



BILL LOCKYER
TREASURER
STATE OF CALIFORNIA

United States Securities and Exchange Commission
Via email submission

Re: File No. S7-13-08

INTRODUCTION

I applaud the Commission's initiative to change its rules governing nationally recognized statistical rating organizations (NRSROs).

Since March, I have been leading a nationwide effort to end the dual system, the NRSROs use to grade municipal and corporate bonds. This system discriminates against municipal issuers, holding them to a higher standard and costing taxpayers hundreds of millions of dollars in higher interest rates and insurance premiums.

We want the agencies to adopt a global, uniform rating standard that bases ratings for municipal and corporate issuers on the risk of default. We believe this approach will bring fairness to taxpayers, better information to investors and increased stability to capital markets. Our effort has gained support from municipal issuers across the country, major institutional investors and some of the world's largest investment banks.

I believe the Commission's rulemaking initiative can dovetail nicely with our uniform rating campaign. With that in mind, I urge the Commission to paint with a broader brush and expand the changes beyond structured finance products. In nearly every instance, the policies underlying the proposal would be advanced further by broadening the scope to include all classes of credit ratings – including ratings for other types of corporate bonds and municipal bonds – set forth in the Credit Rating Agency Reform Act of 2006 (Act).

The Commission states the regulatory package aims to:

- Enhance the disclosure and comparability of credit ratings performance statistics.
- Increase the disclosure of information about structured finance products.
- Require more information about the procedures and methodologies used to determine credit ratings for structured finance products.
- Strengthen internal control processes for reporting requirements.
- Address conflicts of interest arising from the process of rating structured finance products.
- Promote investor due diligence by reducing the importance of NRSRO ratings in Commission rules.

It should be noted that, to some extent, the proposed regulations also will remove some unfair barriers that confront certain classes of issuers, particularly municipal issuers, who must compete in the marketplace. These barriers directly result from the NRSROs' continued use of different processes and methodologies – without disclosure or explanation – when rating various types of securities.

In my view, the Commission's intent is laudable, but the regulations do not go far enough. Remove the words "structured finance products" and replace them with any of the classes set forth in the Act, and the rules' rationale remains just as sound. I believe the Commission should expand the proposed rulemaking in nearly every instance to include all classes of credit ratings.

As Treasurer of the State of California, the nation's largest municipal bond issuer, my comments focus on municipal debt securities. The soundness of the overarching public policy, and the need to level the playing field and increase ratings process transparency, is particularly strong in the municipal debt securities arena. Historical NRSRO practices have created a significant competitive disadvantage for these instruments as compared to corporate debt.

In this day and age, investors have the opportunity to choose from a vast number of different types of securities that compete in the marketplace. To the extent ratings processes and methodologies differ from class to class, all but the most sophisticated investors risk unwittingly comparing apples to oranges when reviewing credit ratings. This is true without regard to the class of the credit rating.

Under the current regulatory scheme, municipal AA does not equal corporate AA. As Orwell might have said, some ratings are more equal than others. The lack of transparency, and the substantial potential for the ratings to confuse or even mislead investors, will exist until many of the changes in the Commission's proposed rules are extended to all ratings classes. And the existing inequities will also continue to work substantial and unfair hardships on various classes of issuers.

COMMENTS

Proposed Rule 17g-7

The first area warranting expansion of scope is proposed new rule 17g-7. As proposed, the rule would require disclosure when the NRSRO uses different methodologies in the rating of structured finance products. Specifically, the rule requires disclosure when the employed methodology differs from that used to establish ratings for other products.

Does this mean the NRSRO must disclose how the methodology differs from every other credit rating class? Will the NRSRO simply have to spell out the differences between how it rates structured finance products and other corporate debt? Or, will it also be required to explain how the structured finance rating differs from municipal debt rating? If it is the former, it seems large gaps will remain that will preclude a meaningful comparison by investors.

If it is the latter, then almost by default the NRSRO will spell out how the methodology for corporate debt compares to that used for municipal debt. If that is the case, why not take the overt step of requiring the use of the same methodology (i.e., the same reliance placed on the same factors) or the disclosure of differences across all classes of credit ratings? In this way, an investor conducting due diligence will be armed with the information necessary to guard against inadvertently comparing apples to oranges.

On this point, the Commission specifically requested comment on two questions, which are set forth below along with responses.

1. Should the rule be expanded to require reports or different ratings symbols for each class of credit ratings identified in Section 3(a)(62)(B) of the Act? Alternatively should the rule be expanded to require reports or different rating symbols for only certain classes or subclasses, such as municipal securities?

The rule should be expanded, at a minimum, to include municipal and corporate securities. While we would prefer a direct approach of requiring the use of methodologies that place the same reliance on the same factors, anything that will discourage the current discriminatory practice is welcome. Resorting to the use of distinguishing symbols will do little to enable investors to fairly compare credit ratings across various classes of securities.

2. Should the rule prohibit an NRSRO from using a common set of symbols to rate different types of obligors and debt securities (e.g., corporate debt and municipal debt) where the NRSRO uses different methodologies to determine such ratings? Would such a proposal raise questions related to the scope of the Commission's legal authority in this area?

The example offered is telling. The effort to force equitable NRSRO treatment among corporate and municipal issuers has been underway for some time now. Prohibiting the use of a common set of symbols is one approach to correcting the misleading system currently in place. Given the enormous potential for misinformation, and the significance of the government's interest in making sure the market operates efficiently, it is likely the Commission could lawfully compel the use of unique symbols or, at a minimum, mandate disclosure of the differences underlying the ratings.

Unfortunately, whichever class winds up with the "new" symbols will be immediately placed at a disadvantage until the public learns to read the system. Further, while the approach would facilitate comparisons within a class, it would do little to help investors make comparisons between classes.

In sum, while mandating symbols that highlight disparate treatment by the NRSROs can be helpful, the Commission's ultimate goal should be to minimize or eliminate the disparate treatment. Only in this way can the Commission ensure that investors have access to information that will allow them to evaluate comparable risk across various classes of securities. To the extent the proposed rule creates momentum toward that end, we wholeheartedly support its adoption.

Conflict of Interest

The dangers created by potential conflict relationships exist beyond the structured finance world. Ratings of all classes may be unduly influenced in a variety of ways. This is especially true in today's market where many issuers view the purchase of a rating as being somewhat akin to buying a seal of approval that will enhance their ability to compete.

The proposed rules governing disclosure and unsolicited opinions will help address conflict concerns, but only relative to the structured finance product ratings. They will do little to ameliorate these same concerns with regard to other classes of ratings.

No matter the nature of the issuance, the involvement of an NRSRO in the structuring of a "deal" results in the NRSRO effectively rating a product of its own making. The same holds true relative to the proposed prohibition on the involvement of those participating in fee discussions from playing a role in the rating process. This conflict between the NRSRO's business interests and the rating process exists regardless of the class of the rating.

Obviously, the risk potential is magnified for all classes when the party seeking the rating is a repeat customer. Again, this is true across all ratings classes. The same can be said of the proposed gift prohibition.

Similarly, there is no good policy reason for limiting the requirement to create, retain and make publicly available the records of ratings actions. The same interest underlying the requirement vis-à-vis structured finance products applies with full force to all classes of ratings.

As the Commission notes, the proposed rules will enable market participants to evaluate ratings and potentially expose when NRSRO ratings are unduly influenced by a desire to gain influence with the arranger or an issuer. These benefits should extend across all classes of ratings.

Requiring documentation of rating decisions that materially deviate from model output

Perhaps a more generic approach would expand the requirement not just to all classes but also to NRSRO ratings that rely on any sort of formulaic approach. When a NRSRO uses a model or formula to determine rates, the NRSRO should be required to explain its actions when a rating deviates from that model or formula in a material way.

Such deviations may be a red flag indicator of some other factors at work in the rating determination. The proposed requirement certainly will provide market participants background information to consider in performing their own due diligence. Additionally, it will facilitate fair and open comparisons across various classes of ratings in the marketplace.

Changes to reporting requirements on performance measurement statistics

This is a welcome change. Current rules cloud performance metrics by allowing NRSROs to aggregate ratings classes. The proposed rule, by requiring NRSROs to report performance statistics by class, will enable market participants to readily identify those with expertise in specific areas.

Flaws relative to the ratings determination processes and methodologies for a particular class will be readily available, and the potential for those flaws to create confusion will be minimized. In sum, the proposed changes will make due diligence a more worthwhile undertaking by giving investors access to specific performance measures that will allow meaningful comparisons.

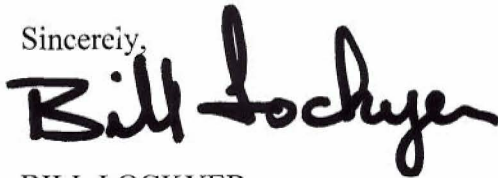
Required disclosure of ratings methodologies

This is an essential element of the package. Only through disclosure can different methodologies be well understood and disparate ratings be explained. The characteristics of a particular methodology may shed light on whether an NRSRO's determination is the product of conflict of interest or adherence to a specific process. One cannot know if a model or formula has been disregarded in the rating process unless its use is first disclosed.

In addition, the disclosure will lay out in a very public forum the extent to which classes of securities are arbitrarily subjected to disparate treatment. This will, in turn, facilitate a discussion about the propriety of this treatment.

At a minimum, disclosure will help investors performing due diligence verify they are making valid comparisons. Specifically, the proposed disclosure will enable them to understand the process utilized in the rating determination, rather than being forced to simply rely on an end product of unknown origin.

Sincerely,

A handwritten signature in black ink that reads "Bill Lockyer". The signature is written in a cursive, flowing style with a large initial "B".

BILL LOCKYER
California State Treasurer