MEMORANDUM

TO: Public Comment File on Dodd-Frank Implementation
Title IX: Credit Rating Agencies Review and Rulemaking

FROM: Alicia F. Goldin
Office of Commissioner Elisse B. Walter

DATE: November 1, 2010

On October 14, 2010, Commissioner Elisse B. Walter and Alicia F. Goldin, Counsel to the Commissioner, met with the following individuals:

Mahesh K. Kotecha, CFA – President, Structured Credit International Corp
Roy P. Weinberger – Credit Research, Advisory, Consulting
Michael D. DiGiacomo – Vice President, Finance and Administration, the Levin Institute

The discussion included, among other things, the participants' views regarding credit rating agencies. Attached to this memo are materials provided by the participants, including: a letter that indicates the proposed agenda for the meeting; biographies of meeting participants; a presentation that was provided at the meeting; and an updated version of the same presentation which was provided after the meeting. The participants also provided a copy of an article entitled "The Future of Structured Finance Ratings After the Financial Crisis, by Mahesh Kotecha, Sharon Ryan, and Roy Weinberger, which was published in the Winter 2010 volume of The Journal of Structured Finance.

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August 19, 2010

Commissioner Elisse B. Walter
US Securities and Exchange Commission
100 F Street, NE, Washington, DC 20549

Dear Commissioner Walter:

We understand you said in a speech in March 2009 that: "We need to consider alternatives to the issuer-pay model." We could not agree more that the issuer-pay model is broken and needs to be fixed. We have proposed (in an article published earlier this year in the *Journal of Structured Finance*, copy attached herewith) that both issuers and investors should pay for ratings following the MSRB precedent of charging fees on new issues and secondary market trades of municipal securities. Our article shows that we know and have thought carefully and long about these issues from a public policy perspective.

The SEC is required to study the matter of rating agency compensation within two years of passage of Dodd Frank bill, per its section 439F(b): "The Commission shall carry out a study of 1) the credit rating process for structured finance products and the conflicts of interest associated with the issuer-pay and the subscriber-pay models; (2) the feasibility of establishing a system in which a public or private utility or a self-regulatory organization assigns nationally recognized statistical rating organizations to determine the credit ratings of structured finance products, including (A) an assessment of potential mechanisms for determining fees for the nationally recognized statistical rating organizations; (B) appropriate methods for paying fees to the nationally recognized statistical rating organizations; (C) the extent to which the creation of such a system would be viewed as the creation of moral hazard by the Federal Government; and (D) any constitutional or other issues concerning the establishment of such a system; (3) the range of metrics that could be used to determine the accuracy of credit ratings; and (4) alternative means for compensating nationally recognized statistical rating organizations that would create incentives for accurate credit ratings."

We believe that SEC may benefit from assistance of a party such as Structured Credit International Corporation ("SCIC"), a New York based advisory firm which I established in 1999 which specializes in advising clients on matters related to credit ratings and structured financings. Further background on SCIC is at www.4scic.com

Accordingly, we request an appointment with you to solicit your views and your guidance on how we might be of assistance to SEC to carry out this study in part of in full under contract to the SEC.

Respectfully yours,

Mahesh Kotecha, CFA
President

Mahesh K. Kotecha, C.F.A.

Mr. Kotecha is President and founder of Structured Credit International Corp. (SCIC), which provides advisory services on credit ratings and securitizations both in the US and globally. At SCIC he has provided advice to securities market regulators in Brazil and Thailand and to central banks in Uganda and Bahamas and to large and medium size financial institutions worldwide. For ten years prior to forming SCIC, he was Managing Director of MBIA Insurance Corporation and of CapMAC Asia and an Alternate Director for ASIA Ltd. Mr. Kotecha helped establish ASIA Ltd in Singapore and ABS Finance in Indonesia. Prior to establishing ASIA Ltd., his responsibilities at CapMAC included US deal origination and deal execution, involving many types of underlying collateral and debt instruments. Before joining CapMAC, Mr. Kotecha was Senior Vice President and Director of the Market Analysis and Product Development Group in the Asset Finance Department at Kidder, Peabody. .

From 1979 to 1987, Mr. Kotecha worked for Standard & Poor's Corporation (S&P), where he founded and headed the international public sector credit ratings department, with responsibility for all credit ratings on non-US municipalities, some thirty sovereign governments, supranational borrowers as well as financial and industrial institutions owned or largely controlled by national or regional governments. He also founded and headed S&P's non-US structured finance group to rate transactions backed by non-US collateral. Prior to joining S&P, Mr. Kotecha worked at the Federal Reserve Bank of New York, where he introduced the concept of loan sampling in the supervision process, helped implement the shared national credit program and invest foreign central banks' dollar reserves in the US capital markets. Previously he worked at the United Nations Development Program (UNDP) for three years.

Mr. Kotecha holds a Master's degree in management from the Sloan School of Management at MIT (1974), and a Bachelor's degree in physics and engineering from Harvey Mudd College in Claremont (1970), California. He is a Chartered Financial Analyst (1985) and is a member of the US-based Council on Foreign Relations, where he was an Adjunct Senior Fellow (1999 – 2002) conducting policy analysis. He is a partner and a member of the Rating Committee of BRC Investor Services (a Colombian rating agency) and a member of the Board of Directors of TurkRating, a Turkish rating agency. He is also a member of the Bretton Woods Committee.

Roy P. Weinberger

Roy P. Weinberger has achieved broad recognition as a pioneer in the practice of credit research. He has held executive positions with two international rating organizations, and has analytical expertise in all rating areas. At Standard & Poor's Corporation ("S&P"), he was consistently offered opportunities to manage new rating initiatives, among them ratings assigned to non-US obligors and to structured finance instruments such as residential mortgage backed securities for which he developed and published rating criteria and directed S&P's ratings, gaining a three-year lead over other rating agencies. Every one of the securities rated investment grade during Mr. Weinberger's tenure paid off on time and in full.

As director of S&P's corporate rating unit, he:

- Developed the first rating methodology profiles – i.e. analytical systems to ensure that rating committees consider all essential risk factors in a consistent and systematic manner;
- Conceived and implemented the concepts of "CreditWatch" and "Credit Outlooks," practices now used by all international rating agencies; and
- Prepared and publicly distributed the first-ever guide to rating agency practices.

In combination, these actions dramatically enhanced the efficiency, effectiveness, timeliness and transparency of the rating process.

Mr. Weinberger was Director - International Business Development at Thomson Financial BankWatch. In that role, he formed new rating agencies to support capital market development in Latin America, Asia and Eastern Europe.

In recent years Mr. Weinberger has served as an independent consultant and advisor on matters related to credit risk and ratings, principally by assisting institutional investors protect the value of their fixed income portfolios. He is also a shareholder and a member of the Rating Committee of BRC Investor Services S.A., a credit rating agency based in Bogota, Colombia and chairman of the Board of Directors and a member of the Rating Committee of TurkRating S.A., a credit rating agency based in Istanbul, Turkey.

Mr. Weinberger is a past president and director of the Fixed Income Analysts Society, Inc., and is a member of The CFA Institute. He holds a Masters of Science degree in business policy from Columbia University, New York.

Michael D. DiGiacomo

Michael DiGiacomo is a director and former chief administrative officer of The Levin Institute in New York City. The Institute, part of the State University of New York, offers graduate programs in economic and international affairs, with an emphasis on the impact of globalization.

Prior to joining the Levin Institute he worked for fifteen years as an investment banker, at J.P. Morgan Chase, Jones Lang Wootton, and Kidder Peabody. He specialized in mortgage and asset securitization, and corporate and municipal debt. He dealt extensively with the rating agencies and with investors both domestically and abroad.

Mr. DiGiacomo was the International Monetary Fund's representative on the Board of Directors of the Korea Mortgage Corporation in Seoul, South Korea, which securitizes home mortgages in that country.

Prior to his banking career he practiced law, first as a clerk to the Hon. William Hughes Mulligan, a judge on the U.S. Court of Appeals for the Second Circuit, and then at Dewey Ballantine LLP in New York City. He was an adjunct professor at Fordham Law School in New York, where he taught capital markets.

Mr. DiGiacomo is a graduate of Yale College and Fordham Law School (J.D. *cum laude*), where he was an editor of the Law Review. He served to Lieutenant (junior grade) on active duty for three years with the United States Navy.

Sharon Ryan[1]

Ms. Ryan is a former investment banker with broad experience in debt and equity financings for US and non-US (particularly emerging markets) clients.

At Lehman Brothers and HSBC, she structured debt capital markets transactions involving equipment leases, consumer and corporate receivables providing credit ratings advice in connection with such financings. At HSBC, in addition, she broadened her experience to include the placement of US tranches pursuant to Rule 144A of global equity issues for emerging market companies in India, Hungary, Ghana, Thailand, and Mexico. Her work extends also to public sector clients for example, at SCIC, she advised the Public Utility Commission of the State of New Hampshire, regarding the impact of Rate Reduction Bonds on ratepayers.

Ms. Ryan's experience includes Capital Re Management Corporation, a financial guarantee company, where she developed underwriting guidelines for reinsurance of securitized transactions, Standard & Poor's, where she developed criteria for rating asset backed securities and other structured financings, and the Federal Reserve Bank of New York where she was a bank examiner in the Supervision and Regulation Division specializing in the analysis of the non-banking operations of money center bank holding companies.

Ms. Ryan holds an MBA from Pace University, an MA in social sciences from Columbia University and BS in social psychology from Cornell University. She also has been an instructor in the Federal Financial Institutions Examination Council training program on Capital Markets.

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[1] Ms Ryan co-authored with Mahesh Kotecha and Roy Weinberger the article in the *Journal of Structured Finance*, Winter 2010 entitled "The Future of Structured Finance Ratings After the Financial Crisis".

October 14, 2010
Washington. DC

PRESENTATION TO SEC COMMISSONER ELISSE WALTER ON RATING AGENCY COMPENSATION MODEL

BY MAHESH KOTECHA, ROY WEINBERGER, MICHAEL DIGIACOMO

Based on an article in the Journal of Structured Finance, Winter 2010: "The Future of Structured Finance Ratings After the Financial Crisis", by Mahesh Kotecha, Sharon Ryan and Roy Weinberger

SEC Mandated Under Dodd-Frank To Study Rating Agency Compensation Models

Under Section to 439F(b) of Dodd-Frank, SEC to Assess by mid-2012 Rating Agency Compensation Models

1. The credit rating process for structured finance products and the conflicts of interest associated with the issuer-pay and the subscriber-pay models

2. The feasibility of establishing a system in which a public or private utility or a self-regulatory organization assigns nationally recognized statistical rating organizations to determine the credit ratings of structured finance products, including:
   - an assessment of potential mechanisms for determining fees for the nationally recognized statistical rating organizations
   - appropriate methods for paying fees to the nationally recognized statistical rating organizations
   - the extent to which the creation of such a system would be viewed as the creation of moral hazard by the Federal Government; and
   - any constitutional or other issues concerning the establishment of such a system

3. The range of metrics that could be used to determine the accuracy of credit ratings; and

4. Alternative means for compensating nationally recognized statistical rating organizations that would create incentives for accurate credit ratings

SCIC Experience

- SCIC team members have been involved in ratings from its early days
- SCIC is knowledgeable on structured finance markets
- SCIC team members have been involved in structured finance and their ratings from their very beginnings
- SCIC believes that reform of rating agency compensation models is critical to restoring confidence in rating agencies

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SEC Rule 17g-5(a)(3) is a Mixed Blessing and Does Not Address Conflicts of Interest

SEC Rule 17g-5(a)(3): A Step in the Right Direction?

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- Rule 17g-5(a)(3) is designed to improve the quality of credit ratings through increased competition by making it possible for NRSROs not hired by the issuer or arranger to rate structured finance products on an unsolicited basis
- The Rule requires disclosure of all material information, including non-public information provided to the hired NRSRO, to all other NRSROs qualified to rate the particular type of structured product so the latter can at their option provide unsolicited ratings for a transaction even when not mandated to do so for a fee
  - The Rule obliges an arranger to set up a website to provide the information to NRSROs not retained by the arranger qualified to rate their transactions without request and for no fee.
- But there is confusion regarding implementation of the Rule
  - On information that should be released to the non-hired NRSROs
  - On the use of unsolicited ratings in capital requirements for banks
- Seems out of step with concept that investors should do their own homework and not rely as much as in the past on the rating agencies

Importantly, Rule 17g-5(a)(3) Does Not Address Conflicts

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- The Rule tips the scales in favor of "investor pay" model whose subscribers gain privileged access relative to other investors
  - Investor pay" NRSROs can use the information to assign unsolicited ratings of structured products and sell them privately only to their subscribers
- The rules on information disclosure to non hired agencies from (for example) face to face discussions or telephone calls between the hired NRSRO and the issuer to other NRSROs are unclear and may inhibit such discussions
  - Some critical information will inevitably be missed by non hired agencies
  - Does the rule contemplate recording every meeting and conversation?
- The Big Three "issuer pay" agencies (S&P, Moody's and Fitch) must weigh the cost of incurring issuer's wrath if they were to give low unsolicited ratings as doing so would cannibalize potential future fee paying business from the issuer
  - Indeed, in April 2010 Redwood Trust RMBS issue carried a Moody's triple–A: S&P issued an "unsolicited commentary" (not a "rating") declaring that in its view some tranches would not have warranted a triple-A had they rated it
- Smaller and/or less established rating agencies will issue unpaid ratings only if they see a realistic opportunity for future fee paying business
  - To attract issuer interest they may be incented to provide more lenient ratings potentially fostering a "race to the bottom"

Issuer Pay Model is Flawed

Birth of the "Issuer Pay" Model

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- The debt rating business as we know it today dates from 1969, when a rating cut by Standard & Poor's was widely credited for precipitating the bankruptcy of the Penn Central Railroad Corporation
- The footprint of ratings grew in the capital markets and this jump in demand for ratings allowed Standard & Poor's and its competitors to begin charging debt issuers for ratings during the 1970s.
- The justification was that increasing demands on the agencies required much higher staff and compensation levels than could be afforded through sale of publication subscriptions alone. Income from rating fees quickly eclipsed amounts previously earned from subscriptions.
- A great benefit of the "issuer pay" model is that agencies with this business model typically distribute all their ratings
  - But rating analyses are available only to paying subscribers

"Issuer Pay" Model Conflicts Are Intractable

- Regulatory authorities throughout the world would appear to have blessed the issuer pay model, notwithstanding wide recognition that there are embedded and intractable conflicts of interest
- Rating agencies have long argued that any professional services firm faces conflicts of interest and that the rating agencies have in place policies and processes that effectively manage such conflicts.
- However, the poor performance of ratings on both structured and non-structured products have seriously undermined rating agency assertions that conflicts of interest have been effectively managed.
- *Conflicts must be removed from the rating agency compensation models if confidence in rating agencies is to be restored*

What about the Investor Pay Model ?

Is "Investor Pay" Model the Answer?

- A small number of entrepreneurial, US-based firms have within the past 15 years developed a sufficient following among institutional investors to be financially viable with an "investor pay" model
  - This includes three *NRSROs: Egan-Jones, LACE Financial, and Real Point LLC (which however uses the "issuer pay" model for new issue ratings)*
- *Benefits of the investor pay model*
  - *As these companies derive income mainly from subscriptions, they do not have the same conflicts of interest as "issuer pay" firms.*
  - *Also, as long as their subscriber base is sufficiently diverse, it is unlikely that one or a small number of subscribers could unduly influence their opinions.*
- *Shortfalls of the investor pay model*
  - *Limited coverage – especially for structured finance, project finance, international and US municipal markets partly because they can only rate an issuer or an issue when publicly available information is adequate*
  - *Limited ratings disclosure because a value addition for investors is that neither the ratings nor the analyses are generally available to non-subscribers*
  - *Risk of undue subscriber influence if the agency's customer base is not adequately diversified*

We Think There Is A Better Solution – Both Investors And Issuers Should Pay For Ratings

A New Compensation and Assignment Model

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- The new model would lead over time to better ratings which are more accurate in predicting default rates and expected losses though different phases of the business cycle and more timely in terms of rating changes
  - The new model could be rolled out in stages beginning with structured finance markets and extended in time to all ratings.
- Payment for ratings should come from a fee levied on new issues and secondary market trades
- The fee levels would be determined and reset periodically based on a review of the historic and projected volumes of primary market issuance and of secondary market trading so as to equal or exceed the current level of rating agency revenues from ratings
  - The fees would be negotiated by the Fund with the NRSROs on the basis of a ROE target for the NRSROs in a manner not unlike regulated utilities
- For an initial period of , for example five years, if possible two and perhaps more rating agencies qualified to rate such structured issues would be assigned on a rotating basis per a queuing system
  - Over time, the rotating system of rating assignments to be replaced by assignments based on ratings accuracy, which would be reviewed periodically (say 5 years)

The US Ratings Fund

- Fees collected to be deposited in a dedicated Ratings Fund
  - The US Ratings Fund would be modeled after the Municipal Securities Rulemaking Board (MSRB) which was established by an Act of Congress in 1975
  - Like the MSRB, the Fund would likely be established pursuant to an Act of Congress
- The Ratings Fund would pay for ratings of publicly issued securities and others such as those under Rule 144(a)
  - Both term debt and commercial paper would be included
- Governance of the US Rating Fund
  - The Fund should be overseen by a Board of Directors made up of representatives of issuers, investors, intermediaries, NRSROs and independent directors
- The Fund system could expand globally by allowing new jurisdictions to either join or clone the US system

Comparing the Three Rating Agency Business Models

The Three Compensation Models Compared

Attribute V	Investor Pay	Issuer Pay	Pay from Deal Proceeds
Fee paid by =>	Investors	Issuers *	Both issuers and investors
Conflict of Interest	Investors would like ratings as low as possible to increase return	Issuers would like ratings as high as possible to reduce funding costs	Neutral as both investor and issuers pay for ratings
Disclosure of ratings and rationales without paying subscription fee	Disclosure limited to criteria as the paying investors want ratings to be provided only to them	Ratings and criteria disclosed to all; full rating reports, industry and other research only available to fee paying subscribers	Ratings, rationales and criteria would be disclosed for free
Ratings Shopping	Not a concern under this model	Great scope for rating shopping as issuers want to reduce costs of financing by getting as high a rating as possible	Initially, (two or three) agencies would be assigned to rate each issue on a rotating basis if each agency is (i) recognized by the regulator and (ii) qualified to offer ratings for the specific type of issue. Later, assignments would be made subject to accuracy of the agency's ratings
Regulatory issues	Generally not used by regulators	Have been used widely to determine permissible investments and adequacy of capital but their use is likely to decline	Given the lack of conflict, their use likely would and probably should be fostered by regulators.

* Includes investment bankers, e.g., in the context of arbitrage vehicles

Next Steps ?

SCIC is Prepared to Assist SEC

- Our proposal addresses issues to be studied by the SEC under Dodd-Frank
- The goal is to develop a US solution first and then to work with regulators and market participants world-wide to develop a consensus
  - We have sought and obtained inputs from US and London-based stakeholders
  - Feedback has been positive and we believe building consensus is possible
- SCIC welcomes SEC's and others' views