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September 13, 2011

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

Re: Solicitation of Comment to Assist in Study on Assigned Credit Ratings
Release No. 34-64456: File No. 4-62

Ms. Murphy:

The Reason Foundation welcomes the opportunity to comment on the feasibility of the federal government establishing a system in which a public or private utility or self-regulatory organization assigns nationally recognized statistical rating organizations to determine the credit rating of structured products.

Our understanding is that the purpose of such a system would be to eliminate conflicts of interest that compromised structured finance ratings prior to the recession in 2008-2009 and subsequent economic contraction.

We acknowledge that a system with an assigned ratings procedure would eliminate the need for Nationally Recognized Statistical Ratings Organizations (NRSROs) to market their services to issuers, and would prevent issuers from engaging in "ratings shopping," i.e. selecting the rating agency that has the most lax standards for the securities it issues. Unfortunately, the assigned ratings approach would have to overcome a number of potential problems. Among these are:

(1) Conflicts of interest at the assignment organization. If this organization employs junior analysts who aspire to work at a high paying investment bank, it will have the same problem that has historically affected ratings analysts: employees would have a motive to build good relationships with issuers who may one day become their employers. At the assignment organization, analysts could further their careers by assigning a more lenient agency to the issuer's deal.

(2) Issuers and investors being deprived of the ability to choose the highest quality rating firm, and depriving rating agencies of the motivation to improve their quality. While some issuers may simply want the highest rating, some may wish to attract sophisticated investors by obtaining the rating of an agency that has established a reputation for expertise and quality in rating a certain asset class. Rating agencies can and do compete with one another by publishing rating methodology papers that they hope will impress the community with their analytical excellence. Assigned ratings could remove incentives to compete in this manner, and could thus result in worse rating methodologies. If a firm obtains no competitive benefit from publishing a more analytically robust methodology, it may stop making the investment in research to improve its methodologies.

(3) First Amendment concerns. In the past, credit ratings have been successfully defended as opinions meriting free speech protections. The government cannot decide which newspapers, broadcasters or bloggers cover a particular political issue, nor can it create an organization that would do so. Likewise, government intervention into the selection of who can or cannot render an opinion about the creditworthiness of assets could attract litigation on First Amendment grounds. This issue is especially relevant in light of recent criticism of Standard & Poor's decision to downgrade the U.S. sovereign credit rating. Government actions that penalize or appear to penalize rating agencies for stating their views of U.S. creditworthiness could hamper the free flow of opinions in investment markets and thus the ability of investors to make fully informed decisions.

While we have concerns about the assigned ratings approach, we agree that rating agency performance is a legitimate issue. We believe that alternative mechanisms are available to regulators to improve ratings quality.

Specifically, we advocate lowering barriers to entry into the structured finance security assessment market. If the costs of complying with regulations and accessing required data are minimized, more firms and individuals could cost-effectively serve investors directly, using a subscriber-paid or advertiser-based revenue model. A number of organizations independent of rating agencies have or could rapidly develop expertise needed to assess individual deals. These organizations include Corelogic, Intex Solutions, Lewtan, PF2 Securities Evaluations and Andrew Davidson and Company. New entrants, potentially employing open source models and/or crowdsourcing of insights using Wiki technologies could also enter the fray.

Ideas already under consideration by the SEC promise to lower the cost of entry for these potential competitors. Requiring issuers to provide a standardized loan level data set and a cashflow waterfall program, as envisaged under Proposed Rule 33-9117, would make it easier for non-NRSRO analytical firms to assess deals coming to market as long as these inputs are made publicly available several business days prior to deals being marketed.

Corporate securities markets provide an excellent analogy. Because data for publicly listed firms is universally available via EDGAR, investors have access to a plethora of opinions regarding stocks and bonds. If data for structured finance securities were also widely available, investors would have access to a wider range of opinions.

In a perfect world, we would advocate the NRSRO system be completely phased out. In the context of this study by the SEC, however, we argue that NRSRO regulations should be carefully vetted to ensure that they do not restrict the activities of or impose compliance costs on firms that rate structured finance instruments unless they receive compensation from issuers. If it is clear to existing and prospective firms that they can issue opinions—even in the form of letter ratings—without regulatory barriers, they would have a strong incentive to do so.

While the presence of additional voices may help investors avoid deals with inferior collateral or disadvantageous structures, it does not address the implications for bank capital adequacy. To the extent that new Federal Reserve regulations still permit the use of NRSRO ratings for capital calculations, overly lenient ratings produced by issuer-paid NRSROs could still threaten bank solvency.

One alternative available to the regulatory community with the empowerment of non-NRSRO participants would be a procedure for third party rating challenges. Under such a system, an independent credit assessment firm could submit a statement to the Federal Reserve challenging the rating assigned by an NRSRO. If the Federal Reserve determined that the challenge had merit, it could ask the NRSRO to respond and potentially hold a public hearing to determine the validity of the challenge. If the Federal Reserve determined that the rating was flawed, the affected securities would attract a maximum capital charge until the rating agency issued a rating supported by the challenger or another rating agency selected by the issuer published a rating.

Non-NRSRO assessment firms could establish or burnish their reputations through successful challenges while NRSROs would have an incentive to properly rate deals and thus avoid the embarrassment of seeing their ratings dismissed.

In summary, an assigned ratings system is a well-intentioned solution to the very real problem of ratings quality. However, it is also a highly engineered solution that is thus vulnerable to unintended consequences. We believe that regulators can address this problem at lower cost and with greater confidence by fostering greater competition to incumbent rating agencies.

Sincerely,

Anthony Randazzo
Director of Economic Research, Reason Foundation

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