Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations

Comments to the SEC's Proposed rule S7-04-07

Adding Sections 240.17g-1 through 240.17g-6 to the General Rules and Regulations of the SEA of 1934.

Herwig M. Langohr, INSEAD[1]
Patricia T. Langohr, ESSEC[2]
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Designing an optimal set of SEC rules in implementation of the CRA Reform Act of 2006 is quite a challenge and might even be impossible because the Act suffers from several internal tensions. In our comments, we focus on the considerations that lead us to propose changes in specific rules. We first highlight very briefly some internal tensions in the CRA Reform Act of 2006. We then highlight the critical choices that the SEC made within its discretionary parameters on how to implement the Act and what rules to make. Next we evaluate the rule-making in the light of the high-level animating principles of the Act. We draw on the implications of the discussion to propose a number of changes in specific rules. We then sum up and conclude.

1 Analysis: internal tensions in the Act

1.1 Number of NRSRO players, the nature of competition and ratings quality

[1] Professor of Finance and Banking, INSEAD Business School, Boulevard de Constance, 77300 Fontainebleau, France. Herwig.Langohr@insead.edu.
[2] Assistant Professor of Economics, ESSEC Business School, Avenue Bernard Hirsch, 95021 Cergy-Pontoise, France. langohr@essec.fr

The Act aims to improve ratings quality and increase the number of NRSRO players in the industry, yet, due to the very competitive nature of the industry, only the few highest quality players can survive.

1.2 Broad statutory authority and NRSRO autonomy

The Act endows the SEC with broad statutory rule-making and enforcement authority, thereby appealing to the SEC's great sense of responsibility and duty to make process control rules. Yet the Act requires that these rules be 'narrowly tailored to meet the requirements of the Act' and that they may not 'regulate the substance of credit ratings or the procedures or methods by which an NRSRO determines credit ratings'.

1.3 Competition and the eradication of the costs of moral hazard

The Act aims to stimulate competition, yet, due to unavoidable moral hazard problems within the CRAs themselves, this competition must be monitored. But monitoring done through administrative oversight stifles competition.

1.4 Prohibitions and their justification

The Act mandates the SEC to prohibit any credit rating practice that is unfair, coercive, or abusive, yet the Committee sponsoring the act 'intends that the SEC, as a threshold consideration, must determine that the practices subject to prohibition are unfair, coercive or abusive before adopting rules prohibiting such practices'.

1.5. Presumption of abusiveness or not

The Act includes as a possible abusive practice the refusal by a NRSRO to rate the securities issued by an asset pool unless it has also rated a set fraction of the securities in the pool itself. Yet, the Committee sponsoring the act 'recognizes that there are instances when a rating agency may refuse to rate securities for reasons that are not intended to be anticompetitive'. What takes precedence: the presumption of abusiveness or the presumption that these refusals are not intended to be anticompetitive?

2 Analysis: critical choices of the Proposed rule

2.1 Number of NRSRO players: 17g-1

The Act abolishes the Catch 22 in the traditional NRSRO recognition procedure. The Proposed rule grants NRSRO status to CRAs that are registered under Form NRSRO, have been in business for at least three consecutive years, and are endorsed by a limited number of qualified market participants. Registration entails, amongst others, the public disclosure of nine useful characteristics of the NRSRO and its ratings, and four types of confidential data that are either competitive or pertain to the private company status of the NRSRO. The largest NRSROs publish most of these data already on their websites and elsewhere. Any serious potential entrant NRSRO should be able to comply with these conditions, considerably flattening the world of credit ratings and increasing in the short-run the number of licensed NRSRO.

2.2 The exercise of broad rule making authority: 17g-2 and 17g-6 (b)

The Proposed rule chooses to impose broad requirements for keeping books and records as the primary means of monitoring compliance with applicable securities laws. It is designed to ensure that an NRSRO makes and retains records that would assist the Commission in monitoring, through its examination authority, whether an NRSRO is compliant with the provisions of Section 15E of the Exchange Act and of the Proposed rule. For example, examiners would use the records to monitor whether an NRSRO has followed or has been following its disclosed procedures and methodologies for determining credit ratings.

For the SEC's approach to be effective, the following condition needs to hold. Given a CRA's set of procedures and methods for determining credit ratings and all its records related to the rating of a specific issue, compliance or non-compliance could be declared unambiguously according to the accepted procedures and methodologies. Unfortunately, that condition can only hold if rating methodologies and procedures are completely describable, and they would only be completely describable if an outsider provided with the complete exhaustive methodologies and procedures, along with all the relevant private information, could do a unique mapping onto a credit rating. While one can try to describe the methodologies and procedures used to determine a rating in extensive detail, the very essence or raison d'être of ratings, makes it impossible to extract the essential algorithm, of a deliberative process, that maps a methodology and an issuer's given set of information into a unique rating. If it were possible, CRAs would not exist, because all issuers would be able to use their own private information as input to an algorithm that would give a replicable rating as output. The essence of a credit rating is not just to provide important information concerning an issue's credit quality but, by assigning a rating, to do so in an observable and verifiable way. By this we mean that anyone can unambiguously observe a rating and, if they wish, write a contract based on it (for instance rating triggers or investment guidelines). The ratings process transforms a mass of private and public information into a single contractible measure.

2.3 The eradication of the costs of moral hazard: 17g-5 (c) (1)

The rule basically says that a NRSRO must withdraw its ratings from very important clients, the threshold of importance being 10% of net revenues. The potential market failure associated with an NRSRO is the moral hazard of free-riding on its reputation. The temptation and short term profits of so doing may increase with the revenues extracted from a particular client. Presumably, the rule aims to protect an NRSRO from being tempted, and to protect investors from the profits that an NRSRO would extract from them by assigning biased ratings to big clients at the investors' expense.

As a matter of analysis, this rule contradicts the NRSRO's duty to monitor its ratings and keep them current. And while it may radically protect investors against any bias that an NRSRO's short-term commercial interests might induce, it is also against the interest of investors who want a particular NRSRO to cover a complete spectrum of substitute issuers, using its rating standard.

2.4. Prohibitions: 17g-6 (a) and (b)

The provisions regarding prohibited acts and practices rule that (i) tying, (ii) refusing to rate or to endorse at face value ratings of competing agencies, and (iii) seeking to obtain payment for an unsolicited rating are unfair, coercive or abusive. They rule in addition that a refusal to rate asset pools, or securities issued against them, ought to be justified in writing to the SEC.

The Act of 2006 refrained from deciding what practices were unfair, coercive or abusive in the CRA industry. It left it up to the SEC to decide, based on the merits of the case. In fact, "SEC, as a threshold consideration, must determine that the practices subject to prohibition are unfair, coercive or abusive before adopting rules prohibiting such practices", according to the Senate Report.

When analyzing 17g-6 (a) and (b) and their justifications (pages 94-105), one observes that the SEC does not provide in its Proposal the evaluation that the Act and the Senate Report required. The SEC, while offering several considerations, in the final analysis asserts and then prescribes.

2.5. Presumption of abusiveness or not? Forced recognition of third party ratings: 17g-6 (a) (4)

This provision forces as a matter of principle, NRSROs asked to rate the paper issued against asset pools to accept at face value the ratings that competitors assigned to securities belonging to these pools.

2.6. Form NRSRO – Exhibit 1 on Performance Statistics

This rule requires the publication of some vaguely defined performance statistics. The SEC requests comments and suggestions on this exhibit, which we will offer in our evaluation section.

2.7. Form NRSRO – Exhibit 5 on Ethical Codes

This rule requests the publication of a code of ethics, or an explanation of why there is no code of ethics. The SEC requests comments and suggestions on this exhibit, which we will offer in our evaluation section.

3 Evaluation

3.1 The number of NRSRO players, the nature of competition and ratings quality

By doing away with the Catch 22 and leaving relatively little discretion to the SEC to grant or deny NRSRO status, the Proposed rule respects one of the key purposes of the CRA Reform Act to foster competition. The credible threat of new entrants will re-invigorate competition. This will ensure that CRAs invest ever more in quality; it will facilitate reversals of market dominance, and improve choices for issuers.

But the degree of competition should not be equated with a large number of players. A high degree of competition can be consistent with a small number of NRSROs. In the CRA industry the equilibrium number of global or niche players in any confined segment will be small, probably around three, for the following reasons.

However beneficial the dynamics that credible threats of new entrants create, reputation and network effects will continue to prevail in this industry, maintaining high barriers to entry and industry concentration. Ratings from the same CRA offer a common standard for interpreting risk, and the more that standard is used, the more the market will be willing to adopt it. CRAs compete for the market rather than in the market, because switching from one standard to another is costly. Issuers would need a major reason to switch agency once they have spent considerable executive time establishing initial ratings and developing a trust relationship with a CRA. Ratings from CRAs represent different opinions about a possible future default. The quality of a particular CRA is thus only revealed over time. For investors to pay attention and for issuers to pay, they must trust the lifetime accuracy of a rating. You can only assess that using large samples, not by studying a unique event, such as the timeliness of predicting a singular default. Users thus need experience with a lot of ratings from a particular CRA to figure out how accurate they are.

Clearly, this situation is advantageous for incumbents who occupied the field early and acquired an installed base, giving them a head start over new entrants. A small number of CRAs with the highest reputation for quality and independence will thus always dominate. This should not be a concern provided regulations do not protect incumbents artificially nor scare away new rivals. There are several strongly branded and technologically skilled infomediaries that might be keen to catch a share of CRA industry profits.

Indeed, the good news is that the ratings business is well segmented according to issuer product, industry and geography (e.g. sovereign bonds versus structured finance, insurance companies versus manufacturing, the U.S. versus emerging markets). This facilitates entry by new contenders because, once they have established their reputation in a specific segment, they can leverage that reputation as they move into nearby segments. Rapidly growing segments provide unique opportunities for agencies to invest in creating an installed base. Fast growth in a segment increases the likelihood that it will tip in favour of a new entrant, reversing the position of a dominant firm. The current intense rivalry in the fast-growing structured finance segment illustrates these dynamics. The SEC should not stifle that with protective prohibitions as the Proposed rule would.

In conclusion, the animating principle of the Act is great: harness markets. In the interest of all, the SEC significantly abolishes the current Catch 22. But reassuringly for the true independence of CRAs vis à vis issuers, the industry will remain concentrated. For the better, 17g-1 relieves entrance to the industry from artificial regulatory protection, thereby stimulating innovation, improving product quality, and lowering rating costs to issuers. But the Proposed rule also, in several of its other provisions, tries to promote the public interest by administrative interference in the substance of credit rating decisions and by restricting competitive rivalry practices. Thereby it risks doing away with the benefits of 17g-1, because these other provisions obstruct the process of creative destruction and Darwinian selection. Entry and exit should be stimulated to ensure that only the very best survive. The Proposed rule should remain respectful of the nature of competition in this very particular industry. Economic history has taught that the lasting public interest is best served by respecting the natural dynamics of an industry. This suggests that administrative discretion should not obstruct the emergence of a small number of well-qualified NRSROs.

To sum up, the different provisions of the Proposed rule should consistently give precedence to ratings quality, rather than to the number of NRSRO players per se.

3.2 Administrative examination of rating decisions and NRSRO's substantive autonomy

As mentioned, credit rating methodologies and procedures cannot be completely described. Therefore, any administrative scrutiny based on testing compliance implies a margin of interpretation by the scrutinizer, meaning that the scrutinizer must exercise their discretion. Thus, testing compliance under the Proposed rule risks the de facto - if not the formalistic - regulation by the SEC of the substance of credit ratings or the procedures or methods by which an NRSRO determines credit ratings. This is contrary to Section 15E(c) (2) of the Exchange Act.

Take the case of Proposed rule 17g-6 (b). Requiring a CRA to justify why it did not do a rating is manifestly regulating the substance of credit ratings. It is a direct infringement upon CRA independence and autonomy concerning the substance of its ratings. By analogy, it is like requiring a journalist to justify why she has not written an article.

In addition, consider two other possible detrimental effects of rule 17g-2 that may end up reducing the quality of credit ratings.

One, it gives a sense that the SEC is good at conducting rating process control and thus at vouching for rating quality. In this respect, the proposed rule lacks coherence with the principle of non-endorsement. The Act is clear that the SEC should not formally endorse the NRSROs, yet the SEC monitoring provisions of rule 17g-2 will in practice have the effect of endorsement. Not only is the provision therefore in contradiction with the Act, but as a consequence of it, market participants will have fewer incentives than they otherwise would have to incur costly monitoring expenses. They would disengage from their own indirect monitoring, provided by their competitive choices, and the quality of ratings would go down.

Two, the SEC's heavy administrative scrutiny imposes fixed costs and diversion of scarce resources on NRSROs. These risk discouraging new entry, replacing the previous barrier to entry with a new one. If entry into the industry is painful, it will not occur. Incumbents will not feel the same pressure to perform, once again lowering the quality of ratings.

For these reasons, we believe that the provisions of the Proposed rule that refer to rating methods or methodologies should be rebuked.

3.3 The fiat requirement to withdraw ratings from important customers

The fiat requirement to withdraw ratings from important customers, in case a '10% net revenue' customer rule, is biased, only spuriously effective, probably redundant and in a sense beside the point. An alternative requirement could be more realistic and effective in helping market participants to gauge for themselves the likely quality of a rating.

It is biased in that it expresses in its current form the value judgment of the rule-maker that the expected bias cost to investors in ratings of large customers exceeds the expected benefits to investors for their NRSRO of choice to cover a complete spectrum of substitute issuers according to its own rating standard.

It is only spuriously effective, because it creates an incentive to stay at 9.9%...which is materially the same as 10%.

It may very well be redundant because it overlooks two forces that counterbalance the temptation for an NRSRO to free-ride on its reputation. One, an NRSRO has a lasting self-interest in its reputation capital, i.e. to produce unbiased and efficient ratings. Two, as a client becomes more important, it also becomes more visible, and an increasing number of bond portfolios will hold its issues. In that sense, the reputation self-interest of an NRSRO may very well increase with the importance of the customer. As a result, the expected potential long run reputation penalty of shirking on large clients could very well outweigh the short-term expected financial payoffs.

It is in a sense beside the point because if an industry that is naturally concentrated on the supply side is confronted with a demand side in which there are a number of very large issuers, these large issuers will unavoidably be important customers to one or two of the largest suppliers. It is not just that size seeks size, like a magnet, but that the numbers work out like that. So the question then becomes, are any competitive rivalry dynamics that punish opportunistic behaviour (such as biasing a rating to please an important customer)? As it turns out, the observed adjustment behaviour of credit ratings in advance of defaults suggest significant mutually corrective rating action moves. The rating agencies act as mutual monitors. Moreover, any split rating induces market participants to extra monitor the quality of the ratings more carefully, and eventually to push for a third rating. These suggest that the very high visibility of a rating due to the importance of the issuer in the market will act as a constraint on opportunistic behaviour.

One could try to argue theoretically that the big NRSROs act in concert with respect to very big issuers and thus big customers. That therefore this high concentration of big issuers among a small number of NRSROs has to be broken up. And that a fringe benefit will be to stimulate competition by leaving a bigger slice of the pie available for smaller players or new entrants. However, one should not overlook the fact that the industry is going to need a very large number of small players to prevent the big issuers from hitting the 10% hurdle in any agency while at the same time have all their paper properly rated.

For all these reasons, we conclude that the 10% rule needs to be withdrawn and that it ought to be replaced by a public disclosure requirement on any NRSRO of any issuer name that represents more than a to–be-determined fraction of a measure of revenues. The purpose of such a public disclosure requirement is to give the market relevant information to assess the quality of a rating. An analogy is the public disclosure requirement of shareholder threshold stakes in publicly listed companies, which gives the market information relevant for assessing the quality of a share price.

Such a disclosure requirement has several advantages. One, it avoids the problems analysed and evaluated above. Two, it lets the NRSRO conduct its business and decide if it wants to submit itself to that disclosure or not, offering a 'good' NRSRO an additional instrument to credibly signal its type. Three, it helps the users of ratings do their work and encourages them to be proactive.

To sum up and conclude, we argue in favor of giving precedence to competition in rule design, and to use the forces of competition and user self-interest to eradicate the costs of moral hazard, rather than administrative fiat.

3.4 Administrative process control versus market sanctions on output quality or prohibitions and their justification:17g-6 (a) and (b)

While the case against undue tying has been widely made in competition theory and should a fortiori apply to the business model whereby the rated issuer pays for the rating, the cases against refusing to rate and against some commercial practices that surround unsolicited ratings are much harder to make.

One has to realize that provisions g-6 (a), (4) and (5) and g-6 (b) impose significant administrative discretion in place of the discipline of market forces. This, in a decentralized market economy, usually supposes that there are demonstrated, material and costly market failures that are pervasive. The three-year worldwide scrutiny of the CRA industry (BIS, SEC, CESR, IOSCO, US Congress, and European Parliament) certainly uncovered cases of, sometimes extremely costly, ad hoc shortcomings in how CRAs prevented the surprise of defaults. Yet, no systematic academic or official evidence was produced establishing the existence of pervasive market failures in this industry. That is why IOSCO offered through its Principles and Code of Conduct an instrument that could rely on the forces of disclosure to enforce competitive market self-discipline; that the EU decided to rely on generic EU competition laws to uncover and discipline eventual unacceptable commercial practices by CRAs; and that the CRA Reform Act 2006 itself was very careful in not imposing discretion in place of market discipline, leaving it up to the SEC to evaluate the merits of doing or not doing so. Unfortunately, nothing in *Section III Description of the Proposed Rules* provides this evaluation. The SEC simply asserts and then prescribes, enabling it to fully second guess the work of a CRA.

Take the case of unsolicited ratings. Proposal 17g-6 (a) (5) de facto shifts to the NRSRO the burden of proof that issuing an unsolicited rating and communicating with the rated person did not occur 'to induce or attempt to induce…with the rating organization'. By doing so, this proposal reinforces the suspicions about unsolicited ratings.

Such an approach risks throwing out the baby with the bathwater for the following reasons:

a. Unsolicited ratings are necessary for entrants to credibly challenge incumbents. Rating agencies compete for the market rather than in the market. They tend to focus on capturing a whole market by going for complete spanning and establishing a strong reputation in that market, rather than competing fiercely for each individual issue and taking the risk of compromising their reputation. Reputation is a rating agency's essential asset and they need to establish it by building an up-to-date, dense track record that is evaluated by investors. Agencies therefore actively seek to increase this track record by issuing unsolicited ratings that will also help them develop expertise in a segment and span the segment in the interest of investors. Unsolicited ratings are the consumer goods equivalent of advertising or distributing free software.

b. To foster competition in the industry, it is important to reduce the stigma attached to issuing unsolicited ratings. The most effective way to do so would be to systematically and very openly disclose all unsolicited ratings as such. The necessary market discipline to ensure the quality of unsolicited ratings would work best if the performance of unsolicited ratings was also disclosed.

c. There is an important distinction to be made between unsolicited ratings and non-issuer participating ratings. Unsolicited ratings are ratings that are initiated by the agency and for which the issuer does not pay. Non-issuer participating ratings are ratings that are based on public information. Generally, unsolicited ratings are based on public information but this is not always the case, sometimes issuers are willing to participate to a certain extent in the unsolicited rating process. A certain degree of communication is then inevitable, and certainly it is in everyone's interest to encourage this communication between the issuer and the rating agency.

d. To minimize abuses while maximizing competition, full and clear disclosure that a rating is unsolicited as long as it remains unsolicited is what counts, together with perhaps a reasonable waiting period between the last unsolicited rating and the first paid rating. Providing and disclosing performance data for unsolicited ratings would ensure that the agency's incentives were aligned with the public interest and would allow any potential systematic bias in these ratings to be monitored.

3.5. Presumption of abusiveness or not? The imposition of third party ratings (17g-6 (a) (4)

This provision could have the commendable intend to prevent real closed shop tactics among competitors. A competitor refusing to rate securities issued against pools rated by third parties or refusing to recognize rating parity without disclosure to it of the third party rating method makes it harder for the third party to have its rated securities included in the pool and/or to obtain business for rating the securities issued against the pool, alongside with the refusing party. Inasmuch as the intention of such refusals would be to keep competitors abusively out of a business, they ought to be condemned and sanctioned, of course.

However, what the provision requires, as a principle, is very serious. It requests an NRSRO to blindly endorse the ratings of competitors and to assume the subjective trade-offs of their competitors as one's own. In other words, the provision requires an NRSRO to put its own reputation at risk on behalf of the commercial interests of a competitor.

This is not only a completely unreasonable request on the grounds of fair competition, this provision also contradicts the independence of CRAs in making risk assessment judgments and destroys the legitimacy of a CRA's concern about its reputation. The rule is like forcing a doctor to prescribe treatment for a patient based on another doctor's diagnostics that remain locked in a black-box. [3]

[3] This is just an analogy. Of course, CRAs don't prescribe anything with a rating, and issue ratings as an opinion to 'the best of their knowledge'. By their very nature, ratings are positive rather than normative.

It is possible to prevent abusive closed shop tactics while preserving CRA independence and legitimate concerns about reputation. The SEC has the authority to require the rating agency responsible for rating the assets in the pool to fully disclose the methods by which it has reached those ratings.

So, rather than creating a presumption of abusive tactics against refusing CRAs and imposing an administrative prohibition rule, our proposed required disclosure rule would offer those rating agencies that want their ratings to be considered the option of coopetition: i.e. to allow competitors to cooperate for some of their activities (concurrent cooperation and competition), as exists in many industries confronted with similar problems.

3.6. Form NRSRO – Exhibit 1 on Performance Statistics

There is a dichotomy between a requirement to publish prescribed statistics versus ensuring that the best possible statistics are being published and that CRAs minimize free-riding on their reputation. We propose providing market participants with the necessary information to make their own informed decisions concerning the performance and quality of the CRAs. Who monitors the monitor and what to monitor? Monitoring the rating agencies' inputs and processes could be too costly, provide the wrong incentives and therefore be counterproductive. But what really matters for public welfare and the functioning of markets is the rating agencies' output. The certifier's output is what should be monitored most closely. This is what really matters for the optimal functioning of credit markets. The process of how rating agencies issue a rating is too complex to monitor accurately and effectively in any case.

To apply output control to performance measurement statistics, we would therefore strongly recommend that the SEC uses its authority to impose two powerful principles, rather than prescribing the actual statistics that NRSROs must provide. In fact, we would leave it up to the NRSROs to decide what exact statistics to publish, giving them thereby an instrument of credibly signalling their quality. But the principles would ensure that the publication of statistics is not just a form of advertising that can be done at the full discretion of the advertiser and without verifiability of the advertising message

The first principle should be that of *replicability*. *Any NRSRO if it publishes a performance statistic should provide with it in digital format the data that a user of the performance statistic needs to replicate the statistic*. The data provided should allow the users of NRSRO performance statistics to replicate whatever summary statistics on default benchmarking that the NRSRO publishes. In other words, the default benchmarking performance materials that NRSROs publish should be subjected to the same principle of replication tests as in any top tier scientific professional journal, be it in the positive or human sciences.

We emphasize that this proposal deals with the monitoring of outputs, not inputs or processes. This is not a proposal to make rating actions fully replicable by rating users, which in any case would be strictly unfeasible. It is undesirable as well because it would remove the incentive for NRSROs to innovate, since any innovation would fall immediately in the public domain.

The second principle would be that of *disaggregation*. The potential market failure associated with the certifier is the moral hazard of free-riding on its reputation. This could be corrected by disclosing the statistical default benchmarking performance of the NRSROs, not only across the overall sample of their ratings, as is required in the registration process, but also by disclosing the statistical performance of ratings according to several relevant disaggregated categories such as unsolicited versus solicited ratings, ratings that are based on public information versus private information, ratings of the largest clients versus others, of clients providing substantial non-rating revenue, etc…

3.7. Form NRSRO – Exhibit 5 on Ethical Codes

Exhibit 5 limits itself to publishing the code or explaining why there is not one. In other words, the requirement in this exhibit is merely symbolic.

We would advocate that the SEC endorses explicitly that it is desirable that NRSROs respect the December 2004 IOSCO Code of Conduct, as the CESR does in implementation of Section 3.2. of the December 2005 Communication from the Commission of the European Communities on Credit Rating Agencies.

In that spirit, the public disclosure of potential cases of abusive practices and how NRSROs deal with them should be strongly encouraged. The market will function as smoothly as possible if any potential deviation is observed very quickly by market participants, who can then decide whether they need to act by switching to another rating agency or not. NRSROs will not free-ride on their reputation for integrity and accuracy if the risk of substantially depreciating it is high. The main benefit of this approach is that it does not discourage entry, and it is almost costless. It requires some trust in the industry's competitive dynamics and market participants' incentives to monitor and their capacity to make market discipline effective, just as one requires trust in any type of public or private monitoring activity.

3.8. Overall

We believe that the potential monitoring of the Proposed rule is excessive in its extent and detail. A reputation for accuracy and integrity is a rating agency's most valuable asset. It is this reputation capital that issuers buy when they pay for a requested rating. It is this same reputation that investors trust when using rating information to decide how to invest their capital. Each time an agency issues a rating; its reputation capital is at stake. Increasing transparency by public disclosure within the limits of competitive confidentiality is the safest and cheapest way to monitor compliance. Such transparency would ensure that any potential systematic deviation from an unbiased and objective rating process would be detected promptly and punished by the market withdrawing its trust from the agency in question.

The potential failure of the market for credit ratings results from the fact that the quality of an individual rating cannot, and can never be, properly observed, even ex-post. One can really only observe the performance of sufficiently large samples over a sufficiently relevant period of time. Hence the crucial importance of an agency's reputation. Trustworthy agencies will always have a strong incentive to signal their quality and differentiate themselves from average ones.

Any market participant should be able to observe and compare the statistical performance of different classes of ratings, of ratings based on public information versus issuer-participating ratings, of issuer initiated ratings versus unsolicited ratings, from issuers constituting a large share of an agency's revenue versus all the other issuers.

The largest focus of the monitoring should be on the output, which is the quality of the ratings, rather than scrutinizing the inputs and controlling the rating process per se. The more transparent the quality of the ratings the more effective the market discipline will be in aligning the agencies' incentives with public welfare.

In view of the tensions and ambiguities in the Act, it is certainly not easy for the SEC to design a set of implementation rules that is solid, coherent, and market supported; that will achieve the different goals of the act; and will also pass the test of time. On the other hand, the ambiguities of the Act leave the SEC a vast discretionary space. It can freely choose where to position itself and how much space to take, starting from that position.

According to our analysis, the SEC chose to take the position of detailed administrative oversight of the management of CRA organizations, rather than adopting a more hands-off approach similar to that advocated, in a sense, by IOSCO, according to the principles underlying its December 2004 Code of Conduct and as enacted by the Commission of the European Communities in December 2005.[4]The SEC decided to occupy a vast space of

[4] On page 9 of its Proposed Rule, 'The Commission notes that international standards, such as those promulgated by the Technical Committee of IOSCO, are generally consistent with the Act and the rules the Commission is proposing.' We agree with that assertion inasmuch as the higher level principles of the Act are concerned and the intention of the rules that the commission is proposing. However, nothing in the

administrative input and process control, rather than focusing primarily on reinforcing market output control. These design choices underlying the Proposed rule lead in several instances to SEC provisions that the Act does not really require and that are at odds with the highest animating principle of the Act, which is to improve ratings quality. We therefore formulate the following proposals.

4 Proposals

In view of our analysis and evaluation, we propose the following changes to Proposed rule S7-04-07.

4.1. Proposed Rule 17g-2 – Record keeping

Proposal: remove all direct or indirect references to rating methods or methodologies, as we argued in 3.2.

4.2 Proposed Rule 17g-5 – Management of Conflicts of Interest

Proposal: cancel rule 17-g5 (c) (1) and replace it with a disclosure rule advocated in 3.3.

4.3 Proposed Rule 17g-6 – Prohibited Unfair, Coercive, or Abusive Practices

(a) (2) A credit rating [‘that is not determined … for determining credit ratings’].

Proposal: drop the qualifier

This qualifier is redundant and subjects the independent judgment of a CRA to administrative discretion, which should be rebuked as we argue in 3.2.

IOSCO Code of Conduct or its underlying principles requires the SEC to have chosen detailed administrative oversight and input and process control as a means to achieve the international standards. Nor has the Proposed rule exhaustively integrated the IOSCO principles. Nor does the Proposed rule require accountability from the CRA directly to the public to the extend that IOSCO requires it. For example, Form NRSRO Exhibit 5 instructs a CRA to publish its Code of Ethics or to explain why it does not have one. The IOSCO Technical Committee requires CRAs to explain to the public *‘if and how their own codes of conduct deviate from the Code fundamentals and how such deviations nonetheless achieve the objectives laid out in the Code Fundamentals and the IOSCO CRA Principles’*. (December 2004 Code of Conduct, page 2.).

Specifically here, this raises the concern that it is possible and likely that the two following two events occur together, without any causal relationship:

1. a credit rating is not determined in accordance with the rating organization's established procedures and methodologies for determining credit ratings;

AND

2. the rated person, or an affiliate of the rated person, does *not* purchase or will *not* purchase the credit rating or any other service or product of the rating organization or any person associated with the rating organization.

The causal or non-causal relationship would be difficult to prove and allows for much administrative discretion. Procedures and methods are impossible to describe in all their complexity, and should constantly evolve with innovations and improvements in methods. Hence the risk of not conforming to the established procedures and methodologies is large.

(a) (3) a credit rating ['in a manner that is contrary …credit ratings']: exactly the same concern as under (a) (2).

Proposal: drop qualifier

4.4 Proposed rule 17g-6 (a) (4)

Proposal: drop the rule and replace it with full disclosure of the basis of the ratings of the assets in the pool if they are to be used to determine the ratings of the securities to be issues against the pool, as discussed in 3.5.

4.5 Proposed rule 17g-6 (a) (5)

Proposal: drop the rule and replace it with a disclosure and waiting period rule, as advocated in 3.4.

4.6. Proposed rule 17g-6 (b)

Proposal: drop the rule, on the basis of the arguments developed in 3.2.

4.7. Form NRSRO – Exhibit 1 on Performance Statistics

Proposal: do not prescribe what statistics should be publish but impose the principles of replicability and disaggregation, as discussed under 3.6.

4.8. Form NRSRO – Exhibit 5 on Ethical Codes

Proposal: for the SEC to align itself with the international approaches followed in the use of the IOSCO Code of Conduct Fundamentals, including the market pressure exercised on CRAs by the requirement to comply with all the provisions of the Code or to explain, provision by provision, why the CRA has decided not to comply and yet believes that it is conform to the IOSCO Principle, as discussed under 3.7.

5. Summary and conclusions

As a summary of our comments, we support the current proposals in rules g-1, in abbreviated versions of g-2 and g-3, in g-4 and in g-5 minus (c-1). However, we have important objections to several of the provisions in g-6 and some in g-2, g-3 and c-1 of g-5. With these provisions, the SEC would gain a very high degree of intrusion into CRAs and process control of rating actions. It would do so without having presented a true economic cost-benefit calculation to make the case that these provisions are on balance beneficial to achieving the goals of the Act.
