



# BETTER MARKETS

May 23, 2022

Vanessa A. Countryman  
Secretary  
U.S. Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549-1090

Re: Removal of References to Credit Ratings from Regulation M (File No. S7-11-22, RIN 3235-AL14)

Dear Ms. Countryman:

Better Markets<sup>1</sup> appreciates the opportunity to comment on the above-captioned Proposed Rule (“Proposal”), which was published by the Securities and Exchange Commission (“SEC” or “Commission”) in the Federal Register on March 20, 2022 (“Release”).<sup>2</sup>

As noted by Chairman Gensler, the Proposal represents the final step in the implementation of a long-standing mandate that Congress set forth in Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”), which was designed to reduce regulatory reliance on ratings. Section 939A essentially required the Commission to “remove any reference to or requirement of reliance on credit ratings” in its regulations and “substitute in such regulations such standards of credit-worthiness” as the Commission determined to be appropriate.<sup>3</sup> In making such a determination, the Commission was required to establish, to the extent feasible, uniform standards of credit-worthiness for use by the Commission, taking into

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<sup>1</sup> Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies—including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system that protects and promotes Americans’ jobs, savings, retirements, and more.

<sup>2</sup> Removal of References to Credit Ratings from Regulation M, 87 Fed. Reg. 61, 18312 (Mar. 30, 2022).

<sup>3</sup> *Id.* The Commission was also required to issue a report on the use of credit ratings in its regulations, which it issued in 2011. See [Report on Review of Reliance on Credit Ratings: As Required by Section 939A\(c\) of the Dodd-Frank Wall Street Reform and Consumer Protection Act \(2011\)](https://www.sec.gov/files/939astudy.pdf), available at <https://www.sec.gov/files/939astudy.pdf>.

account the entities it regulates and the purposes for which such entities would rely on such standards of credit-worthiness.

The Proposal is a largely appropriate implementation of the Section 939A mandate with respect to Regulation M, although we urge the Commission to improve the Proposal by requiring the use of specifically designated credit risk models to promote reliability and consistency in the application of the “probability of default” alternative standard of creditworthiness.

Perhaps more important than the Proposal itself, however, is what it signifies about the broader need for reform in the credit ratings industry. By finally completing the process of removing references to credit ratings in SEC regulations, and thus fulfilling one of the Dodd-Frank mandates, the Proposal serves as a reminder that *other reforms remain incomplete*. In fact, a host of persistent and fundamental problems in the credit ratings field must still be addressed: powerful conflicts of interest still inflate ratings; the SEC’s examination and enforcement program still suffers from a lack of transparency and resolve; the NRSROs still avoid legal accountability in direct conflict with the Dodd-Frank Act; and the credit ratings field is still dominated by three NRSROs that stifle competition.

In this letter, after commenting on some specific aspects of the Proposal, we highlight these enduring concerns about credit ratings, and we call on the SEC to move forward with additional reforms to address these problems.

## **OVERVIEW OF PROPOSAL**

The Proposal would remove references to credit ratings currently included in Regulation M. Regulation M is a set of rules designed to protect the pricing integrity of the securities markets by prohibiting issuers, selling security holders, distribution participants, and any of their affiliated purchasers from engaging in activities that could artificially influence the market for an offered security. Rule 101 of Regulation M applies to distribution participants and their affiliated purchasers. Rule 102 of Regulation M applies to issuers, selling security holders, and their affiliated purchasers. Rules 101(c)(2) and 102(d)(2) of Regulation M currently have carve-outs or exceptions for nonconvertible debt securities, nonconvertible preferred securities, and asset-backed securities that are rated investment grade. The rationale for the exceptions is to allow for activities necessary for successful distribution to occur, to limit adverse effects on the trading markets, and to allow conduct that is not likely to have a manipulative impact.

The Proposal contains three substantive changes and one new recordkeeping requirement.

- With respect to Rule 101, applicable to distribution participants and their affiliated purchasers, the Proposal would remove the requirement for reliance on the exception that the nonconvertible debt securities, nonconvertible preferred securities, and asset-backed securities be rated as “investment grade” by at least one NRSRO. In place of the reference to investment grade, the Proposal would except—
  - nonconvertible debt securities and nonconvertible preferred securities of issuers having a probability of default of less than 0.055%, as measured over a certain

period of time and as determined and documented using a “structural credit risk model,” as defined in the rule; and

- asset backed securities that are offered pursuant to an effective shelf registration statement filed on the Commission’s Form SF-3.
- With respect to Rule 102, which applies to issuers, selling security holders, and their affiliated purchasers, the Proposal would simply eliminate altogether the exception contained in Rule 102(d)(2) of Regulation M for investment grade nonconvertible debt securities, nonconvertible preferred securities, and asset-backed securities. It would thus remove any reference to investment grade ratings and at the same time obviate the need for any alternative standard of creditworthiness to be installed in its place.
- Finally, the Proposal would require broker-dealers acting as distribution participants or affiliated purchasers and relying on the proposed exception under Rule 101 to preserve the written probability of default determination supporting their reliance on the exception, for not less than three years.<sup>4</sup>

## **COMMENTS**

### **I. THE PROPOSAL APPROPRIATELY REMOVES REFERENCES TO CREDIT RATINGS FROM REGULATION M BUT THE PROVISION ON CREDIT RISK MODELS MUST BE STRENGTHENED.**

The Proposal is generally a well-reasoned and appropriate collection of reforms. It obviously succeeds in removing references to credit ratings, as required by Section 939A. The decision to eliminate altogether the exception in Rule 102 is also appropriate. As explained in the Release, the exception is unnecessary to facilitate orderly distributions, it is rarely relied upon, and in any case, it is unwise, as issuers and selling security holders have comparatively strong incentives to manipulate the price of the distributed security. In addition, the recordkeeping

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<sup>4</sup> The Commission previously issued a release addressing the references to credit ratings in Regulation M and focusing on the trading characteristics of securities that would make them less prone to the type of manipulation that Regulation M seeks to prevent, but it did not finalize its proposal. See Better Markets Comment Letter to the Commission on Removal of Certain References to Credit Ratings Under the Securities Exchange Act of 1934 (July 5, 2011), <https://bettermarkets.org/wp-content/uploads/2021/07/SEC-Comment-Letter-Removal-of-References-to-Credit-Rating-Agencies-7-5-11.pdf>; see also generally Better Markets Comment Letter to the Commission on References to Credit Ratings in Certain Investment Company Act Rules and Forms (Apr. 25, 2011), <https://www.bettermarkets.org/sites/default/files/SEC-%20Comment%20Letter-%20Credit%20Ratings%20CL%204-25-11.pdf>; Better Markets Comment Letter to the Department of the Treasury on Government Securities Act Regulations; Replacement of References to Credit Ratings and Technical Amendments (Nov. 28, 2011), <https://bettermarkets.org/wp-content/uploads/2021/07/TREAS-CL-Replacement-of-References-to-Credit-Ratings-11-28-11.pdf>.

requirement is plainly appropriate as a means of assisting the SEC in its examination and oversight of broker-dealers who rely on the exception in Rule 101 and would be required to conduct the new probability of default determination.

The principal concern the Proposal raises is in its reliance on credit risk models. As a condition for the exception in Rule 101 of Regulation M, the Proposal replaces the “investment grade” test with one requiring a probability of default of less than 0.055%,<sup>5</sup> as measured over a certain period of time and as determined and documented using a “structural credit risk model,” as defined in the rule. While we agree that the purposes of Section 939A would be served by this reform, and that the new standard is a reasonable alternative standard of creditworthiness, it still leaves a wide range of choices among credit risk models that market participants can select. It also fails to provide criteria that will help ensure the reliability of the chosen models, affording market participants wide-ranging discretion. This raises a variety of concerns.

First, it will create a lack of uniformity. As the Commission itself acknowledges in the Proposal, “the complex nature of the models, assumptions, and estimated inputs used to estimate the probability of default may not be comparable across different issuers or if the estimates are done using different Structural Credit Risk Models.”<sup>6</sup> That lack of uniformity conflicts with Section 939A of the Dodd-Frank Act, which calls upon agencies to establish, to the extent feasible, “uniform standards of credit-worthiness.”

On a more practical level, this approach creates challenges for the SEC and investors alike. The SEC’s task of monitoring implementation of the probability of default test will be more difficult with the multiplicity of available credit risk models. In addition, investors will have less confidence in the consistency and reliability of the determinations made under the new standard, unless they are willing to familiarize themselves with innumerable models.

This approach also creates a significant risk of evasion and manipulation of the new creditworthiness test, as participants choose the models that best achieve their desired results. The Release acknowledges this concern and to a degree, addresses it. The Release explains that under the Proposal, the permitted models will be limited to those that are “commercially or publicly available,” to help ensure that those with an interest in the outcome of a distribution cannot develop and rely upon “their own models to achieve favorable results.”<sup>7</sup> But we fear that this limitation will still leave too much room for abuse, as firms will have a wide variety of models to select, especially as any number of new “commercially available” models emerge over time.

Finally, setting no minimum standards for the models and allowing market participants the discretion to choose among a wide range of models threatens to create a race to the bottom, as distribution participants seek to avoid the competitive disadvantages that will arise from having an appropriately rigorous risk of default evaluations. For all of these reasons, the Commission should

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<sup>5</sup> According to the Release, this percentage approximates the current standard under the current “Investment Grade” exemption. *See* Release at 18319.

<sup>6</sup> *Id.* at 18318.

<sup>7</sup> *Id.* at 18319.

set standards governing the permissible models or prescribe a limited list of vetted models from which distribution participants can choose.

## **II. THE COMMISSION MUST MOVE MORE AGGRESSIVELY TO ADDRESS A LONG LIST OF PERSISTENT PROBLEMS IN THE CREDIT RATINGS FIELD.**

### **A. Credit ratings have enormous power to affect investors, markets, and the economy.**

Credit ratings have become an extremely important fixture in our capital markets. They are heavily relied upon by investors and issuers, and they even became embedded in our securities laws and regulations as shorthand standards of creditworthiness used by regulators. When credit ratings are honest and accurate, they help promote investor confidence, capital formation, and market liquidity in corporate, municipal, and sovereign debt offerings.

However, it is an undeniable fact that when credit ratings are erroneous, conflicted, or otherwise corrupted, they can also wreak havoc on investors and on the financial system as a whole. Grossly inflated credit ratings assigned to thousands of mortgage-backed securities in the years leading up to the 2008 financial crisis helped bring our economy to its knees, costing over \$20 trillion in lost GDP and untold suffering.<sup>8</sup> As one leading report on the crisis explained, inaccurate AAA credit ratings and the inevitable and sudden downgrades thereafter “perhaps more than any other single event” triggered the crisis.<sup>9</sup>

And that wasn’t the first high-profile failure linked to credit ratings. The spectacular collapse of Enron in 2001, preceded by strong ratings up to the eve of its bankruptcy, generated fresh concerns about the role of credit ratings and the need for oversight. The same sobering lesson was driven home again during the 2010 Eurozone crisis, which was inflamed when NRSROs issued sudden downgrades of Greek sovereign debt after consistently rating it A+ for years. And the fact that only one of the three major rating agencies downgraded long-term U.S. debt in 2011 speaks volumes about the arbitrary, unreliable, and at times even politically driven nature of credit ratings.

### **B. Dodd-Frank was a commendable blueprint for reform.**

The Dodd-Frank Act (Sections 931-939) required reforms in the credit rating industry, not only to increase transparency and oversight, but also to root out the driving force behind bloated ratings: the powerful conflicts of interest inherent in the “issuer-pays” compensation model. Those incentives induce NRSROs to inflate their ratings to attract business from issuers and underwriters, earn lucrative fees, and maintain the flow of future deals.

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<sup>8</sup> BETTER MARKETS, THE COST OF THE CRISIS: \$20 TRILLION AND COUNTING (2015), <https://bettermarkets.com/sites/default/files/Better%20Markets%20-%20Cost%20of%20the%20Crisis.pdf>.

<sup>9</sup> *Wall Street and the Financial Crisis: Anatomy of a Financial Collapse*, Majority and Minority Staff Report, United States Senate Permanent Subcommittee on Investigations, at 6 (Apr. 13, 2011).

First, the Dodd-Frank Act built on the **regulatory requirements** that were implemented in the Credit Rating Agency Reform Act of 2006, adding new provisions on corporate governance, disclosure of methodologies and performance, training standards, and conflicts of interest, including measures to prevent marketing or sales considerations from influencing ratings. And it created the SEC’s Office of Credit Ratings to conduct annual examinations of the NRSROs and oversee the credit ratings marketplace. Second, it sought to promote **accountability and compliance** by removing important immunities from liability, including SEC Rule 436(g), which the Dodd-Frank Act—on its face, at least—repealed.

Third, it sought to **reduce reliance** upon credit ratings by requiring the SEC and other federal agencies to remove any references to credit ratings in regulations and to substitute appropriate standards of creditworthiness in their place, leading to the Proposal and other previous rules. And fourth, in Section 939F, it required the SEC to study the feasibility of establishing an **assignment system** in which a public or private utility would assign NRSROs to determine the initial credit ratings for structured finance products. That provision also imposed an unequivocal mandate: It required the SEC either to establish such an assignment system (which would prevent the issuer or underwriter of the structured finance product from selecting the NRSRO) or pursue an alternative system if the SEC found one that would better serve the public interest and the protection of investors.

**C. But the promise of Dodd-Frank has not been fulfilled, as gaps and weaknesses persist.**

Over the last 10 years, the SEC has implemented a number of the Dodd-Frank Act mandates on credit ratings, but none of them individually or together has been strong enough to fulfill the promise of Dodd-Frank. Periodically, academics and policymakers on the Hill draw well-deserved attention to the deficiencies in the credit rating field,<sup>10</sup> but little concrete action follows. Consider these persistent and emerging challenges.

**Conflicts of Interest.** Perhaps most important, almost all of the credit rating agencies—and certainly the three largest NRSROs—suffer from ongoing and deeply embedded conflicts of interest due to their primary “issuer-pay” compensation model. Under that model, bond issuers shop for high ratings, and the NRSROs have an incentive to accommodate those issuers in an effort to receive and maintain a steady and lucrative stream of revenue. As noted above, Congress mandated that the SEC establish an assignment system for the initial ratings on structured products (or a more effective alternative), to help end the practice of ratings shopping. However, with the exception of the SEC’s 2012 study of the problem and a later roundtable, no real progress has been made. In particular, the SEC has failed to successfully address the conflicts of interest that dominate the “issuer pays” model and lead to dangerously inflated ratings. Other indications are

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<sup>10</sup> See, e.g., Frank Partnoy, *What’s (Still) Wrong With Credit Ratings?*, 92 Wash. L. Rev. 1407 (2017); Hearing before the Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets of the House Financial Services Committee, *Bond Rating Agencies: Examining the “Nationally Recognized Statistical Rating Organizations* (July 21, 2021).

no more encouraging. Conflicts of interest continue to rank high among the violations uncovered during SEC examinations and reviewed in the SEC’s annual reports. And Rule 17g-5(a)(3), issued over 10 years ago to facilitate non-hired, unsolicited ratings to balance out the paid-for ratings, has proven to be wholly ineffective. While the SEC announced some time ago that it would review the issues surrounding that rule, no progress is evident.

**Transparency and Enforcement.** The SEC’s approach to examinations and enforcement is doubly flawed. In accordance with Section 932 of the Dodd-Frank Act, the SEC conducts annual examinations of the NRSROs. Also in accordance with the Dodd-Frank Act, the SEC makes those reports public. However, although those annual reports typically reveal significant violations of law, they include no identifying information that would inform the public as to which NRSROs are engaged in illegal acts and practices. Last year, the SEC’s Investor Advisory Committee specifically recommended that the SEC abandon this opaque approach and instead “identify in its reports the specific NRSRO whose conduct was deemed by OCR staff to be materially deficient.”<sup>11</sup> The practice has not changed. Moreover, we see little evidence that the SEC is pursuing violators in enforcement actions. As reflected in the examination reports, the SEC’s approach appears to be primarily to “encourage” firms to take remedial action, not actually enforce the law.<sup>12</sup> And when the SEC does take action, it appears focused on the smaller NRSROs, not the bigger, richer, and more powerful players.

**Accountability.** Accountability for the NRSROs has been undermined on another level. Section 939G of the Dodd-Frank Act expressly eliminated the exemption for NRSROs set forth in Rule 436(g). That step was intended to ensure that the NRSROs could be held accountable under Section 11 of the Securities Act of 1933 for misleading ratings included in registration statements. However, in July 2010, the SEC issued no-action relief, known as the Ford No-Action Letter, which allowed the omission of credit ratings from a prospectus. That in effect negated Congress’s language and intent yet it remains intact,<sup>13</sup> notwithstanding calls for its rescission<sup>14</sup> and notwithstanding the plain fact that liability is one of the most effective ways not only of making investors whole but also deterring violations of the law by market participants.<sup>15</sup>

**Competition.** The credit rating industry continues to be dominated by the three largest NRSROs—S&P Global Ratings, Moody’s Investors Service, Inc., and Fitch Ratings, Inc. The SEC’s latest annual report indicates that those three firms collectively account for 94.7% of all

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<sup>11</sup> Recommendation of the Market Structure Subcommittee of the SEC Investor Advisory Committee Regarding Credit Rating Agencies (Mar. 11, 2021).

<sup>12</sup> SEC Office of Credit Ratings, Staff Report on Nationally Recognized Ratings Organizations, at 7 (Jan. 2022), <https://www.sec.gov/files/2022-ocr-staff-report.pdf>.

<sup>13</sup> Response of the Office of Chief Counsel Division of Corporate Finance to Ford Motor Credit Company *et al.* (Nov. 23, 2010), <https://www.sec.gov/divisions/corpfin/cf-noaction/2010/ford072210-1120.htm>.

<sup>14</sup> Letter from Americans for Financial Reform Education Fund, Better Markets, and eight other organizations or individuals to the SEC (Jan. 20, 2022), <https://ourfinancialsecurity.org/wp-content/uploads/2022/01/1.20.22-systemic-risk-AFREF-sign-on-letter-to-SEC-on-Credit-Rating-Agencies-FINAL.pdf>.

<sup>15</sup> Frank Partnoy, *What’s (Still) Wrong With Credit Ratings?*, 92 Wash. L. Rev. 1407 (2017).

outstanding ratings and 94.1% of all revenue among the NRSROs.<sup>16</sup> While other firms have gained ground in some asset classes, those gains have been modest. Institutional fund manager guidelines and inclusion requirements for fixed income indices still require or favor the large firms. And preferential treatment has also been a factor, as exemplified during the pandemic in the emergency credit facilities that conditioned participation in those programs on ratings from the three dominant firms. Potentially anticompetitive practices have surfaced in other areas. Recent controversy centered around S&P’s December proposal to mechanistically “notch” or lower the ratings for constituent assets in a pool if those assets haven’t been rated by S&P.<sup>17</sup> The Antitrust Division of the Department of Justice expressed concern about the practice as a possible violation of the Sherman Act, and others noted that it might represent a violation of SEC rule 17g-6(a)(4), which prohibits notching in the rating of structured products if engaged in for an anti-competitive purpose.<sup>18</sup> On April 14, 2022, a bipartisan group of twenty-six Senators and Representatives asked the Commission to investigate.<sup>19</sup> And the House Financial Services Committee convened a hearing on the topic, among others, earlier this month,<sup>20</sup> all of which prompted S&P to withdraw its proposal for the time being.<sup>21</sup>

**D. The threat of harm is real and growing, as ever stronger market stresses loom ahead.**

As the coronavirus pandemic swept over the country last Spring, potentially triggering another financial crisis, we saw ominous signs that the SEC’s failure to follow through on the Dodd-Frank reforms was contributing once again to financial market instability and chaos.<sup>22</sup> Credit rating downgrades—especially for highly leveraged companies and the securitizations built on their debt (the “CLOs”)—exploded amidst the financial market turmoil triggered by the pandemic. Based on this experience and other developments, many believe that fundamentally,

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<sup>16</sup> SEC Office of Credit Ratings, Staff Report on Nationally Recognized Ratings Organizations, at 24, 29 (Jan. 2022), <https://www.sec.gov/files/2022-ocr-staff-report.pdf>.

<sup>17</sup> Leslie Scism, *S&P Revamp of Insurer Ratings Draws Criticism*, Wall St. J. (Apr. 21, 2022), <https://www.wsj.com/articles/s-p-revamp-of-insurer-ratings-draws-criticism-11650506793>.

<sup>18</sup> Hearing Memorandum, U.S. House Committee on Financial Services Subcommittee Hearing on Investor Protection, Entrepreneurship and Capital Markets, “*A Notch Above? Examining the Bond Rating Industry*” (May 6, 2022) (for hearing on May 11, 2022).

<sup>19</sup> Letter to Gary Gensler, Chairman of Securities and Exchange Commission, from 26 Members of Congress, re: “Anticompetitive Concerns Regarding ‘Notching’ in the S&P Proposal” (Apr. 14, 2022).

<sup>20</sup> U.S. House Committee on Financial Services Subcommittee Hearing on Investor Protection, Entrepreneurship and Capital Markets, “*A Notch Above? Examining the Bond Rating Industry*” (May 11, 2022), <https://financialservices.house.gov/events/eventsingle.aspx?EventID=409376>.

<sup>21</sup> Leslie Scism, *S&P Drops Controversial Part of Ratings Plan for Insurers*, Wall St. J. (May 9, 2022).

<sup>22</sup> See, e.g., Better Markets Fact Sheet: Credit Rating Agency Conflicts of Interest Again Fueling A Financial Crisis (Apr. 27, 2020, updated May 19, 2020), [https://bettermarkets.org/wp-content/uploads/2021/07/CRA\\_Fact\\_Sheet\\_updated\\_5-19-20.pdf](https://bettermarkets.org/wp-content/uploads/2021/07/CRA_Fact_Sheet_updated_5-19-20.pdf); Lisa Lee, *Battered CLO Investors Are About to Get a Look at Their Losses*, Bloomberg (Apr. 20, 2020); Patrick Temple West, *Ratings Agencies Brace for Backlash After Rash of Downgrades*, Financial Times (Apr. 2, 2020).



nothing has changed in the regulation of the credit ratings industry. The SEC must do its utmost to solve the perennial problem of flawed and conflicted credit ratings once and for all, as Congress required.

The need for reform is urgent and increasingly so. Even during periods of relative market calm, inaccurate credit ratings inflict harm on investors who rely on those ratings when deciding how to allocate their investments. When markets go through periods of extreme stress, the stakes are even higher, and flawed credit ratings can have an outsized impact on markets and financial stability. We are now confronting a period of increasing market volatility and stress due to a number of factors. While the pandemic is less severe than it once was, it may resurge, and in any event, the economic impact of the last two years is certainly still being felt. The cryptocurrency markets have recently experienced a huge downturn and can be expected to exhibit volatility for some time to come. Inflation generally and particularly in the all-important real estate market is an additional factor introducing uncertainty into the financial markets. And the ESG movement is affecting virtually all market sectors and participants, presenting new challenges not only for issuers and investment managers but also for the credit rating industry. Under these circumstances, it is more important than ever for the persistent deficiencies in the oversight of the credit rating industry to be addressed and corrected.

## CONCLUSION

We hope these comments are helpful as the Commission finalizes the Proposal.

Sincerely,



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