

Comments of Professor Frank Partnoy on Release Nos. IC-28327; IA-2751 File No. S7-19-08, References to Ratings of Nationally Recognized Statistical Rating Organizations

A decade ago, I published an article criticizing the regulatory dependence on NRSRO ratings, and proposing that the Commission, along with other regulators, eliminate references to NRSROs in its regulations.¹ Since then, I have advocated the elimination of such references in several articles and in sworn testimony before Congress.² I am submitting comments to applaud the Commission's proposed rules, to indicate that there is strong academic support for its proposal, and to make a few modest comments regarding some alternative provisions the Commission has proposed substituting for the regulatory reliance on NRSRO ratings.

I want to offer just one substantive addition to the Commission's proposals, and also to urge that the Commission resist the focused lobbying efforts of some special interests who might criticize the proposals. I have not yet had the opportunity to review any comments on the proposal from the major NRSROs, but it is worth noting for the Commission that representatives from these NRSROs already have stated publicly that they would not oppose the elimination of regulatory references to NRSRO ratings. The major NRSROs have earned substantial fee income from regulatory dependence on NRSRO ratings, particularly from structured finance ratings that are driven largely by financial engineering designed to exploit the fact that regulations depend on NRSRO ratings even if those ratings are not accurate or reasonable. Indeed, one of the core causes of the sub-prime crisis was dependence on inaccurate and unsupportable credit ratings.

My one substantive recommendation to the Commission is that it include in its Final Rules some language indicating that reliance on market-based information and market prices, rather than NRSRO ratings, can be an acceptable – indeed, preferable – method of satisfying obligations to assess the credit quality and risk of particular assets. For example, in directing that money market fund boards of directors look to outside quality

¹ See Frank Partnoy, *The Siskel and Ebert of Financial Markets: Two Thumbs Down for the Credit Rating Agencies*, 77 WASHINGTON UNIVERSITY LAW QUARTERLY 619 (1999), reprinted at 33 SECURITIES LAW REVIEW 161 (2001).

² See Frank Partnoy, *Do Away With Rating Based Rules*, Financial Times, July 9, 2008; Frank Partnoy and David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives*, 75 UNIVERSITY OF CINCINNATI LAW REVIEW 1019 (2007); Frank Partnoy, *How and Why Credit Rating Agencies Are Not Like Other Gatekeepers*, in FINANCIAL GATEKEEPERS: CAN THEY PROTECT INVESTORS? (Brookings Institution Press 2006, Yasuyuki Fuchita and Robert E. Litan, eds.); Frank Partnoy, *The Paradox of Credit Ratings*, in THE ROLE OF CREDIT REPORTING SYSTEMS IN THE INTERNATIONAL ECONOMY (Kluwer Academic Publishers 2002, Richard M. Levitch, Giovanni Majnoni, and Carmen Reinhart, eds.); Frank Partnoy, *Assessing the Current Oversight and Operations of Credit Rating Agencies*, Sworn Testimony before the United States Senate Committee on Banking, Housing, and Urban Affairs, Washington, DC, Mar. 7, 2006; Frank Partnoy, *Legislative Solutions for the Rating Agency Duopoly*, Sworn Testimony before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, U.S. House of Representatives Committee on Financial Services, Washington, DC, Jun. 29, 2005.

determinations, I believe the Commission should highlight in the Final Rules that, in addition to NRSRO ratings, it would be appropriate for directors to look to, and rely on, market measures of credit risk, including both the credit spreads of fixed income instruments and the market prices of credit default swaps. To the extent there are concerns about short-term market volatility, market participants could look to rolling averages of market prices with an appropriate term (e.g., a 90-day rolling average).

In particular, credit default swap data, including data provided by institutions such as Markit, have proven valuable and accurate in assessing and reflecting credit risk. Indeed, the NRSROs rely on such market data in their own ratings process, although NRSRO ratings continue to lag the market data by months. I believe it would be helpful for the Commission to include explicit references to market data in its rules.

Other than the above detail, my only comment is to thank the Commission for the courage and hard work that led to the proposal, and to say that I look forward to the positive impact it will have on the financial markets.

Frank Partnoy