December 22, 2020

Michael Heaney
Committee Chairman
Fixed Income Market Structure Advisory Committee
100 F St. NE
Washington, D.C. 20549

Amy McGarrity
Chair of Credit Ratings Subcommittee
Fixed Income Market Structure Advisory Committee
100 F St. NE
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Re: FIMSAC Recommendation Regarding Ways to Mitigate Conflicts of Interest in Credit Ratings

Dear Mr. Heaney and Ms. McGarrity,

The Structured Finance Association ("SFA") appreciates the opportunity to comment on the recommendation (the "Recommendation")[1] made on June 1, 2020 by the Fixed Income Market Structure Advisory Committee ("FIMSAC") of the Securities and Exchange Commission (the "Commission") related to the regulation of nationally recognized statistical rating organizations ("NRSROs").

As an association representing participants across the entire value chain of the securitization market—including issuers, investors, financial intermediaries, credit rating agencies, law firms, accounting firms, technology firms, servicers and trustees—SFA plays a vital role in the development of market-consensus solutions that support efficient and stable markets, thus helping to make credit more affordable and available to households and businesses in a responsible manner.[2]

[1] Securities and Exchange Commission, Fixed Income Market Structure Advisory Committee, *Recommendation Regarding Ways to Mitigate Conflicts of Interest in Credit Ratings*, June 1, 2020.

[2] SFA is a member-based, trade industry advocacy group focused on improving and strengthening the broader structured finance and securitization market. SFA provides an inclusive network for securitization professionals to collaborate and, as industry leaders, to drive necessary changes, to be advocates for the securitization community, to share best practices and innovative ideas, and to educate industry members through conferences and other programs. Further information can be found at www.structuredfinance.org.

Credit ratings contribute to the efficiency of the securitization and other financial markets by enhancing the ability of issuers to raise capital for their businesses. As the Commission has noted, investors indicate that they "use ratings issued by credit rating agencies as one of several valuable 'inputs' to their independent credit analysis," and issuers indicate that "they seek credit ratings because of the value placed on the ratings by investors."[3]

It is important to ensure that there are proper regulatory requirements and market practices to address the "potential conflicts of interest associated with the current issuer-pay model" (as described in the Recommendation),[4] and thus to instill confidence in the investor community that the NRSROs will issue ratings that are independent and free from influence resulting from conflicts of interest. As discussed below, we believe that, with the right balance of information disclosure, supervisory oversight and market discipline, concerns related to potential conflicts of interest in the credit rating agency process can continue to be carefully monitored and managed in a manner that protects and enhances the critical role that NRSROs play in the health and stability of our financial system and within the securitization market. We note at the outset that a large portion of the Recommendation correctly emphasizes the importance of transparency and disclosure. We agree that high-quality information is a requisite for financial markets if they are to efficiently allocate capital and create liquidity, and thus allow the country's households and businesses to grow and to invest responsibly.

Given the vital role that credit ratings play, we agree that it is important for the Commission to periodically review its regulation of the credit rating process. In doing so, the Commission should keep in mind the comprehensive changes to the oversight of NRSROs, including new disclosure requirements, that have been adopted since the financial crisis of 2008. The checks and balances already in place should continue to be evaluated to ensure that they are sufficient and effective, and that their benefits continue to outweigh related costs. It is particularly important to recognize that the securitization market has evolved in response to this system of checks and balances, and that new regulatory initiatives should be prudently designed to provide adaptable oversight.

1. SFA's Approach to the Recommendation

The Recommendation addresses the use of NRSRO credit ratings in the capital markets generally. In one part, it also addresses the use of credit ratings in the securitization market specifically. Our comments address not only the securitization-specific part of the

[3] Securities and Exchange Commission, *Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets* (January 2003) at 21, available at: https://www.sec.gov/news/studies/credratingreport0103.pdf.

[4] *See also* Securities and Exchange Commission, *Nationally Recognized Statistical Rating Organizations*, Final Rule, 79 Fed. Reg. 55078 (September 15, 2014) at 55084 note 66 ("The issuer-pay model often raises concerns of potential conflicts of interest because the collection of fees from rated entities and issuers of rated securities, as a principal source of revenue, may provide an NRSRO with an economic incentive to issue inflated ratings as a way to promote business with its clients."), available at https://www.govinfo.gov/content/pkg/FR-2014-09-15/pdf/2014-20890.pdf.

Recommendation, but also the other parts of the Recommendation, as those parts may also affect the securitization market.

In preparing this letter, SFA engaged its membership as a whole, and also separately engaged three key membership stakeholder groups: securitization issuers, securitization investors and NRSROs. As indicated below, there was broad agreement that transparency and disclosure are beneficial if properly tailored to inform and improve investment decisions.

Before separately addressing the three main parts of the Recommendation—Enhanced Issuer Disclosure, Increased NRSRO Disclosure, and Bondholder Ratification of Issuer-Selected NRSROs—we provide general comments regarding credit ratings and the perception of related potential conflicts of interest.

2. <u>Potential Conflicts of Interest Generally</u>

The Recommendation addresses "perceived potential conflicts of interest associated with the current issuer-pay model."

We believe that our member discussions have likely reflected FIMSAC's own deliberations: it is relatively straight-forward to conclude that the issuer-pay model creates a *potential* for conflicts of interest; but it is more difficult to determine how best to reduce the risk that *potential* conflicts of interest result in detrimental consequences to markets and market participants. Our members ruminated extensively over the viability of alternative means to address potential conflicts of interest. Concepts previously proposed for consideration, such as an investor-subscription model for credit ratings and a rotational-assignment model, were carefully weighed by SFA members. Foreseeable consequences that would be undesirable were identified for each alternative. As a result, we recommend that neither alternative replace the existing issuer-pay model. Nevertheless, our membership welcomes continued dialogue regarding means to further strengthen governance and transparency in the rating agency selection and ratings disclosure processes for structured finance transactions.

During our internal discussions, members noted the importance of reviewing the Recommendation in the context of the current regulatory framework for the credit ratings process. Since the financial crisis over a decade ago, lawmakers and regulators have taken many steps to address potential conflicts of interest related to NRSRO credit ratings. NRSROs are now directly regulated in a way that they were not regulated before the financial crisis. Perhaps most importantly, the Dodd-Frank Act directed the Commission to increase oversight of NRSROs by creating an Office of Credit Ratings ("OCR") and toughening available sanctions. OCR's mission is, in part, to "work[] to ensure that credit ratings are not unduly influenced by conflicts of interest and that NRSROs provide greater transparency and disclosure to investors." Dodd-Frank requires OCR to conduct examinations of each NRSRO at least annually, focusing on eight separate areas, which include management of conflicts of interest and implementation of

ethics policies. The law also requires greater transparency from NRSROs, including a requirement that credit ratings be determined by NRSRO board-approved methodologies and made publicly available. Moreover, the law has led the Commission to adopt rules setting forth a broad range of requirements related to internal controls and mandated disclosures, including those related to conflicts of interest of credit analysts, standards for credit analysts, methodology transparency and rating performance statistics. Our comments below are informed both by the progress made since the financial crisis and by a desire to improve NRSRO-related regulation and related market practices in an appropriate manner.

3. Enhanced Issuer Disclosure

The Recommendation addresses issuer disclosure in two separate contexts: corporate credit and securitization products. Given SFA's focus, we address only the latter here. SFA's comments relate not only to the content of enhanced issuer disclosure, but also to the form that any such disclosure might take.

a. Enhanced Issuer Disclosure: Content

SFA members support the goal of reducing concerns related to potential conflicts of interest that may arise from the issuer-pay model by prudently enhancing issuer disclosure. Accordingly, SFA issuer members are willing to consider providing enhanced disclosure regarding their rating agency selection processes.

However, SFA observes that the Recommendation, with one limited exception, provides little guidance regarding how issuer policies and practices might be further developed. We address that guidance below; in addition, our members will stand ready to address other ways that may be suggested to enhance issuer disclosure practices.

As noted above, the Recommendation is specific in one regard with respect to issuer disclosures: it suggests that "issuers should disclose any non-disclosed NRSROs that rated the deal." We first observe that the concept of "deal" (as so used) is ambiguous. In the securitization market, NRSROs rate specific bonds rather than "deals"—i.e., rather than overall transactions or issuers themselves. Thus, it is hard to know exactly what the Recommendation intends when it suggests disclosure of any non-disclosed NRSROs that rated a "deal." We assume, for purposes of the following paragraph, that "deal" may be interpreted in accordance with the NRSRO practice of rating specific bonds for securitization transactions.

SFA issuer members are willing to consider adopting disclosure policies that would generally accord with the idea that public NRSRO ratings of bonds should be disclosed. Such disclosures should, however, extend only to the ratings of those NRSROs that an issuer hires; disclosures

should not extend to private ratings or to tranches that issuers do not ask NRSROs to rate.[5] This approach would be consistent with market practice, inasmuch as NRSROs typically assign ratings to a securitization transaction's bonds only if they have been hired by its sponsor to do so. Issuers would be concerned if they became responsible for disclosing unsolicited ratings. Any requirement in that regard would lead to uncertainty, particularly because there is no mechanism that would ensure that issuers are aware of ratings that they have not solicited. Moreover, even if an issuer were to learn of an unsolicited rating, a requirement to disclose it could prove difficult to manage in the context of bringing particular transactions to market. For example, an unsolicited rating could be assigned to a bond while the bond is initially being offered but before it is priced. If that were to happen, the issuer could be required either to revise and recirculate its prospectus or to withdraw its offering altogether.

b. Enhanced Issuer Disclosure: Form

SFA's members generally support the concept of enhancing issuer disclosure related to the credit rating process. However, they also agree that it is critically important for careful consideration to be given to the form that any additional disclosure takes. SFA recommends that any additional disclosure be made in "free-writing prospectuses" (as defined pursuant to Commission rules), and not incorporated in registration statements themselves. Under current market practice, final credit ratings are included in free-writing prospectuses, which avoids creating issues related to the potential exposure of NRSRO's as "experts" under the securities laws.[6] If additional disclosure related to credit ratings were required in registration statements, we would expect there to be significant market disruption, as there was in 2010, before the Commission's staff provided prompt no-action relief allowing issuers to exclude credit ratings from prospectuses filed as part of their registration statements.[7]

4. Increased NRSRO Disclosure

The Recommendation suggests in general terms that additional disclosure by NRSROs would be

[5] Unless otherwise specified, when this letter refers to credit ratings, it is referring to "public" credit ratings, whether or not so specified.

When used to described credit ratings, the word "public" means a credit rating that results from the engagement of an NRSRO by an issuer or sponsor for use in connection with an offer and sale of rated securities, whether the securities are offered and sold publicly (e.g., through a prospectus that is part of a registration statement filed with the Commission) or non-publicly (e.g., in reliance on Rule 144A). Thus, "public" credit ratings may be distinguished from "private" ratings, such as a rating sought by an investor in respect of a bond it holds in order to support the investor's capital or other treatment of the bond.

[6] Credit ratings are predictive opinions, which NRSROs offer as independent providers of credit analysis and not as agents of issuers. Thus, it would be inappropriate to treat NRSROs as "experts" for purposes of the securities laws. Moreover, unlike the forward-looking, independent assessments offered by NRSROs, the work performed by auditors and other experts, which may be included in registration statements (and thus be subject to consent requirements), typically validates, to one extent or another, the issuer's own conclusions regarding its current financial position.

[7] *See* Ford Motor Credit Company LLC, SEC Staff No-Action Letter (November 23, 2010), available at https://www.sec.gov/divisions/corpfin/cf-noaction/2010/ford072210-1120.htm.

beneficial and that the Commission should require "more in-depth information about [the NRSROs'] models and how the models differ by industry."

SFA, including its NRSRO members, is supportive of initiatives to enhance transparency with regard to the methodologies and models employed by NRSROs. However, SFA believes that the specific suggestions described in the Recommendation may reflect a misunderstanding of the ratings process for securitization transactions, a process that is influenced significantly by the scope and extent of Dodd-Frank requirements related to model criteria and methodology development and verification processes.

The misunderstanding relates to the Recommendation's assumptions regarding how methodologies and models operate (and how they relate to one another). For example, the Recommendation assumes that NRSRO ratings of securitizations result from an internal process that has two distinct steps:

- running a model to produce a "model-implied rating" that takes into account only *quantitative* inputs; and then

- reviewing the "model-implied rating" from a *qualitative* perspective to arrive at a final rating—i.e., adding "qualitative inputs in the application of" the model, whether as a result of internal ratings committee deliberations or otherwise.

The Recommendation's assumption of a distinct two-step process is also indicated when the Recommendation speaks of "pure quantitative scores," on the one hand, and acknowledges that "NRSROs sometimes have good reasons to deviate" from such scores, on the other. However, NRSRO models, generally speaking, incorporate qualitative elements as well as quantitative elements. Moreover, models are designed and intended to function as a part of the comprehensive credit rating methodologies that NRSROs follow when rating securitization securities.

Models are intended to produce outputs that reflect the collective impact of financial ratios, credit scores and other parameters, together with judgment-based assessments regarding inputs. NRSRO structured finance methodologies call for multiple model "runs," for which model inputs are varied, so that several sets of quantitative model results are presented to ratings committees, which are overseen by NRSRO boards. Different model inputs can be tied to different macroeconomic scenario assumptions, such as defaults rising in a recession. While the outputs of resulting model runs arguably are quantitative, assumptions and scenarios such as those described above are distinctly qualitative.[8]

[8] For example, for collateralized loan obligations (CLOs), NRSROs typically use models that assume various default scenarios. They might assume 50% defaults occurring in year one and 10% in each of the other five years, or they might assume 25% in year one and 10% in each of the other five years—or any number of other permutations, all depending on judgments regarding current market conditions.

Credit ratings are not derived from models, but from broader methodologies, which incorporate the models as only one element. Methodologies are not intended to result in rigid tools that take into account all factors that should be reflected in a credit rating. They are designed to allow NRSROs to respond to changing credit conditions. One of the reasons that this flexible approach has developed is that a more static approach could create market risks resulting from ratings that have procyclical biases, instead of reflecting credit outlooks that adjust as market cycles change. Ratings committees assign ratings applying published methodology; deviations from published methodology are publicly disclosed in the accompanying rating commentary.

One key in all of this: The NRSROs make their methodologies freely and publicly available. In addition, proposed substantive changes to their methodologies are published and subject to public comment before being adopted. We believe that undue focus on *model outputs* can create market confusion by detracting from the rating rationales that are described in press releases accompanying ratings actions and from the information that is available about the methodologies, and thus the models, themselves.

Accordingly, the Recommendation's specific suggestions regarding NRSRO disclosure do not lend themselves to direct response by SFA. Nonetheless, our NRSRO members are committed to providing investors and other market participants useful information to help them make informed decisions. Accordingly, SFA and its members remain available for discussions with FIMSAC and the Commission's staff as they consider whether further NRSRO disclosure would benefit the market.

5. Bondholder Ratification of Issuer-Selected NRSROs

The final part of the Recommendation is a brief suggestion that the Commission explore bondholder ratification.

SFA appreciates that FIMSAC has thus suggested a means of mitigating potential conflicts of interest that is not disclosure-based. As noted above, SFA acknowledges that disclosure cannot entirely eliminate certain potential conflicts of interest in the financial markets, including those related to the issuer-pay model for NRSRO ratings. However, we are concerned that a bondholder ratification process, as suggested by the Recommendation, would be unworkable for securitization transactions and could result in consequences that, though unintended, are foreseeable and adverse.

Our members, including issuers and investors, reached a consensus on this point. The consensus evolved, in part, from a belief that the ratification precedent cited in the Recommendation—the ratification of public auditors by corporate shareholders—would be difficult, if not impossible, to adapt effectively for purposes of seeking bondholder ratifications

of NRSROs chosen by sponsors of securitization transactions.[9] There are several reasons for the belief:

- The ratification precedent cited by the Recommendation—public companies' seeking shareholder ratifications of their public auditors—generally results from stock exchange requirements applicable to public companies. Those requirements dovetail with annually required shareholder proxy solicitations. There is no similar periodic solicitation mechanism for securitization issuers or their sponsors.

- Public auditor ratifications take place in advance of audit work that the ratified public auditors will undertake. Ratifications take place on a corporate shareholder basis and relate to all aspects of a public auditor's work for the coming year. In contrast, sponsors of securitization transactions typically hire NRSROs on a transaction-by-transaction basis, and an NRSRO's work on a transaction is complete before the issuer's securities are issued—i.e., before there are bondholders from whom ratifications might be sought. Thus, there would be no opportunity to ratify the NRSRO for a securitization in advance because there are not yet any bondholders from whom to seek ratification.

- The alternative to ratification in advance would be ratification after the fact, but that approach would introduce its own complications and seems unlikely to produce meaningful results. A bondholder would, in effect, be voting against its own economic interest if it voted to withhold NRSRO ratification in connection with bonds that the bondholder held, because it would be discrediting the credit rating of one of its own holdings. After-the-fact ratification would also create its own potential conflicts of interest, depending on the economic positions of different market participants.

- A sponsor may have dozens of outstanding securitization transactions, each one often with multiple classes of securities. Some NRSROs may rate some certain securities of a given issuer, but not other securities of that issuer. Thus, even if after-the-fact ratifications were pursued, the multiplicity of ratification solicitations could overwhelm sponsors.

- Seeking bondholder ratification on a sponsor-by-sponsor basis would raise different, though equally acute, issues. How would a sponsor's bondholders be identified, given the variability of issuer and transaction types that a given sponsor may bring to market? Which NRSROs would be identified for ratification—all NRSROs across the sponsor's programs? Would all parts of each program be ratified collectively by all bondholders, even though bondholders across programs may have distinctly different investing perspectives?

[9] SFA did not explore, and does not take a position regarding, whether bondholder ratification may be more feasible for corporate issuers and their related engagements of NRSROs.

- The role played by NRSROs in the financial markets differs significantly from the role played by public auditors of public companies, and the goal of their credit ratings differs significantly from the goal of the work undertaken by public auditors. The forward-looking nature of an NRSRO's credit rating differs from the backward-looking nature of audit opinions provided by public auditors. The position of public company shareholders (who are owners) and securitization bondholders (who are merely providers of debt financing for specific pools of assets) are fundamentally different. Finally, shareholders of a public company that withhold ratification might naturally expect the company's board or audit committee to take responsive action for the benefit of shareholders going forward. There would be no analogous body, capable of taking analogous action, in connection with a securitization.

SFA appreciates that FIMSAC, in formulating the entire Recommendation, sought neither to be "overly prescriptive" nor to "recommend[] structural changes to the current NRSRO selection process." However, given the considerations discussed above, we believe that requiring bondholder ratifications for NRSROs for securitizations would be unproductive and impracticable —and thus would be overly prescriptive and structurally disruptive. Alternatively, SFA believes it may be of value for the Commission to expand its own education program, specifically the Commission's investor bulletins,[10] for the purposes of educating market participants regarding NRSRO credit ratings, how they are determined, and how they should be viewed from an investor perspective. Additionally, the OCR's examination and monitoring of NRSROs, industry outreach and supplemental guidance with respect to the Commission's regulatory NRSRO initiatives all provide an additional source of information for market participants.

We hope that our comments in response to the Recommendation are useful to FIMSAC and the Commission. Our membership stands ready to provide further input regarding this important topic. Thus, if FIMSAC or the Commission is interested in exploring ways in which to build upon the Recommendation, we and our members will welcome the opportunity to engage further. If you have any questions about this matter, please contact Kristi Leo, SFA President, at [redacted] or via email at [redacted].

Very truly yours,

Kristi Leo, President
Structured Finance Association

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[10] *See, e.g.,* Securities and Exchange Commission, Office of Investor Education and Advocacy and Office of Credit Ratings, *Updated Investor Bulletin: The ABCs of Credit Ratings* (October 12, 2017), available at https://www.investor.gov/introduction-investing/general-resources/news-alerts/alerts-bulletins/investor-bulletins/updated-8.