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VIA EMAIL TO RULE-COMMENTS@SEC.GOV

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 (File No. 4-629)

Dear Ms. Murphy:

On behalf of Morningstar Credit Ratings, LLC, we appreciate the opportunity to comment on a proposed credit rating assignment system for nationally recognized statistical rating organizations ("NRSROs")[1] for the initial ratings on structured finance products. Morningstar Credit Ratings, LLC (f/k/a Realpoint LLC) is a NRSRO and wholly owned subsidiary of Morningstar, Inc., a leading provider of independent investment research in North America, Europe, Australia, and Asia with operations in 26 countries.

We agree with the Commission that the assignment system proposed for initial credit ratings in Section 15E(w) of the Exchange Act (the "Section 15E(w) System") will be required to be implemented, unless an alternative system is proposed that better serves the public interest We believe that an assignment system best serves the public interest by increasing competition to allow for new NRSRO participants. However, if the Commission disagrees, we have proposed an alternative system utilizing the information available pursuant to Rule 17g-5, and described under Section C.1 of this letter.

A. The Credit Rating Process for Structured Products and the Conflicts of Interest Associated With the Issuer-Pay and the Subscriber-Pay Models

Section 939F of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") provides that the Commission must undertake a study regarding its findings related to assigning credit ratings for structured finance products.[2] As part of its study, the Commission has requested comment on the conflicts of interest associated with the issuer-pay and subscriber-pay models.[3]

Although we do not believe that any business model is completely void of potential conflicts of interest, we have found that certain potential conflicts of interest are more easily managed than

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[1] *Solicitation of Comment To Assist in Study on Assigned Credit Ratings,* SEC Release No., 34-64456 File No. 4-629 (May 10, 2011); 76 F.R. 28265 (May 16, 2011).

[2] *Id.* at 28266.

[3] *Id.* at 28268-28269.

others. While the conflicts of interest for both the issuer-pay and subscriber-pay models can be managed through the implementation of internal controls, policies, and training, the difference in the pricing strategies between the issuer-pay and subscriber-pay models ultimately results in the issuer-pay model being more susceptible to undue influence and greater levels of manipulation. We estimate that a NRSRO's revenues from a one-year surveillance subscription are between 1% to 20% of the revenues a NRSRO would receive from issuing an initial rating for a structured finance transaction. Moreover, there are significantly fewer arrangers than there are potential subscribers. NRSROs, consequently, are more susceptible to the undue influence of a single arranger than any single subscriber since the more favorable economic incentives and the smaller number of players for business creates an environment more susceptible to manipulation or undue influence.

This is not to say that the issuer-pay model is not without merit or that arrangers do not consider technical competence, the quality of the analysis, or investor desires when selecting a credit rating agency. One of the biggest benefits of the issuer-paid model is that it is efficient in bringing transactions to market and ensuring timely payment to the NRSROs for their services. Conversely, subscription-based services have enormous infrastructure costs in terms of employees and technology that may not be appropriate for all NRSROs to undertake or may be difficult for them to do so quickly. The additional employees required are not limited to additional analysts or information technology professionals, but would also include additional sales and marketing and legal employees to facilitate sales to investors and adequate contract review. From our experience in providing subscription services, we concede that it could be very difficult to organize a large group of investors and negotiate individual agreements for rating services on a per transaction basis in the typical time frame permitted to take securitization transactions to market. Moreover, a mandate of subscription-based ratings going forward may result in NRSROs not dedicating adequate infrastructure in order to provide high-quality analysis, which is not consistent with the Commission's efforts to improve the integrity of credit ratings.

Therefore, we advocate for the implementation of a system that permits the subscription-based and issuer-pay models to continue and co-exist. However, because of the more favorable pricing provided with respect to issuing initial ratings for transactions and the concentration of NRSROs and arrangers, we believe that the Commission must take some action to improve competition in the ratings process.

B. The Section 15E(w) System

As requested by the Commission, in this section we evaluate the feasibility of the Section 15E(w) System alternative within the seven-factor GAO Framework[4]:

1. Independence: The ability for the compensation model to mitigate conflicts of interest inherent between the entity paying for the rating and the NRSRO.

[4] *Id.* at 28270.

The independence of the NRSRO is increased under the Section 15E(w) System since the NRSRO will not be dependent upon securing business through providing preliminary ratings. The elimination of this process allows NRSROs to provide an analysis independent of pressure to win business for a particular transaction or on an ongoing basis.

Although the proposed CRA Board or any other alternative oversight body that will oversee Section 15E System may be subject to certain conflicts of interest related to political or business relationships, these conflicts can be mitigated through processes that require the CRA Board to act as a majority; the publication of selection criteria and results; and through processes, which automate the selection process so that the CRA Board is not actively involved in each rating agency selection decision.

Furthermore, we believe that the CRA Board could be eliminated or its role minimized (and thereby any potential conflicts of interest) through the investment in information technology that makes assignments on a rotational basis subject to certain calibrated qualifications (i.e., the capability of the NRSRO to rate the particular class of asset-backed securities, an adjustment to the frequency of a NRSRO's turn in the rotation to reward or penalize the accuracy of its ratings). A rotation with specific mathematical formulas for selection could eliminate any undue influence or the necessity for the CRA Board to make any individual decisions with regard to particular securitization transactions. The rotational formulas could be required to be disclosed and revisited annually or when material changes arise, so any undue influence exercised by the Section 15E(w) System's administrator or CRA Board could be reviewed and detected.

2. Accountability: The ability of the compensation model to promote NRSRO responsibility for the accuracy and timeliness of their ratings.

Accountability could be increased by under the Section 15E(w) System through the qualification process.[5] Although we believe that assignments would be issued on a rotational basis initially after each NRSRO has been designated to participate, we believe that the Commission's examination process and the enhanced ratings performance disclosures recently proposed by the Commission for Exhibit 1 to the Form NRSRO, which provide for performance reporting for asset-backed securities on a class by class basis[6], could provide a basis to evaluate the accuracy and timeliness of ratings under the Section 15E(w) System. NRSROs would be held accountable for their accuracy and timeliness by adjusting the frequency the NRSRO is selected for a particular type of transaction.

3. Competition: The extent to which the compensation model creates an environment in which NRSROs compete for customers by producing higher-quality ratings at competitive prices.

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[5] *See,* Section B.7 of our letter for more information regarding how this qualification process would operate.

[6] *See, Proposed Rules for Nationally Recognized Statistical Rating Organizations*, SEC Release No., 34-64514, File No. S7-18-11 (May 18, 2011); 76 F.R. 33420, 33433 (June 8, 2011).

A Section 15E(w) System that examines ratings accuracy and timeliness in the future assignment of ratings will encourage competition among NRSROs to provide the most accurate and timely ratings in order to ensure that they will continue to secure additional business under the Section 15E(w) System.

NRSROs and arrangers should still be able to independently negotiate fees. The CRA Board could monitor the market rates for services, based on asset class, deal size, and complexity, and could provide guidance on market rates if fee discussions were to break down.

There may be concerns that the Section 15E(w) System could result in unreasonably high fees being negotiated by selected NRSROs. Because the issuer's securities are typically rated by two or three NRSROs, we believe that the Section 15E(w) System could also be revised to require that issuers to obtain only one credit rating through the Section 15E(w) System. Since an arranger-selected market would still exist, NRSROs would have an incentive to maintain competitive pricing and transaction terms and pricing.

4. Transparency: The accessibility, usability and clarity of the compensation model and the dissemination of information on the model to market participants.

The Section 15E(w) System could be as transparent as necessary. We do not believe that the public disclosure of fees would be required to facilitate the effectiveness of the Section 15E(w) System. We believe that NRSROs, issuers and arrangers can determine reasonable fees amongst themselves. Any disputes related to fees could be resolved by requiring the issuer to pay fees at least as high as any other NRSRO rating the transaction or another formula based upon the recommendation of the CRA Board or any other regulatory body or administrator which would analyze the amounts paid for rating transactions of similar size, asset class, and complexity.

5. Feasibility: The simplicity and ease with which the compensation model can be implemented in the securities market.

We believe that Section 15E(w) System is administratively feasible and the regulatory authority required to establish the Section 15E(w) System has been clearly set forth under the Dodd-Frank Act. Furthermore, we do not believe the Section 15E(w) System would prevent securitization transactions from coming to market.

Funding. Transaction fees funded by the proceeds of each securitization transaction based upon the transaction's size could be used to fund the costs of implementing this system. This is similar to the fee calculation utilized by the Financial Industry Regulatory Authority in determining transaction-based fees.

Operations. As stated above, we do not necessarily believe that the CRA Board would be necessary to operate the system (or its operations could be substantially reduced) to the extent calibrated, disclosed rotation criteria and technology could be established. An automated process

for selection would also ensure that transactions are brought to market in a timely manner. Furthermore, we do not believe it is necessary to establish a system to facilitate payments to the NRSRO from the issuer under the Section 15E(w) System. By maintaining the current system by which payments are directed to the NRSRO directly from the issuer, the Section 15E(w) System will avoid a substantial operational cost, thereby making it more administratively feasible.

6. Market Acceptance and Choice: The willingness of the securities market to accept the compensation model, the ratings produced under that model, and any new market players established by the compensation model.

We expect that some commenters will suggest that there is an unwillingness to accept the ratings of certain NRSROs by investors, who may be limited by certain investment policies restricting their investments in asset-backed securities to those rated by specified (usually the largest) credit rating agencies. Because of the potential increased difficulty of placing these securities, arrangers, likewise, may be unwilling to select these rating agencies. Nevertheless, the Section 15E(w) System represents an opportunity to promote competition among NRSROs by encouraging investors to review these policies and consider other NRSROs.[7] This is also consistent with the Commission's efforts pursuant to the Dodd-Frank mandate to eliminate references to credit ratings under the federal securities laws[8] and the efforts of other regulatory entities and industry groups to expand the number of acceptable NRSROs that may be utilized.[9]

Because an issuer's securities are typically rated by two or three NRSROs, we believe that the Section 15E(w) System could also be revised to require issuers to obtain only one rating through the Section 15E(w) System. The Section 15E(w) System as revised would still provide an independent voice in order to improve the integrity of the ratings process without eliminating the arranger's ability to select any other NRSRO, which should substantially eliminate any concerns that in the event that upon review of the investors' investment policies some investors still found certain NRSROs unacceptable.

7. Oversight: The evaluation of the model to help ensure it works as intended.

The determination as to whether a NRSRO is eligible to participate in the Section 15E(w) System could be done by the CRA Board or another entity, including the Commission. We would suggest that the determination be made through an application and interview process, similar to that

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[7] Encouraging competition in the credit ratings agency industry is a policy initiative for the Commission and under the Credit Rating Agency Reform Act of 2006. *See, e.g.,* the Commission's *Annual Report on Nationally Recognized Statistical Rating Organizations* (January 2011).

[8] *See, e.g., Final Rules for Security Ratings*, SEC Release No. 34-64975, File No. S7-18-08 (July 27, 2011).

[9] *See, e.g.*, *Prohibited Transaction Exemption 2007-05*, 72 F.R. 13126, 13130 (March 20, 2007), as amended 72 F.R. 16385 (April 4, 2007)(U.S. Department of Labor added DBRS to definition of "Rating Agency" under the underwriter exemptions used by employee benefit plans subject to the Employee Retirement Income Security Act of 1974 and Section 4975 of the Internal Revenue Code); *Minutes of NAIC Valuation of Securities Task Force* (September 2009)(Morningstar added to NAIC Acceptable Rating Organization List).

utilized by the Federal Reserve Board in connection with the Term Asset-Backed Securities Loan Facility program. This process may include specific consideration of the NRSRO's record with respect to the accuracy of its ratings and the timeliness of its ratings; its rating procedures and policies; its resources and structure; and its ongoing or planned investments in data, models, studies, personnel and other means to increase the accuracy and timeliness of its ratings and the depth of its analysis.

Oversight also could be provided through the annual Commission exam process and its review of the Form NRSRO. As stated above, oversight of the Section 15E(w) System's CRA Board (or other administrator or regulator) could be done through an annual public disclosure process of the criteria and formula used in selecting the NRSROs.

C. Alternative Means for Compensating NRSROs That Would Create Incentives for Accurate Credit Ratings

In this section we discuss the feasibility of alternatives to the assignment system proposed in Section 15E(w) System above. If the Commission does not propose an alternative system that would better serve the public interest, the Section 15E(w) System will be required to be implemented.

1. The Rule 17g-5 Program

We do not believe that the Rule 17g-5 Program in its current form has made any significant impact on improving the integrity of the ratings process, and therefore is not a feasible alternative to the Section 15E(w) System in its current form. Since Rule 17g-5 became effective, we know of no NRSRO that has issued an unsolicited initial rating as a result of the information available under this rule. We believe that the absence of unsolicited initial ratings primarily results from the costs of providing these unsolicited ratings without adequate compensation and a lack of interest by arrangers and investors in these ratings.

Providing a complete and thorough analysis, consistent with our methodologies requires a substantial investment of our resources. For our CMBS product, we provide a loan-level analysis on every loan in the portfolio. This makes it difficult to produce our ratings for free without reducing the quality and depth of our analysis. We believe that giving away unsolicited initial ratings without compensation would be problematic for most smaller NRSROs. We have not found that investors are willing to pay for unsolicited initial ratings when the arranger typically provides at least two arranger-selected ratings for these transactions. Often, the information required to be provided under Rule 17g-5 is not provided in sufficient time to market these unsolicited initial ratings to investors.

Furthermore, the costs associated with issuing unsolicited initial ratings is rising in light of increasing liability and regulatory requirements, making it difficult for NRSROs to issue these unsolicited initial ratings in an effort to improve the integrity of the ratings process. These costs

are particularly high for smaller NRSROs, who may not be in a position to offer free unsolicited ratings in order to compete and gain market share.

While it may be noted that Rule 17g-5 has resulted in NRSROs issuing commentary on certain initial ratings, these commentaries are provided without liability and are outside of the scope of the regulatory rules designed to protect the integrity of credit ratings. More importantly, these commentaries are not necessarily the result of an analysis consistent with the NRSROs' published methodologies and criteria. Therefore, they are not particularly meaningful (and potentially confusing) as a means of comparison for investors.

Rule 17g-5, therefore, does not go far enough to improve competition among the NRSROs in order to improve the integrity of the ratings process and the quality of ratings. Although we believe that the Section 15E(w) System is feasible, we recognize that the Commission may disagree. If the Commission were not to implement the Section 15E(w) System, we believe two possible alternatives or enhancements to Rule 17g-5 could address any shortcomings the Commission finds with Section 15E(w) System.

Unsolicited Rating Assignments. Rule 17g-5 could be enhanced by providing an assignment system for unsolicited ratings utilizing the information provided under Rule 17g-5. This system can address some of the criticisms of the Section 15E(w) System, while still ensuring that NRSROs are being compensated and incentivized to provide a thoughtful alternative analysis. After an initial qualification determination, which could be much more limited in scope (a confirmation that the NRSROs are prepared to rate the particular class of securities through the publication and release of adequate criteria), NRSROs could be selected on a rotational basis to provide an unsolicited rating. The NRSROs could be compensated on a market-value basis that could represent the average compensation paid by the issuer to the Commission or other organization to the other credit rating agencies rating the same transaction.

This system may have potentially greater market acceptance since arrangers would continue to select what they believe to be the appropriate agency based upon any factor they chose, including price, the agency's technical competence, the quality of its analysis, or investor desires. The unsolicited rating would act as an alternative, independent voice for investors to consider. This alternative system could be less administratively rigorous because transactions would still be rated by arranger-selected NRSROs. Because concerns regarding the acceptability of certain NRSRO ratings by arrangers and investors would no longer be an issue, this 17g-5 assignment system for unsolicited ratings could operate more easily on a rotational basis. Also, if the assignment system is able to avoid considering certain qualitative evaluations of NRSROs regarding the acceptability of their credit ratings to arrangers and investors, it can substantially reduce its administrative costs and rely on the Commission's current NRSRO examination process and the Form NRSRO disclosures to provide adequate oversight.

Disclosure and Compensation for Preliminary Ratings. If the Commission were to conclude that an assignment system was not in the interest of investors, the Commission could mandate the disclosure of the preliminary ratings provided to each non-selected NRSRO with the expectation

that NRSROs would be compensated for these preliminary ratings. The arrangers would be free to disclose the reason for selecting certain agencies and could also explain any differences or structural changes that account for any differences between the preliminary ratings and the final ratings issued by the selected NRSROs. Given the increasing regulatory burdens, expanding liability, and other costs of providing an analysis that will be publicly available, NRSROs could not be expected to release these preliminary ratings unless they are compensated fairly for this analysis.

2. Other Models

We do not see the merit in the other alternative models proposed by the Commission (investor-owned, stand-alone, designation, and user-pay).[10] The administration of these programs raises the same, if not at times more complex, conflict of interest issues inherent in the other models proposed. Additionally, we do not believe that the fee structures proposed by these models would be acceptable to NRSROs or arrangers. Because we believe that these models will create a need to negotiate with, or obtain direction from, investors on an individual basis, these models will eliminate one of the primary benefits of the current issuer-paid model, which is the timely execution of securitization transactions and payment for credit ratings. For this reason, we do not believe that these models will be acceptable to market participants.

Moreover, the receipt of a smaller portion of fees over an attenuated period of time does not create an incentive for NRSROs to make the infrastructure investments necessary to produce higher-quality ratings and promote competition. The fee structures proposed by some of these models may make it difficult for smaller NRSROs to gain market share since it may take longer to achieve profitability and they may be required in some circumstances to provide their ratings without compensation in order to participate in these alternative systems.

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Thank you for the opportunity to provide comments and suggestions regarding the Commission's study on a proposed assignment system. Please do not hesitate to contact us if you have any questions.

Very truly yours,

/s/ Robert Dobilas
Robert Dobilas
President
Morningstar Credit Ratings, LLC

[10] *Id.* at 282786-28277.