

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

Re: Proposed Rules for Nationally Recognized Statistical Rating Organizations (File # S7-28-09)

Dear Ms. Murphy:

I am grateful to have the opportunity to comment on the proposed rules regarding the oversight of rating agencies' compliance function. My name is Eric Kolchinsky and I'm a former Managing Director in the Structured Finance Group at Moody's Investors Service. On September 29<sup>th</sup> 2009, I testified in front of the House Committee on Oversight and Government Reform regarding what I believed were fraudulent ratings issued by Moody's Investors Service ("Moody's"), an NRSRO. Furthermore, I testified about what I saw as weaknesses within Moody's internal compliance function.

I believe that the proposed rules covering the compliance role at an NRSRO may be the most practically useful regulatory tool at the Commission's disposal. Under the Credit Rating Agency Reform Act of 2006, the Commission may not "regulate the substance of credit ratings or the procedures and methodologies by which any [NRSRO] determines credit ratings." This is unfortunate because the methodologies employed by the rating agencies themselves are often a jumble of rules, which contain numerous exceptions and exceptions to those exceptions.<sup>1</sup> Furthermore, these rules are often inconsistently applied by the various business lines and geographic offices. Many of these rules are not written down.

As a practical matter, this situation makes it nearly impossible to judge an NRSRO's compliance with its own methodologies. A rating agency can stall inquiry into its own practices by claiming that the behavior in question is a part of its methodology. Since the rating agency is the sole master of its own procedures, there is no outside expert which the Commission can call on to dispute the NRSRO's claims. Under these constraints, I believe that effective oversight of rating agencies will be limited to violations spotted by the analysts themselves. The compliance office, as the conduit of the internal challenges, is thus the focal point of a successful regulatory system.

I wish to echo the rationale the Commission states for the promulgation of these rules. I too believe that they "would improve the integrity of the credit ratings process by establishing a more structured discipline under which the NRSRO's designated

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<sup>1</sup> During my Congressional testimony I suggested that methodologies be standardized to minimize conflicts, increase transparency and to allow for more effective regulation. I still believe that this is the optimal solution.

compliance officer would need to report to the Commission the steps taken to fulfill the officer's statutory responsibilities."

For these reasons, and given the importance of the compliance office, my general comment on the proposed rules is that they should err on the side of caution and be "over-inclusive" rather than "under-inclusive".

For example, the definition of "material compliance matter" should be construed broadly. Retaliation should certainly be covered by that term. Employees who turn to their managers or to the compliance group to point out, in good faith, what they believe to be violations of law or some procedure should be protected by the organization. However, it is often the same compliance office that investigates the violation and the retaliation. If the compliance office is not incentivized to thoroughly investigate the former, it is not likely to seriously consider the latter. A mandatory report to the Commission would make it more likely that the compliance function is more effective in protecting those employees who step forward to point out violations.

My detailed answers to the questions posed by the Commission are below:

***1. Should the proposal require that the report be furnished to the NRSRO's board or a body performing similar functions of a board or to the NRSRO's senior management in addition to requiring that it be furnished to the Commission or as an alternative to it being furnished to the Commission? Could the requirement to furnish the report to the Commission alter the way the compliance officer conducts compliance reviews or reports the results of those reviews to others within the NRSRO? Would the requirement that it be furnished to the Commission potentially impact the designated compliance officer's incentive to perform a comprehensive and in depth review of the NRSRO's activities, policies, and procedures or to identify material compliance matters? Would requiring the report instead be sent to the board, to a similar body, or to senior management result in a more or less comprehensive review?***

I strongly believe that the Commission should be one of the recipients of the report. As an aside, I also do not see how a board of directors of a public company could discharge its fiduciary obligations without seeing such a report.

In an ideal world, these reports should be made public so that investors and issuers can be aware of the limits of NRSRO actions and procedures. It is a fair assumption that such disclosure would be strongly resisted by the NRSROs due to their (not unfounded) fear of litigation. As a middle ground, I propose that the Commission publish annual reports similar to the "Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies" published in July of 2008 based on the NRSROs' submissions.

These annual reports would discuss, on a "no-names" basis, issues at the NRSROs, their eventual resolution and the Commission's views on the matters. This report would be a tremendous service to the marketplace by communicating the boundaries of permissible

activities for the NRSROs. In the long term, a periodic publication of this type could even serve the same purpose as the Commission’s “no action” letters.

I believe that such a report would be of great interest to rating agency analysts who will better understand their role in the capital markets. As I’ve stated numerous times, the vast majority of credit analysts are ethical and want to do a good job of rating. This report will give encourage them to report questionable activities.

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***2. Should the Commission require other items to be included in the report in addition to those prescribed in proposed paragraph (a)(7)(ii) of Rule 17g-3? Commenters believing this would be beneficial should specifically identify the additional items and describe how the additional information would be useful to the Commission or to the NRSRO.***

I believe that the Commission has covered most of the key items in the proposed rule. Nevertheless, there are other pieces of relevant information which the Commission may find useful. For example:

- How the investigation was initiated. This item would give the Commission a better understanding of how effective the compliance office is – are the bulk of the investigations being initiated by analysts, external parties or the office itself.
- The nature of the actual investigation, the identity of the primary investigator and a list of those interviewed. These items of information can assure the Commission that the investigations performed by the compliance office are substantive. The identity of the investigator and the interviewed will provide the Commission with a contact list if any follow-up is required.

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***3. Should the Commission exclude any of the items currently identified in proposed paragraph (a)(7)(ii) of Rule 17g-3? Commenters believing this would be beneficial should specifically identify the items to be deleted and describe why they would not be useful information for the Commission or the NRSRO?***

As stated above, I believe that the reports need to err on the side of caution and be over-inclusive rather than under-inclusive. As such, I would not recommend the removal of any items from in proposed paragraph (a)(7)(ii) of Rule 17g-3.

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***4. Should the Commission define the term “material compliance matter” in Rule 17g-3? If so, what should the definition be? Alternatively, is the interpretation of the term “material compliance matter” set forth in the release sufficient and appropriate? Should there be limitations on what constitutes a material compliance matter? If so, what should these limitations be? For example, are there securities laws violations that***

***do not rise to the level of concern that they would need to be reported? If so, should such violations be reported if the number of occurrences passes a certain threshold? How should the Commission evaluate what that threshold would be (e.g. taking into account the number of occurrences and the severity of the violation)?***

I do not believe that the Commission should define the term “material compliance matter”. As stated above, I believe that the scope of the report should be over inclusive rather than under inclusive.

My personal experience is illustrative here. Setting aside the merits of my case, I assume that the set of facts in question is precisely the type that the Commission would want to be brought to its attention. However, Moody’s has repeatedly stated that their investigation has not substantiated any of my claims. It should be clear that the NRSROs duty to report should be driven by the weight of the compliance matter in question, not what they claim the outcome may be.

If the Commission adopts the periodic report to the market which I recommend in (1) above, the scope of the annual reporting would gradually narrow based on the feedback from the Commission.

Also, I believe that it is crucial that retaliation complaints are also included in the report. It is the only way to give analysts comfort that they will not be punished for airing their concerns.

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***5. As noted above, the Commission has proposed an interpretation of the category of person that would trigger the reporting requirement if such person were apprised of the finding of the compliance officer. Is the proposed interpretation sufficiently clear to indicate when the reporting requirement applies? For example, should the rule specify that it is a decision maker, someone with authority to implement remedial measures, or some other defined category of person? How should that category be defined?***

I believe that the Commission should adopt the position that the designated compliance officer must communicate the results of the reviews to all relevant personnel. All relevant analytical personnel must know what types of actions would trigger a violation of the law, regulation or internal code. With respect to the culpability of the NRSRO, there should be no defense that the matter was not communicated to the front line analysts. However, as far as individual culpability is concerned, the burden of proof should lay with the compliance office. This will ensure that communications from the compliance office are broadly distributed and in writing. The only way that future violations can be prevented is by a broad understanding of the impermissible actions by those who are actually performing the work in question.

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***6. Should the Commission permit or require someone other than the designated compliance officer certify the report? If so, which person(s) should it be?***

***7. To what extent, if any, should the designated compliance officer be able to rely on subcertifications? What purpose would the subcertifications serve? In some cases, would the designated compliance officer not have all the relevant information in order to sign the statement required by proposed Rule 17g-3(b)(2) without subcertifications? If this is true, would this in some way negate any of the objectives of the proposed amendments to Rule 17g-3?***

6 and 7. I do not believe that the Commission should permit anyone other than the designated compliance officer to certify the report. Doing so would undermine the goals of the Commission for the proposed rule

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***8. What effect would the proposed requirement to furnish the report to the Commission have on the designated compliance officer's duties? How could any adverse effects be addressed?***

I do not believe that the proposed rules would have any negative effects on what the role of the compliance officer is supposed to be. The proposal merely requires the compliance officer to furnish the Commission with the information which she should already be memorializing as part of her normal routine.

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***9. Should the Commission as an alternative to the proposed report from the compliance officer consider proposing a requirement that an independent third party perform a review of the NRSRO's adherence to its policies and procedures and its compliance with the securities laws. Commenters who believe such a requirement would be appropriate are asked to provide data with respect to the costs and benefits.***

My experience with the role of external third parties hired by management is that they tend to echo the views and concerns of their clients. Nevertheless, it may be useful for the Commission to review the report of a third party hired by independent members of the board of directors in addition to the report from the compliance officer.

Thank you again for the opportunity to comment on these proposed rules.

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