

DAVIS POLK & WARDWELL

450 LEXINGTON AVENUE
NEW YORK, NY 10017
212 450 4000
FAX 212 450 3800

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July 24, 2008

Re: File No. S7-13-08

Ms. Florence E. Harmon, Acting Secretary
U.S. Securities and Exchange Commission
Station Place
100 F Street NE
Washington D.C. 20549

Dear Ms. Harmon:

We appreciate the opportunity to comment on the Commission's proposals set forth in *Proposed Rules for Nationally Recognized Statistical Rating Organizations*, Securities Exchange Act of 1934 Release No. 57967 (June 16, 2008). We are submitting this comment letter on our own behalf, and not on behalf of any client of our firm.

Our comments relate to proposed rule 17g-5(a)(3), which would require the broad dissemination of information provided to a nationally recognized statistical rating organization ("NRSRO") by an issuer, arranger or trustee and used by the NRSRO to determine or monitor a structured product credit rating, and proposed rule 17g-5(c)(5), which would ban "recommendations" made by an NRSRO to the obligor or the issuer, underwriter, or sponsor of a security about the corporate or legal structure, assets, liabilities, or activities of the obligor or issuer of the security. It is not clear that the proposals reflect the express limit on the Commission's authority set forth in Section 15E(c)(2) of the Securities Exchange Act of 1934 (as amended, the "Exchange Act"), in which Congress stated that "[t]he rules and regulations that the Commission may prescribe pursuant to this title, as they apply to nationally recognized statistical rating organizations, shall be narrowly tailored to meet the requirements of this title applicable to nationally recognized statistical rating organizations."

Section 15E(c)(2) is the only provision of the federal securities laws that imposes a narrow-tailoring requirement on Commission rulemaking authority. It therefore seems evident that with respect to NRSROs, Congress did not give the Commission the same broad remedial rulemaking authority that the Commission enjoys in other contexts.

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It would be useful to understand why Congress imposed this boundary in order to appreciate what narrow tailoring means in the context of the Commission's regulatory authority. Credit rating agencies have long been accorded First Amendment protections, and it is reasonable to think that Congress included the narrow-tailoring requirement out of deference to the First Amendment concerns implicated when the government compels speech by an NRSRO (as in the case of proposed rule 17g-5(a)(3)) or bans speech by an NRSRO (as in the case of proposed rule 17g-5(c)(5)). There is of course a rich history of First Amendment jurisprudence interpreting the narrow-tailoring requirement. Narrow tailoring is an element of the "strict scrutiny" test that courts use when judging whether a government action improperly impinges on a constitutional right. If a rule sweeps more broadly than is necessary to further a compelling government interest, or fails to address essential aspects of the compelling interest, then the rule is not narrowly tailored.

The proposing release does not refer to Section 15E(c)(2) or to the narrow-tailoring requirement, and does not appear to demonstrate that the proposed rules, as they apply to NRSROs, are narrowly tailored to meet the requirements of the Exchange Act. Nor does the proposing release broadly seek comment on whether the Commission's objectives could be achieved through means less burdensome to NRSROs.¹ As a result, we believe the Commission should consider whether it has the ability to move to final rulemaking on these proposals without reopening the comment period and broadly and explicitly seeking comment on more narrowly tailored alternatives.

Proposed rule 17g-5(a)(3)

Proposed rule 17g-5(a)(3) would create an unprecedented ongoing public disclosure obligation each time an NRSRO rates a "security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction," if the NRSRO's rating "was paid for by the issuer,

¹ In discussing proposed rule 17g-5(a)(3), the Commission asked:

"Do NRSROs obtain information about the underlying assets of structured products – particularly in the surveillance process – from third-parties such as vendors rather than from issuers, underwriters, sponsors, or trustees? If so, would it be necessary to require the disclosure of this information as proposed or can the goals of the proposed amendments in promoting unsolicited ratings be achieved under current practices insofar as the information necessary for surveillance can be obtained from third-party vendors, albeit for a fee?" (Proposing release at pp. 40-41.)

This raises a specific question of whether there may be a less burdensome means of accomplishing the objectives of the proposed rule. We believe the Commission should consider whether this is adequate notice to the public that all aspects of the proposed rule – including its application to private and offshore offerings – are open for examination as to whether or not they are narrowly tailored to achieve the Commission's objectives.

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sponsor, or underwriter of the security or money market instrument.”² The ongoing public disclosure obligation would apply regardless of the nature of the transaction in which the security or money market instrument was issued, regardless of the size of the issue, regardless of the sophistication of the investors in the security and regardless of the location of the offering and trading market for the security. The extraordinary breadth of the disclosure requirement alone raises the question of whether the Commission could have employed a more narrowly tailored means to accomplish its objectives.

The Commission noted that “[a]s sources of constant deal based revenue, some arrangers have the potential to exert greater undue influence on an NRSRO than, for example, a corporate issuer that may bring far less ratings business to the NRSRO.”³ In explaining its rationale for the proposal, the Commission stated that “[t]he intent behind this disclosure is to create the opportunity for other NRSROs to use the information to rate the instrument as well. Any resulting ‘unsolicited ratings’ could be used by market participants to evaluate the ratings issued by the NRSRO hired to rate the product and, in turn, potentially expose an NRSRO whose ratings were influenced by the desire to gain favor with the arranger in order to obtain more business.”⁴

It seems clear that the Commission could employ several different, more narrowly tailored ways to achieve these goals. To suggest some alternatives that the Commission could consider:

- The Commission could leave the disclosure obligation with the party that already bears it – the issuer – rather than putting a disclosure burden on the NRSRO. The Commission may have been concerned that it does not have jurisdiction over all issuers; if so, the relevant question is whether the Commission’s goal of exposing overly compliant NRSROs can be accomplished by placing the burden on those issuers that it does have jurisdiction over. As discussed below, the Commission should in any event consider whether it has a compelling interest in exposing overly compliant NRSROs who rate securities that do not trade in U.S. markets, or that trade only among highly sophisticated institutions.
- Since an arranger that does a comparatively small amount of business with an NRSRO would not be in a position to exert undue influence over the NRSRO, the Commission could tailor the rule

² See proposed rule 17g-5(b)(9).

³ Proposing release at p. 29.

⁴ Id. at p. 30.

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so that it applies only to arrangers who account for more than a specified percentage of the NRSRO's revenues.

- An overly compliant or compromised NRSRO could be exposed by comparing its ratings on a handful of securities to the ratings assigned by other credit rating agencies, even if those other credit rating agencies developed their ratings days or weeks after the NRSRO published its rating. Therefore the Commission could tailor the rule so that it applies only to a narrow subset of an NRSRO's ratings, and there would be no need for the rule to mandate pricing date or real-time disclosure.
- Similarly, a compromised NRSRO could be exposed by comparing its initial ratings with other credit rating agencies' initial ratings. It is not clear that comparing subsequent ratings actions would be necessary to expose NRSROs whose ratings decisions are shaped by a desire to win more business from sponsors.

It is true that if the Commission were to more narrowly tailor proposed rule 17g-5(a)(3) along the lines suggested above, the rule would be somewhat less effective in accomplishing what may be an implicit policy goal of aiding credit rating agencies that operate on a "subscriber pays" business model.⁵ However it is not evident that the Commission's authority under Section 15E(h)(2) of the Exchange Act to "prohibit, or require the management and disclosure of, any conflicts of interest relating to the issuance of credit ratings" by an NRSRO should also be understood to authorize the Commission to require that NRSROs operating on the "issuer pays" business model subsidize credit rating agencies operating on the "subscriber pays" business model.

Beyond the question of whether proposed rule 17g-5(a)(3) is sufficiently narrowly tailored to meet the requirements of Section 15E(c)(2), we think the Commission should pause before creating an affirmative disclosure obligation that would apply to transactions in which the only U.S. nexus is an SEC-registered credit rating agency, and to securities offerings focused exclusively on qualified institutional buyers and other sophisticated market players. If the Commission believes that it has a compelling interest in requiring disclosure of information given to NRSROs in offshore offerings and private offerings, it would be useful for the Commission to explain that interest in detail and allow the public ample opportunity to comment before adopting a rule that would extend the reach of the Commission's authority as dramatically as contemplated by proposed rule 17g-5(a)(3).

The Commission has of course historically concluded that, as a matter of policy and comity, it should limit the reach of U.S. disclosure rules to transactions

⁵ See proposing release at note 122.

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with a clear U.S. nexus. In adopting Regulation S under the Securities Act of 1933 (as amended, the “Securities Act”), the Commission stated as follows:

“The Regulation adopted today is based on a territorial approach to section 5 of the Securities Act. The registration of securities is intended to protect the U.S. capital markets and investors purchasing in the U.S. market, whether U.S. or foreign nationals. Principles of comity and the reasonable expectations of participants in the global markets justify reliance on laws applicable in jurisdictions outside the United States to define requirements for transactions effected offshore. The territorial approach recognizes the primacy of the laws in which a market is located. As investors choose their markets, they choose the laws and regulations applicable in such markets.”⁶

Similarly, in proposing rule 144A under the Securities Act, the Commission noted that “[t]he Congress and the Commission historically have recognized the ability of professional institutional investors to make investment decisions without the protections mandated by the registration requirement of the Securities Act.”⁷ Speaking of private placements to institutions, the Commission observed that “[i]n this type of placement, the investors, ordinarily all sizeable corporations whose decisions are guided by financial experts, have little need for the protections of the Securities Act. They are well able to take care of themselves, no matter how large or small their investment, or how many investors are included in the group.”⁸

While the policy objectives of proposed rule 17g-5(a)(3) may be worthwhile, we believe that the policy objectives that underlie Regulation S, rule 144A and Regulation D under the Securities Act are certainly no less important. These long-standing exemptions are themselves based on years of prior Commission practice and judicial decisions. The concepts they embody are embedded in the U.S. securities regulatory framework and have been understood and relied upon by market participants for decades.

Proposed rule 17g-5(c)(5)

Proposed rule 17g-5(c)(5) would prohibit an NRSRO from rating a security if the NRSRO or an associated person “made recommendations to the obligor or the issuer, underwriter, or sponsor of the security about the corporate or legal structure, assets, liabilities, or activities of the obligor or issuer of the security.” Although the Commission stated that “[t]his proposal would prohibit

⁶ *Offshore Offers and Sales*, Securities Act Release No. 6863 (May 2, 1990) [footnotes omitted].

⁷ *Resale of Restricted Securities*, Securities Act Release No. 6806 (November 1, 1998).

⁸ Id.

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the NRSRO and, in particular, its credit analysts from making recommendations to obligors, issuers, underwriters, and sponsors such as arrangers of structured finance products,”⁹ the rule as proposed is not limited to the structured products market.

This proposed ban on recommendations also raises the question whether the proposal is narrowly tailored to meet the requirements of the Exchange Act. In the first instance, if the Commission’s concerns center on the structured products market, the rule should be narrowly tailored to structured products and should not sweep up all issuers and all securities. At the very least, the Commission should seek public comment on whether the proposed ban would serve any useful function outside of the structured products market.

Beyond the question of whether the rule applies to a broader class of securities than necessary, the inherent vagueness in the proposal’s language strongly suggests that it is not narrowly tailored to accomplish the Exchange Act’s requirements. To illustrate, while the proposing release stated that the proposed rule would prohibit “recommendations” to an arranger “about how to obtain a desired credit rating during the rating process,”¹⁰ during the open meeting at which the rule was proposed, the staff explained the operation of the proposal as follows:

“So for example, if a question were asked that said ‘I would like, my goal is a triple-A rating,’ I come to the rating agency, the rating agency gives me feedback, says this is a double-A rating, that could very well happen, we would not object if that dialogue continued, and the question were asked that said, ‘how much more must I increase my over-collateralization, how many more percentage points so that I can achieve a triple-A rating?’ I think we are perfectly fine with that. What we’re not comfortable with is the crossing the line that says ‘here’s a deal I want to do, how should I best structure this deal in terms of tranching, collateralization, legal structure so that you give me a triple A’ – that’s the step that we don’t want to cross.”¹¹

It is not evident how an NRSRO can respond to a question that asks “how much more must I increase my over-collateralization . . . so that I can achieve a triple-A rating?” without offering a recommendation “about how to obtain a desired credit rating.” The vagueness of the proposed ban suggests that it will chill or inhibit far more speech than necessary to achieve its purpose, and therefore raises serious questions about whether the rule comports with the First

⁹ Proposing release at p. 58.

¹⁰ *Id.*

¹¹ June 11, 2008 Open Meeting of the Commission, available at <http://www.connectlive.com/events/secopenmeetings>; webcast transcript at 31:48 minutes.

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Amendment. In another recent context, the Commission recognized that the goal of enforcing the federal securities laws must be balanced with a healthy respect for protecting First Amendment rights. In 2006 the Commission issued a press release in which it stated that “[i]n determining whether to issue a subpoena to a member of the news media, the approach in every case must be to strike the proper balance between the public’s interest in the free dissemination of ideas and information and the public’s interest in effective enforcement of the federal securities laws.”¹² We think the First Amendment concerns understood by the Commission in the enforcement context are equally relevant in the regulatory context.

Apart from the First Amendment and statutory authority concerns raised by the proposal, we anticipate that issuers will be extremely perplexed by the proposed ban if it goes into effect. Based on the discussion at the open meeting, it appears that the Commission is as much concerned with whether the issuer has improperly phrased a question to the NRSRO as it is with the response given by the NRSRO. Issuers are likely to experience a great deal of frustration if they need to learn how to phrase their questions in order to avoid soliciting a prohibited recommendation. We believe this runs the risk of turning sensitive conversations into a guessing game, and in any event could result in a serious impediment to the free flow of information between NRSROs and rated companies. We question whether this is in the best interests of investors, and instead believe the Commission made the better policy choice in Regulation FD when it determined not to interfere with conversations between issuers and credit rating agencies.

In light of these concerns, if the Commission decides to move to final rulemaking on proposed rule 17g-5(c)(5), we suggest that the Commission require NRSROs to manage the conflict of interest inhering in structuring rated securities through their policies and procedures, rather than creating an absolute prohibition of this particular conflict. We believe that a flexible policies-and-procedures approach is required here because of the extraordinary difficulty the Commission would have in drafting a narrowly tailored rule that clearly prohibits the speech that the Commission is concerned about but that does not chill the speech that the Commission believes is acceptable, speech that indeed may be vital to an issuer’s understanding of the criteria against which it is being rated.

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¹² *Policy Statement of the Securities and Exchange Commission Concerning Subpoenas to Members of the News Media*, Release No. 2006-55 (April 12, 2006).

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Thank you for the opportunity to comment on the Commission's proposals. If you would like to discuss our comments, please contact either of the undersigned at (212) 450-4000.

Very truly yours,

A handwritten signature in black ink, appearing to read "J. Hall".

Joseph A. Hall

A handwritten signature in black ink, appearing to read "Michael Kaplan".

Michael Kaplan