish traditional insurance companies from the special-purpose vehicles solely set up to provide reinsurance to insurance carriers.

IV. Conclusion

A.M. Best appreciates the opportunity to comment on the proposed rules and would be happy to discuss our comments with Commission staff.

Very truly yours,

Larry G. Mayewski