BETTER MARKETS
TRANSPARENCY · ACCOUNTABILITY · OVERSIGHT

September 13, 2011

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

Re: Solicitation of Comments to Assist in the Study of Assigned Credit Ratings; Release No. 34-64456; File No. 4-629

Dear Ms. Murphy:

Better Markets, Inc.[1] appreciates the opportunity to respond to the above-captioned Release (the "Release") of the Securities and Exchange Commission ("Commission"). The Release requests comments to assist the Commission in carrying out a study on, among other matters, the feasibility of establishing a system in which a public or private utility or a self-regulatory organization ("SRO") assigns nationally recognized statistical rating organizations ("NRSROs") to determine credit ratings for structured finance products. This study, and a resulting report to Congress, are required by Section 939F of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").

INTRODUCTION

There is no argument that the credit rating system for asset-backed securities failed catastrophically, precipitating the financial crisis of 2008. However, if asset-backed financing is to be preserved as an element of the financial system, the response should be prudently framed to prohibit these failures without creating costly inefficiencies or even eliminating structured finance as a source of capital for mortgage and credit markets. Therefore, the study will play a significant role in helping the Commission address the conflicts of interest in the current rating system in a fundamental way, while allowing these investment vehicles to remain viable.

While many of the questions raised in the release are directed at market participants who have access to information and data well beyond the reach of the public, we offer comments on the following issues:

- The methodology of the study;

- Concerns that need to be addressed regarding the assignment or lottery system for selecting NRSROs that rate structured finance products, as described in Section 939F of the Dodd-Frank Act; and

[1] Better Markets, Inc. is a nonprofit organization that promotes the public interest in the capital and commodity markets, including in particular the rulemaking process associated with the Dodd-Frank Act.

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- Alternative means for compensating NRSROs that would create incentives for accurate ratings of structured finance products.

METHODOLOGY OF STUDY

The Commission is to be commended for the methodology underlying the study, as reflected in the Release. It comprehensively covers all of the elements set forth in Section 939F and requests a broad range of information from a wide variety of interested parties. However, the scope of the study should be broader still.

Investor Focus

The primary value of credit ratings for asset-backed securities accrues to investors. Properly used, ratings provide several valuable benefits to investors:

- Ratings provide an independent assessment of investment products and analytical models which can be reviewed, but need not be replicated, by each investor. Even where a prudent investor makes an independent assessment of the risks associated with the investment, ratings can perform a valuable function by validating these assessments.

- Ratings also provide an important benchmark for purposes of ongoing price valuation of the instrument. The investor can look to prices for similarly rated, comparable instruments to help determine appropriate pricing.

- The existence of reliable credit ratings can enhance the liquidity of the instrument held by the investor. There are more potential purchasers (and the price obtainable is more predictable) for rated instruments than for those which are not rated.

Credit ratings also confer benefits on other market participants. Credit ratings affect the interest rate required to attract the market in the initial public offering and offset the underwriting risk of distribution. They also affect the ability of underwriters to make a market in the securities. Thus, the ratings benefit underwriters and issuers as well, but overwhelmingly because they benefit indirectly from the lower interest rates required by the investors.

As a result, the study should examine whether a primary driver of the decision to select credit ratings agencies for a given offering are the preferences of targeted investors. If that is the case, the feasibility of the system set forth in Section 939F cannot be understood fully unless the study considers the interaction between this primary driver and the NRSRO selection process.

One example of this interaction relates to investor preferences for single or multiple ratings for asset-backed offerings. Paired ratings may be more valuable to investors than single ratings: they act as a check on one another, they are more reliable independent credit assessments, they are more reliable for benchmark pricing, and they provide better access to secondary market purchasers, thus enhancing liquidity. Therefore, the Commission should focus its analysis on the prevalence of dual ratings and the frequency with which one or a pair of the three largest rating agencies is involved in ratings. If it is determined that the predominant practice is to have large agencies paired in the ratings process, the exceptions to this rule can be analyzed and may be very instructive.

Assuming that this inquiry leads to a determination that asset-backed investors drive the market toward two or three ratings agencies and that dual ratings predominate, the Commission may be able to anticipate the potential market response to a system in which NRSROs are assigned from a list. For example, the Commission may determine that the process for selecting rating agencies is and will continue to be investor-driven based on the benefits listed above (independent assessment, pricing benchmarks, and liquidity).

The Commission may further determine that if the Credit Rating Agency Board ("CRA Board") assigns an NRSRO whose rating is deemed by targeted investors to generate fewer benefits, then the underwriting group or the investors may be induced to procure additional ratings from NRSROs who are thought to provide greater value to the investors. In such cases, the rating of the assigned NRSRO might be less consequential than anticipated and the value received from the selection process might be disproportionately low compared with the cost.

Based on such an inquiry, the Commission can better evaluate the issues of value and cost. Value and cost may be different for each NRSRO on a list. The Commission may conclude that a significant indicator of the value of a rating by a given NRSRO is at least partially a function of its effect on the price demanded by investors. If the ratings of all NRSROs are not equal by this measure, the Commission may determine that the selection process under Section 939F must reflect that factor.

More importantly, these considerations may also have implications for the NRSRO qualification process. If investors rely upon or expect ratings exclusively from the dominant ratings agencies, then the qualification process used for the assignment system should focus more intensely on standards for methodologies (in particular standards for assuring the quality of due diligence which underlies the methodology). Especially rigorous qualification standards may be necessary to compensate for the investors' potential bias against, or lack of confidence in, the less prominent NRSROs. In addition, if the investors successfully demand additional ratings, there will be greater assurance that the additional NRSROs will perform their services using high standards. Ideally, the standards would be detailed and would require the NRSRO to seek approval for deviations from approved methodologies before they are implemented.

Fee Structure v. Source

Additionally, the Commission must evaluate the issues surrounding the entity which pays the fees of the NRSROs. The study should examine whether asset-backed financings are best viewed as a closed system of cash flows. In closed systems, investors pay for the bonds and receive bond principal and interest; underwriters and other intermediaries and service providers are paid from the proceeds; and the issuer receives net proceeds and contributes the cash flow from the assets which funds principal and interest (and ongoing fees). This stands in contrast with fee arrangements linked to volume.

In closed systems, the entity which pays the ratings fees may be of limited consequence. For example, if investors pay the fee, the study may find that the resulting increase in interest rate or discount from par value may not be materially different in ultimate result from payment by the issuer or the arranger, which reduces net proceeds. It may find that the value of the financing is determined by net proceeds of the bond issue plus the net present value of the excess in asset cash flow over bond debt service, which should be roughly the same regardless of which participant pays. This factor, together with identification of the drivers behind NRSRO selection discussed above, might be extremely enlightening to the Commission in its evaluation of the feasibility of the system described in Section 939F.

The logical conclusion of such an inquiry is not that fee amounts and structure do not matter. Rather, it would suggest that the structure of the fees is more important than the source. The Commission may conclude that volumetric fees, detached from results, were a major source of conflict of interest for the ratings agencies. The study should evaluate whether the ratings agencies were influenced to compromise the integrity of their ratings processes, enabling ever more risky offerings, so that they could derive volume-driven revenue from asset-backed securities offerings. The Commission should study whether non-volumetric fees, contingent on rating quality measured by the long term outcome of the offering, would be an effective way to address those conflicts of interest.

THE SECTION 939F ASSIGNMENT SYSTEM

Section 939F envisions that the Commission ultimately will implement an assignment system for the rating of structured products. The statute specifies that the template for that assignment system should be the framework referred to as "Section 15E(w)," which is set forth in the Release. Implementation of this framework will help address the fundamental conflicts of interest arising from the issuer-pay model, which has dominated the credit rating industry for so long.

However, it is clear from the Section 15E(w) language that the Commission will have to provide significantly stronger and more detailed guidance in any final rules implementing that framework before it will achieve its objectives. To inform that critical part of the rulemaking process, the study must thoroughly evaluate the areas where the Section 939F system would need enhancements, including the following:

- Independence and expertise of the CRA Board;
- Qualifications of NRSROs and quality control over ratings produced;
- Fair fee arrangements;
- Transparency of all of the CRA Board operations; and
- Oversight and enforcement, an area in which the statute provides very little guidance.

In addition, it will be particularly important for the CRA Board to establish standards for methodologies that are broad and detailed. The rating of an asset-backed offering is based on several categories of analysis, and the standards must reflect these categories:

- Due diligence and disclosure of the quality of the assets which are pooled;
- Econometric assumptions that define expected and possible conditions which might affect the results from the asset pool;
- Assumptions as to the performance of the asset pool under various conditions;

- Standards, such as debt service coverage ratios, which define the assigned ratings; and

- Analytical models which measure the performance of the asset pools under assumed conditions and related performance.

The qualifications of the NRSROs will also be extremely important. The CRA Board should actively evaluate each NRSRO in respect of their established methodologies and ability to carry out these methodologies, as well as reviewing their performance. Special emphasis should be placed on the NRSRO's procedures regarding the confirmation of due diligence as to the quality of the assets underlying offerings. To the extent that the emphasis focuses on the quality of NRSROs and their methodologies, the specific effectiveness of the assignment process will be less consequential.

The Release refers to the potential for an audit of the NRSROs work. While the concept is promising, it may be inadequate. To the extent that an audit focuses on the adequacy of the modeling, the quality of the underlying assumptions (and in particular, due diligence regarding the assets and the transaction structure) is not assessed. As a result, an audit requirement may foster the mistaken view that ratings are appropriate, even where underlying assumptions are erroneous. To be truly effective, an audit requirement must apply both to methodologies and to underlying assumptions.

ALTERNATIVES AND SUPPLEMENTS TO THE SECTION 939F APPROACH

The Release correctly identifies a number of alternative systems for compensating NRSROs that rate structured finance products. They all deserve careful evaluation once data from the study is collected. Two additional possibilities should be added to the list.

Appointment of Financial Advisor

The Commission should consider the required appointment of a financial advisor for each asset-backed offering. The financial advisor would provide a "cold comfort letter" as to the due diligence and underlying assumptions and methodologies of the NRSROs.

The Commission should consider whether the financial advisor must be experienced with similar structured financings and must have underwritten substantial offerings in the past. Such a financial advisor would clearly have an interest in the continued viability of the asset-backed securities markets, but would have no specific interest in the subject transaction. If the financial advisor role is a pre-requisite, the major firms would be required to provide the service so that the markets can function smoothly and without uncertainty regarding the costs associated with the advisor's work.

A valid concern underlying Section 939F is that financial institutions acting as underwriters and arrangers influence the rating agencies through superior analytical capability and aggressive negotiating tactics, pushing the rating agency personnel as advocates for the success of the offering while disregarding the quality of the security. This behavior may be a consequence of bonus-dominated compensation systems and inadequate "skin in the game."

Ideally, adding a financial advisor would provide a counterweight against the influence driven by problematic incentives of financial institution professionals.

The interests of a financial advisor that earns a fee and has potential liability under a cold comfort letter would help counteract this phenomenon. Fee-based advisory business does not offer the profitability (and bonus potential) of asset-backed underwritings, which incentivize the behavior described above, and the potential liability constitutes serious "skin in the game." If the financial advisor is as capable, aggressive, and motivated as the underwriter/arranger, it might help neutralize the forces influencing the rating agency personnel. While financial advisors may be tempted to compromise standards to increase overall opportunities, the potential consequences of the cold comfort letter would more likely result in forceful resistance against a deal-by-deal drift toward overly aggressive methodologies, assumptions, and due diligence practices.

It is obvious that the fees for the financial advisor would add costs to financings, but the trade-off in terms of market confidence is a real value.

In summary, there are a number of benefits to this approach.

- To the extent that inappropriate influence from financial institutions which are principals in asset-backed financings is a concern, the financial advisor, which would not have the interests of a principal, would counter-balance this influence.
- Such a financial advisor would have the expertise and resources to meaningfully evaluate the determination by NRSROs, including assumptions and due diligence.
- The approach would not displace the investor-driven value vs. cost process which is central to the benefit of ratings to the marketplace.

Assessing the Impact of Other Reforms in the Credit Rating Field

Finally, before implementing a new compensation system for the NRSROs that rate structured products, the Commission should carefully assess the impact that other new rules under the Dodd-Frank Act have had on the conflicts of interest pervading the credit ratings industry.

Congress was clearly and correctly intent on addressing those conflicts of interest on a fundamental level. Section 939F reflects this intent, by requiring the Commission not only to conduct the study, but also ultimately to adopt a system that prevents the issuer, sponsor, or underwriter from selecting the NRSRO that will determine the initial credit rating for structured products.

However, Section 939F also provides the Commission with some discretion in designing the final system, in light of the "public interest and the protection of investors." Section 939F also affords the Commission leeway in timing: Given that the study and ensuing report to Congress must be completed within 24 months after the Dodd-Frank Act was enacted, there will be adequate time for informed rulemaking on the selection process for NRSROs subsequent to finalizing and evaluating the study. This will afford the Commission a valuable opportunity to fashion those rules in light of the degree of success—or failure—that the

Commission's other rulemakings have had toward remediating the many flaws in the credit rating industry, including conflicts of interest.

CONCLUSION

We hope these comments are helpful as you proceed with the study, the report, and the rulemakings that follow.

Sincerely,

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