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ROUNDTABLE ON CREDIT RATING AGENCIES

I. Introduction

The following statement is submitted by Moody's Investors Service ("**Moody's**") to the Securities and Exchange Commission ("**SEC**") in connection with the roundtable scheduled for April 15, 2009 on issues relating to credit rating agencies and their role and function in the operation of the securities markets. Moody's believes that the examination of our industry and the broader market is a healthy process that can encourage best practices and support the integrity of the products and services our industry provides. We welcome this opportunity to contribute our views to the discussion that is currently underway both at the SEC and more generally regarding the credit rating agency ("**CRA**") industry.

Moody's is well aware of the loss of confidence in the credit ratings industry, driven in large measure by the performance of credit ratings for U.S. residential mortgage backed securities ("RMBS") and related collateralized debt obligations ("**CDOs**"). There also has been a deterioration in the broader markets which has led to a loss in confidence in the entire U.S. and global financial system. To address these concerns, over the past 20 months we have enacted – and we continue to enact – a number of measures to enhance the quality, independence and transparency of our ratings. We also have been working to adapt, as needed, our policies, systems and organization to implement rules recently adopted by the SEC for nationally recognized statistical rating organizations ("**NRSROs**").

More can be done. And in this regard, we have been in communication with market participants and public sector authorities to better understand their various concerns and recommendations, some of which include:

- increasing the transparency of rating agencies' performance, methodologies and quantitative models;
- reducing or eliminating the regulatory use of credit ratings;
- addressing conflicts of interest;
- replacing the issuer-pays model with one of various potential alternatives, including an "investor-pays" or "deal-pays" model; and
- prohibiting CRAs from publishing their opinions in certain circumstances.

Most of these recommendations are premised on instilling greater accountability in the CRA industry, as well as among other market participants. We share this goal, and we welcome reform efforts that

are likely to reinforce high quality ratings and enhance accountability without intruding into rating opinion content. We believe that some of these suggestions – such as increasing transparency in the ratings process or reducing the use of credit ratings in regulation – likely will have a positive impact and promote greater accountability. We remain concerned, however, that other proposed measures, while well-intentioned, do not address the more fundamental vulnerabilities in credit markets and ultimately will undermine the core of a strong credit ratings process – namely, its independence.

For example, some now argue that replacing the issuer-pays model with an investor-pays or deal-pays model will remove potential conflicts of interest and create greater accountability. Such proposals ignore the fact that conflicts are inherent and must be properly managed for any model in which those paying rating fees are interested in the outcomes. Moreover, there are important public benefits that attend the issuer-pays model that are not retained in alternative proposals. Finally, as we describe in greater detail below, recent research conducted by Moody's shows that the issuer-pays model has coincided with *enhanced* accuracy of ratings since it was introduced in the 1970s.

We agree that there are significant deficiencies in the structured finance sector, and we believe that important reforms can and should be made to restore the smooth functioning of that market. In this regard, we believe that policy makers also should review the weaknesses that currently exist in the structured finance market – in particular, the need for greater transparency and disclosure of information to the investing public about transaction structures and asset pools. We are committed to working with the SEC, Congress and market participants to take whatever steps necessary to restore confidence in our industry and the U.S. financial system.

II. Moody's Efforts to Advance the Quality and Transparency of Credit Ratings

The various contributors to the current market crisis and loss of confidence are by now well-chronicled, starting with the performance of U.S. sub-prime home mortgages and then of mortgage-backed and related securities originated in 2006 and early 2007. Moreover, it is now clear that significant latent vulnerabilities had been developing in the infrastructure of the global financial markets, and that once exposed these weaknesses could, and would, have severe and reverberating consequences.[1]

Between 2003 and 2006, Moody's observed an increase in the risk profile of subprime residential mortgage backed securities ("**RMBS**") that we were asked to rate. In response Moody's undertook several actions which identified the growing risks, but did not fully capture its magnitude or potential severity:

1) **We began commenting about risk in the housing market starting in 2003:** Our commentary included warnings about the deterioration in origination standards and inflated housing prices. We began publishing warnings on these issues in 2003 and continued in 2004, 2005 and 2006.[2] In January 2007, we published a special report highlighting the rising defaults on the 2006 vintage subprime mortgages[3] and thereafter we continued to publish on their increasingly deteriorating performance.
2) **We tightened our ratings criteria:** We steadily increased our loss expectations on pools of subprime loans and the levels of credit protection required for a given rating level. Our loss

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[1] Some of these weaknesses include exceptional leverage and business models that relied on secondary markets for liquidity of complex instruments in periods of stress; the interaction of asset valuation and capital; insufficient risk management practices; interlinked market participants; and limited transparency.

[2] See e.g., "2003 Review and 2004 Outlook, Home Equity ABS," January 20, 2004; "The Importance of Representations and Warranties in RMBS Transactions," January 14, 2005; "An Update to Moody's Analysis of Payment Shock Risk in Sub-Prime Hybrid ARM Products," May 16, 2005; "The Blurring Lines Between Traditional Alternative-A and Traditional Subrpime US Residential Mortgage Markets," October 31, 2006.

[3] "Moody's Special Report: Early Defaults Rise in Mortgage Securitization," January 18, 2007.

expectations and enhancement levels rose by about 30% between 2003 and 2006. As a result, RMBS issued in 2006 backed by subprime mortgages and rated by Moody's had more credit protection than bonds issued in earlier years. In practical terms, this meant that by 2006 more than half the mortgages in a pool could default and suffer a 50% loss in foreclosure without the Aaa tranches defaulting.

3) **We took rating actions as soon as the data warranted it:** The earliest loan delinquency data for the 2006 mortgage loan vintage was largely in line with the performance observed for the 2000 and 2001 vintages, during the last U.S. recession. The 2006 Aaa-rated RMBS had sufficient credit protection to easily withstand such performance. As soon as the more significant loan performance deterioration in the 2006 vintage became evident, however, we took prompt and deliberate action on those transactions showing evidence of significantly heightened risk. Several rating actions were taken in November 2006, with broader actions beginning in April 2007.

4) **We conducted loan modification surveys:** Finally, in an effort to gauge the potential impact that loan modifications might have on reducing losses on defaulted loans, especially in light of interest rate resets when monthly payments increased, Moody's began conducting surveys of the modification practices of 16 subprime mortgage servicers. These servicers together constituted roughly 80% of the total subprime servicing market. The results of our first survey, published in September 2007,[4] suggested that, on average, subprime servicers were not focused on modifying loans and had only modified approximately 1% of their serviced loans that had experienced an interest rate reset (increase) in the months of January, April and July 2007. We published follow-up surveys in December 2007 and July 2008.[5]

We did not, however, anticipate the magnitude and speed of the deterioration in mortgage quality or the suddenness of the transition to restrictive lending. We were far from alone in that regard, but we believe that we should be the leading edge for predictive opinions about future credit risks, and we have learned important lessons from that experience.

The past 20 months have reminded all market participants how rapidly and dramatically markets can change. Throughout this period, Moody's has – in an effort to enhance accountability – reached out to market participants and policy makers globally for feedback regarding the utility of our ratings and ratings system. Based on the feedback we have received and our own deliberations, Moody's has adopted a wide range of measures[6] to enhance the quality, independence and transparency of our credit ratings, including:

1. *Strengthening our ratings methodologies*: including creating permanent internal methodology review, and model verification and validation processes, strengthening the independence of the Credit Policy function, instituting feasibility reviews for new structured products, implementing methodological modifications and formalizing model error discovery procedures.

2. *Enhancing consistency across rating groups:* including incorporating common macro-economic scenarios in rating committees, broadening cross-disciplinary rating committee participation and improving surveillance coordination among credit rating groups.

3. *Bolstering measures to avoid conflicts of interest:* including codifying the existing prohibition against analysts providing recommendations or advice on structuring securities, prohibiting fee discussions by ratings managers as well as analysts, changing rating committee composition to enhance independence and objectivity and conducting "look-back" reviews when analysts leave to join organizations with potential conflicts.

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[4] "Special Report: Moody's Subprime Mortgage Servicer Survey on Loan Modifications," September 21, 2007.

[5] "Special Report: US Subprime Market Update: November 2007," December 17, 2007 and "Special Report: Moody's Subprime ARM Loan Modification Update," July 14, 2008.

[6] *Ibid.*

4. *Improving transparency of ratings and the ratings process:* including enhancing disclosures on attributes of ratings, information provided by issuers and originators and incremental changes to methodologies, publishing detailed summaries of our methodologies for rating U.S. RMBS and CDOs, enhancing the review of loan originators in U.S. RMBS transactions and asking issuers for stronger representations and warranties relating to these transaction documents, publishing assumption volatility scores and sensitivity analysis on new structured finance securities and expanding our reviews of loan originators;

   We would highlight in particular the volatility scores and sensitivity analysis. These added metrics, known as V Scores and Parameter Sensitivities, seek to address two distinct questions asked by investors: (i) what is the degree of uncertainty around the assumptions that underlie our structured ratings; and (ii) how sensitive are Moody's ratings to changes in our key assumptions? We believe that supplementing our traditional ratings with answers to these questions will improve market understanding, a key ingredient to confidence. Moreover, these additional metrics are intended to respond to the interests of various oversight authorities, which have asked that rating agencies more clearly distinguish the performance expectations of securitized instruments versus corporate and public finance obligations.[7]

We believe that we have made good progress with respect to augmenting the analytical framework and credibility of our ratings, and we continue to strive to further enhance our policies and procedures. Among other initiatives we have under way are: formally reviewing all of our structured finance rating methodologies and models; describing the types of measures we employ so that information we use in assigning a credit rating is of sufficient quality to support a credible rating; encouraging more uniform means of presentation and greater discussion of key parameter sensitivities and model uncertainties; and exploring additional rating performance measurements that will allow market participants to better assess our ratings performance.

III. Proposals Regarding "Who Pays" for Ratings

Some market observers remain skeptical that meaningful rating quality improvements can be achieved within the context of the issuer-pays business model. They maintain that the potential conflict-of-interest inherent within the issuer-pays model is fundamentally unmanageable. In particular, these commentators have linked the issuers-pays model with the poor ratings performance for specific sectors of the structured finance market. Based on our experience, such an assertion is an over-simplification of the industry dynamics and will not address the fundamental weaknesses in the structured finance market.

Moody's historical performance, operating first under an investor-pays and then an issuer-pays model, does not support the assertion that the potential conflict of interest in the issuer-pays model is unmanageable. Indeed, we have found that our ratings quality improved under the issuer-pays model.

A. The Evolution of the Issuer-Pays Model

For over 50 years, Moody's operated under the investor-pays model before shifting to the issuer-pays model in the early 1970s. The change was made in response to several market trends, including increasing interest by investors for more in-depth and timely analysis. This more rigorous and more costly analysis could not be sustained by the fees charged to subscribers. And, as investors were seeking this higher quality analysis, advances in reproduction and distribution technologies were

[7] Our Rating Methodology for V Scores and Parameter Sensitivities is available on Moody's website under the title of "Updated Report on V Scores and Parameter Sensitivities for Structured Finance Securities".

simultaneously increasing the "free rider"[8] problem among users of ratings. This made it even more difficult to raise the required revenue from subscribers.

So Moody's adopted a new business model – shifting from one supported by investor fees to one based on fees from issuers – which had the impact of allowing Moody's to increase the depth and quality of its analysis. And, in so doing, Moody's made its ratings publicly available. The resulting increase in revenue allowed individual rating analysts to focus on fewer credits in greater depth. At the same time, analysts were able to increase the frequency of informational meetings with both issuers and investors, and the frequency of rating changes rose over time as well.

B. Comparing Performance: the Issuer-Pays Period vs. the Investor-Pays Period Shows Higher Accuracy During the Issuer Pays Period

This change in our business model in the early 1970s provides insight as to whether ratings quality would likely benefit from a shift away from the issuer-pays model today. In particular, we have investigated whether, after the change in our business model, our ratings performance deteriorated and whether there was any statistical evidence to suggest that Moody's analysts began to cater more directly to the interests of issuers at the expense of the investors. More to the point, we asked:

- Did the pace of rating downgrades decrease?
- Did the average rating assigned to corporate issuers drift upward?
- Did the typical financial metrics associated with issuers within a given rating category weaken?
- As a consequence, did the default rates associated with particular rating categories increase?
- As a further consequence, did the accuracy of ratings as rank-order predictors of relative default risk decrease?

a. <u>Performance of Corporate Finance Ratings</u>

With respect to ratings on companies, as is shown in the table below, Moody's research demonstrates that the issuer-pays era is actually associated with higher accuracy ratios,[9] lower investment-grade loss rates, and higher downgrade rates.[10] All together, the data suggests that Moody's ratings have become more accurate and less "issuer-friendly" over time.[11] Moreover, these findings are consistent with

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[8] Defined as those who consume more than their fair share of a resource, or shoulder less than a fair share of the costs of its production.

[9] Please see, "Measuring the Performance of Corporate Bond Ratings," April 2003. Accuracy ratios measure the ability of ratings to differentiate between issuers that default and those that do not default. The accuracy ratio lies between minus one and positive one, similar to a correlation statistic, and can be converted to a percentage. If all defaulters were initially assigned the lowest rating category, the accuracy ratio would approach one. If all defaulters were distributed randomly throughout the population without regard to ratings, the accuracy ratio would be zero. And, if all defaulters were initially assigned the highest rating category, the accuracy ratio would approach minus one.

[10] *Ibid*., discusses these benchmarks of ratings performance.

[11] Moody's has conducted similar research for structured finance dating from 1993-2008 (as far back as we maintain default and loss data on securitizations), but with two important limitations. First, securitization did not exist during the 1920-1970 period, so the issuer-pays vs. investor-pays comparison available for corporate ratings is not available for structured finance. Second, the current measurement period for structured finance through mid-2008 does not capture the full impact of the current downturn on expected losses for outstanding structured finance securities. Nonetheless, for completeness we include the following table:

academic studies and our own research, which have observed that our corporate rating criteria, as measured by standard credit-related accounting ratios, appear to have become more "conservative" over time.[12]

Comparing Corporate Rating Performance Over Time			
	Investors-Pays Era 1920-1970	Issuer-Pays Era 1971-2008	Difference
Simple averages across monthly cohorts			
1-Year Accuracy Ratio	67%	83%	16%
5-Year Accuracy Ratio	63%	68%	6%
1-Year Investment Grade Loss Rate	0.12%	0.03%	-0.1%
5-Year Investment Grade Loss Rate	1.24%	0.55%	-0.7%
Broad Rating Downgrade Rate (12 month)	5.6%	6.3%	0.7%
Weighted average, by number of issuers			
1-Year Accuracy Ratio	55%	83%	28%
5-Year Accuracy Ratio	54%	70%	16%
1-Year Investment Grade Loss Rate	0.16%	0.04%	-0.1%
5-Year Investment Grade Loss Rate	1.89%	0.54%	-1.4%
Broad Rating Downgrade Rate (12 month)	7.8%	6.6%	-1.2%

While this "before and after" comparison is by no means a definitive test, it indicates that a move from an investor-pays model to an issuer-pays model does not necessarily lead to deterioration in credit standards and rating inflation as some have suggested. Indeed, it suggests that the issuer-pays model is coincident with, and may lead to higher overall ratings quality.

One reason that overall ratings quality may have improved is that the quality of the analysis, itself, may have improved. With the advent of the issuer-pay model, the number of credits followed by individual rating analysts declined, the frequency of informational meetings with issuers and investors increased, investments in better technological tools increased, and the frequency of rating changes all rose over time. A second reason behind the improvement in our ratings performance during this time period may be the considerable increase in both the quantity and quality of corporate issuer-disclosure and reporting.

C. Potential Conflicts of Interest in the Investor-Pays Business Model

As noted above, for the past three decades, Moody's has been paid primarily by issuers of the securities we rate. Some observers argue that an investor-pays business model would have fewer potential conflicts than an issuer-pays model. We believe this presumption ignores the sources and drivers of potential conflicts of interest in the ratings business as well as the significant public policy benefit associated with the issuer-pays model.

<u>First, investors can be just as motivated as issuers to influence ratings.</u> In practice, the term "investor" is a short-hand description for any subscriber to a rating service and describes a variety of parties with vested interests in the credit ratings of securities, including:

Structured Finance Performance Statistics (1993-2008H1)		
	Simple averages across monthly cohorts	Weighted average, by number of issuers
1-Year Accuracy Ratio	90%	76%
5-Year Accuracy Ratio	88%	84%
1-Year Investment Grade Loss Rate	0.18%	0.42%
5-Year Investment Grade Loss Rate	0.54%	0.73%
Broad Rating Downgrade Rate (12 month)	1.9%	3.4%

[12] See, for example, Blume, M.E., F. Lim & A.C. MacKinlay (1998), "The Declining Credit Quality of U.S. Corporate Debt: Myth or Reality?" *Journal of Finance* 53.4, and "Maintaining Consistent Corporate Ratings Over Time," *Moody's Special Comment*, August 2008.

- Short Sellers (for example, hedge funds that take a significant short position on a particular company): as subscribers under an investor-pays model, they may be highly motivated to encourage a negative rating action – and the more negative and unexpected the action, the better for their financial interests.
- Long Investors: similar to their short counterparts, long investors are understandably interested in the outcome of rating actions. Before they purchase a security they may prefer lower ratings to obtain higher yields; following a purchase (especially for those who trade actively) they are likely to prefer to have ratings maintained or raised rather than lowered to avoid, for example, valuation mark-downs or forced sales.
- Governments: governments, often faced with competing financial market and social policy objectives, may seek to have ratings "protect" nationally, systemically or politically important issuers such as large industrial employers, banks or governments themselves. This is particularly an issue in instances where governments have stepped in to provide systemic support to such institutions, *i.e.,* when the prudential regulator also becomes an investor.

Second, there is often no clear distinction between investors and issuers. Investors frequently are entities that also are issuers, such as banks, insurance companies and governments.

Third, shifting "who pays" will not prevent issuers from using other financial means to try to influence ratings. Entities seeking to influence rating actions can and have attempted to do so by challenging rating agencies through commercial mechanisms unrelated to fees, such as litigation to coerce higher ratings.[13]

Put simply, numerous parties – including investors, issuers and governments – may want ratings assigned and maintained in a manner that is most beneficial to their interests, and those interests may often conflict with the goal of the CRA to issue an objective rating.[14]

If Moody's provides a rating and is paid by an entity – regardless of which type of entity – that has an interest in that rating, then we must protect against influence by that entity on our rating actions. Currently, the market broadly understands the potential conflicts of interest in the issuer-pays model, and Moody's makes plain the steps we take to manage those conflicts. Transparency itself is a protection. If the industry adopted an alternative business model in which investors rather than issuers pay for ratings, this would not relieve the perceived conflict – it would merely shift it.

Given that investor-pays business models also embed potential conflicts, a secondary question must be asked: does one model provide superior offsetting public policy benefits over the other? The principal benefit in the issuer-pays model is that it allows all rating actions to be released to the general public simultaneously and at no cost to investors. Larger, wealthier parties have no advantage over smaller rivals. The investor-pays model, however, does not allow for public and broad disclosure of ratings; rather the model involves selective disclosure of information via subscription. The basis of the model, therefore, is to charge fees in return for selective access to information for those who can afford the subscription fees.

D. An Alternative Model: Deal-Pays model may eliminate competition

An alternative business model has been discussed in the public debate, variously referred to as a "deal-pays" or "bond surcharge" model. The principal perceived attraction of such a model is that it would automate the fee payment process by imposing some sort of surcharge on debt issuance that is thereafter allocated among CRAs. The deal-pay model appears to "fix" the two shortcomings of the

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[13] Compuware Corp. v. Moody's Investors Service, 499 F.3d 520 (6th Cir. 2007): Moody's sued by issuer after refusing to forbear from downgrading issuer's credit rating.

[14] These issues are discussed in "The Way Forward for the Credit Rating Industry in 2009," *Moody's Special Comment*, January 2009.

investor-pay model, in that (like the issuer-pay model) it delivers a public rating available to all for free; and, it can generate fees that can be calibrated to fund higher quality analysis.

Leaving aside the complexities of the mechanism by which the model could be made operational,[15] the meaningful distinctions between the deal-pays model and the issuer-pays or subscriber-pays models are: a) who picks the rating agency – the government, institutional investors, or issuers; b) by what criteria is the rating agency chosen; and c) at what price is the rating agency paid. Whatever the mechanism for selecting the rating agencies, the nature of competition is changed. Rather than each rating agency competing for investors and issuers on a one-by-one basis, each CRA will seek to convince a single agent (whether a board of investors, the government, or a board of issuers) to pick the CRA for the next transaction or set of transactions. This power will lead to a similar conflict of interest as that which already exists in the other models. In fact, it may result in "lobbying" activities and greater risk of error, because it is substituting the decision of one entity (the sole decision-maker), for the decision of the many (the market).

Consequently, the deal-pays model is unique only if it ultimately allocates fees differently than the other two models, that is by determination of interested parties – whether issuers, investors or governments. To achieve that would require some form of non-judgment-based fee allocation (for example, rotational, pro rata or lottery system), with the consequence, and perhaps the goal, of eliminating competition – under a theory that if "competition" could be eliminated, so too could "conflict". However, the elimination of competition would also likely eliminate the incentive for ratings agencies to strive to produce better quality ratings. Perhaps the negative influences of competition would be redressed, but if fees are guaranteed (or, conversely, not achievable) regardless of the quality of a CRA's opinions, the incentive for CRAs to innovate, update and adapt methodologies to changing market conditions – i.e., to enhance ratings performance – is removed.

Moody's has always believed that healthy competition in the CRA industry is crucial. It is the mechanism through which each participating CRA is motivated to improve. The answer is not as simple as "more competition is good and less competition is bad"; the opposite may also be true depending on circumstances. The critical question is what form of competition is being encouraged? Are rules and regulations (or the market) structurally encouraging competition for the most flattering ratings? Are they encouraging competition based on the most predictive ratings? Or are they encouraging something else entirely?

We believe that the public interest is served by trying to answer the question of "how can the system encourage high quality ratings" not simply "who should pay for ratings?"

IV. Enhanced Disclosure for the Structured Finance Industry

As described above, Moody's has adopted a number of significant steps to improve the quality and transparency of our credit ratings. However, it should be noted that during this period of market upheaval, Moody's ratings on the corporate finance sector have performed well. Similar to the analysis of corporate securities, analyzing and monitoring structured finance products is a data-intensive process. Consequently, we believe that one of the most significant steps that can be taken to restore confidence in the structured finance market is to improve the availability and quantity of underlying information for structured securities.

[15] This approach introduces intriguing complexities. How will the fees be apportioned? Will fees be equally divided between all CRAs? Will CRAs be paid and therefore authorized to assign ratings on a rotation basis? Will distribution of fees be based on an arbitrary lottery system? In addition, who will be responsible for distribution of the fees? It is conceivable that whoever is authorized to distribute the fees will be similarly conflicted as those entities discussed in the models above, which would negate the underlying purpose of instituting a surcharge model. More importantly still, which CRAs will be eligible to receive such fees? Obviously, if divided only among registered CRAs, or a sub-set of registered CRAs, such a system would leave others at an extreme competitive disadvantage and create significant regulatory barriers.

Unlike in the corporate market, where investors and other market participants can reasonably develop their own informed opinions based on publicly available information, in the structured finance market, there is insufficient public information to do so. Continuing disclosure requirements for publicly offered securities do not require the public dissemination of sufficient information about the structure or underlying assets of a securitization to afford reliable analysis. Indeed, under this limited information disclosure model, CRAs must ask for additional information to analyze and rate securities.

In the absence of sufficient data, investors are unable to conduct their own analysis and develop their own independent views about potential or existing investments. Furthermore, CRAs are unable to effectively offer unsolicited ratings and research, restricting the range of information available to investors and increasing the potential for ratings shopping. Finally, since they are not subject to similar public scrutiny as corporate issuers, structured finance issuers may feel less responsibility for the quality of information related to their securitized products.

To address these problems in the structured finance market, Moody's urges the SEC to enhance the disclosure regime for structured finance products. In particular, Moody's recommends that the SEC consider the following measures:

– *Expanding Regulation AB's disclosure requirements to underlying assets.* Regulation AB currently requires the disclosure of information about asset pools on an aggregate basis, supplemented by some additional information about significant obligors. Regulation AB could be revised to require more disclosure about obligors so that investors could assess more thoroughly the information about the assets underlying the securities. Options could include: (1) broadening the definition of "significant obligor" to increase the amount of information available about the related assets; (2) requiring disclosure about the characteristics of each obligor (instead of just on an aggregate basis); or (3) requiring disclosure about the characteristics of a statistically significant sample of individual obligors.

– *Creating greater transparency regarding privately placed, structured finance products that trade in secondary markets pursuant to Rule 144A.* We recommend that the SEC consider developing an appropriate disclosure regime for privately placed, structured finance products that trade in secondary markets. Privately placed securities can be held or resold, subject to certain restrictions, to qualified institutional buyers (*i.e.*, sophisticated investors). Re-sales of privately placed securities to qualified institutional buyers may be exempt from registration under the Securities Act of 1933 pursuant to Rule 144A, which was developed with general corporate debt obligations in mind and predates the creation of a significant private placement market for structured finance products. In contrast to private offerings of general corporate debt securities, private offerings of certain types of structured finance products often are tailored to meet the needs of specific investors and originators.[16] The rule contains only minimal disclosure requirements and is premised on the assumption that sophisticated investors can and will obtain and analyze the information they need before making investment decisions and, therefore, do not need the protection of a prospectus or continuing disclosure rules.

While Moody's (along with other market participants) is committed to implementing various initiatives that will address shortcomings in this sector, we also believe that confidence in structured finance markets will not be restored unless the SEC enhances and updates the mandatory disclosure

[16] Consequently, structured finance products can be much more complex than general corporate debt securities, which tend to have standardized terms and often are issued by entities for which potential investors have independent access to a substantial amount of information. Due to these factors, the quality and clarity of disclosure for privately offered structured finance products often lags behind the quality and clarity of disclosure for privately offered corporate debt securities. Furthermore, as demonstrated by recent events, the lack of current information regarding structured finance products and the underlying pools of assets can hinder the efforts of secondary market purchasers to make informed investment decisions.

regime for structured finance products. In our view, updating the disclosure regime will yield three principal benefits.

1. *Giving investors access to more information would reduce the risk of investor over-reliance on credit ratings.* Such access also would have the effect of enhancing investors' ability to meaningfully assess the work of the CRAs.
2. *Embedding enhanced information requirements in offering documents intended for investors likely will improve the information quality about structures and assets.* This approach, which is analogous to the approach taken in corporate debt markets, aligns responsibility for information quality with the party who: (i) has the greatest control over the information in the first place; and (ii) will enjoy the greatest benefit from access to the securities markets.
3. *Making more information publicly available to al investors will broaden the range of opinions and analysis available, including from all CRAs.* If sufficient information is made available to investors, then it is necessarily also available to those CRAs not selected to rate a securitization. As a result, all CRAs (as well as a host of other market commentators) would be in a position to offer ratings and research, which would broaden the range of information available to investors.

V. Additional Reform Recommendation

As noted previously, Moody's supports reform proposals that can help restore the credibility of credit rating agencies and help return confidence to structured finance products – and is not opposed to enhanced oversight of our industry. We are concerned, however, that some reforms with negative implications will be implemented, in the end proving harmful to the broader markets.

Authorities, market participants, commentators, and the CRAs themselves have recently offered a number of reform proposals that we believe to be constructive. They include, among others, measures that:

1. encourage investors to rely less on credit ratings by better understanding their attributes and limitations;
2. consider reducing or eliminating the use of ratings in regulation;
3. encourage CRAs to be more transparent about their credit rationale, their methodological approach, and their overall ratings performance;
4. promote healthy competition among opinion providers based on quality by facilitating expression of diverse, independent opinions about credit;
5. provide for oversight of conflicts of interest to ensure that they are being demonstrably, effectively and transparently managed; and
6. promote international convergence in regulatory standards and supervision of CRAs.

We believe that change in each of these areas, properly crafted and implemented, could have a positive effect on the markets. However, policy makers and private sector commentators also have suggested a number of measures that may undermine the very attributes of credit ratings that market participants and authorities value – their independence, reliable and predictive content, global comparability and stability. These include:

1. Measures that use ratings as a substitute for transparency in the structured markets. Several regulators, including the SEC, are considering rule proposals that would, in effect, substitute credit ratings for transparency in structured finance markets. The SEC has indicated that the goals of its re-proposed amendments to paragraphs (a)(3) and (b)(9) of Rule 17g-5 is to curb issuers' ability to rating shop among NRSROs by making the issuer-information available to all NRSROs. As we noted in our March 28th comment letter on the Re-proposed Rules for NRSROs, this amendment

does not address the root causes of rating shopping and is likely to result in replacing one form of rating shopping with another. More importantly, the Re-proposed Amendment allows all NRSROs (and only NRSROs) to have access to material non-public information so long as one NRSRO makes its rating publicly available. This approach further entrenches ratings in federal securities regulation by creating the incorrect impression that one rating is (or ratings in general are) a sufficient substitute for issuer-information transparency in structured finance markets.

2. *Measures that could censor CRA opinions.* Most, if not all, policymakers recognize the need to preserve the independence of CRAs' opinions, methodologies and rating processes. However, policymakers are also understandably interested in whether credit ratings issued by CRAs are reliably predictive and unaffected by potential conflicts of interest, particularly where ratings are used for regulatory purposes. This interest can lead some policymakers to propose "quality control" measures that intrude into the ratings content and methodologies. For example, some proposals have been introduced internationally that would enable regulatory authorities to prohibit CRAs from publishing their opinions in instances where ratings are deemed to threaten the orderly functioning of the financial markets. Such measures clearly undermine CRA independence and create the impression that only governmentally approved opinions are allowed to be published.

3. *Measures that could increase CRA liability and compel CRAs to be more procyclical.* There is apparently some confusion regarding whether CRAs are subject to liability. They certainly are, and there is no immunity from, for example, private rights of action alleging securities fraud or violation of SEC rules and regulations. Courts agree, however, that CRAs should not be sued simply because someone disagrees with an issued rating. Measures that would attempt to create new standards of liability would overwhelm the industry and could negatively impact the markets. More specifically, the majority of the opinions of the CRA industry are provided free to the market. Ratings are not statements of fact; they are opinions about the future and as noted above, someone will always be unhappy with or disagree with these opinions. Consequently, measures designed to allow issuers or investors who disagree with a rating to seek a monetary recovery from a CRA could compel CRAs to change their product to avoid the costs of defense and discovery. Thus, instead of providing their views on fundamental creditworthiness, the rating agencies would simply track market sentiment concerning each debt or issuer. Embedding this type of incentive in the CRA industry will likely reduce differences in ratings, as agencies will seek safety in pack-like behavior, resulting in a lack of diversity of opinion among CRAs. In addition, moving in lock-step with the market will result in rating opinions that are more volatile and pro-cyclical. If ratings continue to be used in the U.S. regulatory framework, such pro-cyclical behavior may adversely impact the U.S. capital markets.

VI. Conclusion

We have always believed that critical examination of the credit rating agency industry and its role in the broader market is a healthy process that can encourage best practices, support the integrity of our products and services, and allow our industry to adapt to the evolving expectations of the market and market participants. Many necessary actions can and have been taken at the individual firm and industry level, and policymakers at the national and international levels have proposed a host of constructive reform measures for our industry and credit markets generally.

Moody's wholeheartedly supports these constructive measures and we are firmly committed to meeting the highest standards of integrity in our rating practices, quality in our rating methodologies and analysis, and transparency in our rating actions and rating performance metrics. We welcome every opportunity to engage in dialogue with policymakers, market participants and observers on further proposals for reform that will instill greater accountability market-wide.