

25 July 2008

Nancy M. Morris
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Proposed Rules for Nationally Recognized Statistical Rating Organizations—File No. S7-13-08

Dear Ms. Morris:

The CFA Institute Centre for Financial Market Integrity¹ is pleased to comment on the SEC's release that proposes changes to the current framework within which NRSROs operate. While we do not believe that NRSROs/credit rating agencies (CRAs) are solely responsible for the dramatic effects on the market stemming from the subprime mortgage crises, we appreciate that the current crises have highlighted shortcomings within the ratings process and CRA operations.

We support disclosure of information to the public that provides investors and regulators alike with the "reasoning" behind ratings that are assigned by CRAs. This includes the methodologies used and assumptions relied upon, which invites stringent review of ratings that do not correlate with the models used. We also appreciate the efforts through these proposals to address and manage some of the more obvious conflicts of interest between those providing and those receiving ratings. As recognized in this release, more than disclosure is required to shore up the credit ratings process and restore investor confidence in the system.

The results of a recent opinion poll conducted by CFA Institute only underscore this need for reform. In a survey that generated nearly 2,000 responses from its members worldwide, 11 percent of respondents reported witnessing a CRA changing its rating in response to pressure from an investor, issuer, or underwriter.² In other results, a plurality - 47% - supported the idea of a different rating system for structured products; and 55% indicated support for CRAs grouping themselves into an international standard-setting and monitoring self-regulatory body with enforcement powers. While as a general rule we favor self-regulation of markets,

¹ The CFA Institute Centre for Financial Market Integrity is part of CFA Institute. With headquarters in Charlottesville, VA and regional offices in New York, Hong Kong, and London, CFA Institute is a global, not-for-profit professional association of more than 96,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 134 countries of whom more than 82,600 are holders of the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 136 member societies in 56 countries and territories.

² See results of survey at www.cfainstitute.org/memresources/monthlyquestion/2008/june.html

whenever possible, we also recognize the current authority of the Commission to regulate aspects of NRSRO activities.

General Comments

As a procedural matter, we question the setting of a 30-day public comment. A 45- or 90- day comment period would have been more appropriate and allowed the analysis that certain aspects of this proposal demand.

As the first 25 pages attest, this issue is complex and requires a thorough understanding of the inter workings of many factions. It follows that this proposal is similarly detailed. While we appreciate the SEC's efforts to address this area quickly, we also believe that complex new policy that is rushed though is often detrimental to the markets in the long run. Given the severity and depth of problems stemming from matters related to these proposals, we urge the SEC to reopen the comment period for all or certain parts of this proposal to enable further public consideration of the issues raised in this release.

We recognize that much of the current problem may have roots in the loan origination process. However, we also believe that CRAs could have done a better job of informing investors about the purpose and use of ratings so that investors did not continue to unduly rely on them or assign them inappropriate significance. We welcome these proposals as an effort to require CRAs to further educate the investing public about the analysis underlying their ratings, as well as to manage conflicts inherent in the appearance of a "pay for ratings" system.

This is an area in which we have been involved for some time and have already taken positions/recommended changes, particularly with respect to structured finance products. This involvement has extended not only to reform efforts within the current US system, but also to reviewing proposals being considered outside of the United States.³

As early as 2006, CFA Institute called for more accountability by rating agencies, noting that "Investors need to be confident that the credit-rating information they use to evaluate companies is accurate, unbiased, and reliable."⁴

Since then, the CFA Institute Centre has called for a number of reforms in this area, including

- Using a rating nomenclature/categorization that distinguishes structured products from both corporate and commercial paper ratings to help investors recognize the differences;

³ See, e.g., April 2008 letter from Charles Cronin, Head, CFA Institute Centre Europe, Middle East and Africa, to Kim Allen, IOSCO General Secretariat—Letter of "public Comment responding to "IOSCO Technical Committee Consultation Report on Credit Rating Agencies"; see also March 2008 comment letter from Charles Cronin to Carlo Comporti, the Committee of European Securities Regulators—Response to CESR consultation paper "The role of credit rating agencies in structured finance."

⁴ See 2008 statement to Congress by CFA Institute CEO Jeff Diermeier:
www.cfainstitute.org/centre/pdf/jeff_diermeier_testimony_credit_rating_agencies.pdf

- Encouraging a global best practice of prohibiting the practice of “notching”, where a credit rating agency unilaterally issues a rating on an entity or structure that was not sought by the issuer, and for the primary purpose of “punishing” the entity or structure for not engaging that CRA;⁵
- Creating an executive-level compliance officer position at credit rating agencies to ensure implementation and enforcement of the IOSCO code;
- Requiring complete adoption of the IOSCO code to claim compliance; and
- Calling on credit rating agencies to refrain from rating new structured products until the statistical data are sufficiently robust to produce a defensible rating.⁶

We also have publicly called for a refinement or even elimination of the concept of “investment grade” in ratings wherever possible to reduce misconceptions about the purpose of assigned ratings. We will address this in our response to the Commission’s second set of proposals to amend rules and forms that reference ratings issued by rating agencies.

We provide specific comments on certain aspects of the proposals below.

Specific Comments

A. Disclosing and Managing Conflicts of Interest--Amendments to Rule 17g-5

(a) Enhanced Disclosure of Information Used in the Rating Process for Structured Finance Products

We appreciate the objectives expressed in the proposal to provide the public with information relating to information the NRSRO has received and uses to determine a rating as a condition to rating a structured finance product. We also recognize disclosure of such information as a way to (1) manage conflicts of interest relating to being paid for providing a rating, (2) increase the transparency of the process, (3) foster competition among market participants, including other NRSROs, and (4) expose inaccurate ratings.

In general, we support additional disclosure by the CRAs that help to manage the conflicts of interests presented in certain credit rating arrangements. In order to achieve the goals stated in the proposal, however, the information must be focused. We feel strongly that providing a large amount of raw data or other

⁵ This position comports with provisions in section 15E (i) (1) (A), (B), and (C) of the Credit Rating Agency Reform Act of 2006, which prohibits conduct by NRSROs that is unfair, coercive, or abusive, including practices related to conditioning the issuance of ratings on the purchase of other services or products; refusing to rate, or lowering/threatening to lower ratings on securities/instruments issued by a pool or part of a transaction unless the NRSRO also rated a portion of the assets within the pool or part of such transaction; and modifying/threatening to modify ratings based on an agreement to purchase the rating or other services or products of the NRSRO.

⁶ See 5 February 2008 press release:

http://www.cfainstitute.org/aboutus/press/release/08releases/20080205_02.html.

Also see comments to Committee of European Securities Regulators —

http://www.cfainstitute.org/centre/topics/comment/2008/pdf/cesr_cra_response.pdf;

and to the International Organization of Securities Commissioners —

http://www.cfainstitute.org/centre/topics/comment/2008/pdf/iosco_consultation_cras_response.pdf.

information that is not closely related to the determination of a debt rating generally is not helpful to investors and will not achieve the desired objectives of this proposal.

Thus, we question the proposed requirement to disclose “all information” provided to and used by the NRSRO in determining the initial credit rating and undertaking credit rating surveillance. By requiring disclosure of “all information”, we fear that this requirement may result in a “data dump” that will be of limited use to investors and regulators. While some of this data may be useful to regulators, we encourage a more focused approach to providing investors with a summary of the underlying information about the process used to assign the rating, including the underlying assumptions relied upon and methodologies used by the NRSRO. If the SEC needs additional information for regulatory examinations or otherwise, it may want to require records of such information to be made readily and publicly available by the CRA for prescribed time periods.

For both the initial credit rating and subsequent credit rating surveillance, the release does not dictate the information that must be disclosed but does note what information the SEC “anticipates” will be disclosed. We suggest that the adopting release explicitly require at least what information is to be provided in order to satisfy the disclosure requirements.

We also support an objective of this proposed amendment which is to foster competition among market participants, including NRSROs, through the broad dissemination of information provided to and relied upon by the rating NRSRO. We understand that this information will not only serve as a check on the accuracy of the rating but also will allow rating agencies to issue unsolicited ratings.

While we support this objective generally, we do, however, caution against the unethical use of unsolicited ratings to “punish” or otherwise manipulate market participants into engaging a particular NRSRO, a practice commonly known as “notching.” As recognized in the Credit Rating Reform Act of 2006, threatening or lowering ratings based on reciprocity by the issuer/obligor or otherwise conditioning a credit rating based on whether the obligor will purchase a rating is prohibited conduct. We encourage the Commission in any final rulemaking to emphasize the illegality of any such conduct in connection with the practice of unsolicited ratings.

We also recommend that the SEC require disclosure about any steps that were taken by the NRSRO, issuer, underwriter, sponsor, depositor, or trustee to verify information about the assets underlying or referenced by the security or money market instrument. Similarly, we recommend that the Commission require disclosure of results of any steps undertaken by these parties to verify information about the assets underlying or referenced by a structured finance product. If no such steps were taken, we believe this also should be noted.

Finally, a number of CRA websites require registration before allowing access to technical information on methodologies and assumptions. We urge the Commission to adopt a requirement that CRAs eliminate this registration requirement as a prerequisite for obtaining such information. To the extent methods or assumptions change, CRAs should be required to maintain archival materials of the methods and assumptions in effect at the time of any earlier rating.

(b) Prohibiting Conflicts of Interest Between NRSROs and Those Receiving Ratings

We appreciate the objective of this proposal to deter those providing the ratings from benefitting from essentially telling the issuer or obligor how to receive a particular rating, thus rating their own work. However, as the Commission recognizes in the release, communication between the NRSRO and other parties about NRSRO procedures and methodologies serves a useful purpose. We encourage striking a balance where useful communication is not deterred but manipulation or self-serving practices are not encouraged.

To that end, we strongly support rules that would prohibit discussions that recommend the creation or design of a securitized finance product, but that would allow discussions of the assumptions and rationales underlying the rating decisions. Such rules would recognize the reality that drawing the line between making recommendations and providing feedback is a challenging process.

Given the difficulty in separating meaningful discussions from proactive involvement in the structuring of instruments to obtain certain ratings, we also recommend that NRSROs be required to create an executive-level compliance position charged with monitoring these discussions and the overall rating process. To further enhance its value, this position should be free of any influence from both the compensation practices and reporting authority of any affiliate consulting or advisory division of the CRA. Vesting oversight in a compliance officer one step removed from initial ratings process would, when combined with appropriate disclosure, help to manage these communications and the potential conflicts of interest they may create, and will further work to ensure that investor interests are being protected.

Additional Recommendations

We recommend that different analyst groups be assigned responsibility for determining initial ratings from those engaged in ongoing monitoring and subsequent actions. Doing so reduces the risk that pressure placed on the analyst providing the initial credit assignment by the issuer or underwriter will be passed on to the analyst responsible for subsequent reviews and adjustments in ratings. We also suggest that analysts responsible for ongoing monitoring be rotated after prescribed time periods so as to discourage the formation of personal relationships that may impair objectivity.

(c) Prohibiting Conflicts of Interest Related to Fee Discussions

We support the proposed amendment to Rule 17g-5 that would separate the NRSRO personnel involved in fee discussions from those actual conducting the credit rating analysis.

The Commission asks whether small NRSROs should be exempt from rules that would separate personnel involved in fee discussions from those conducting credit rating analysis. The Commission further asks whether disclosure of such conflicts would provide sufficient information to investors to permit such an exemption.

While we recognize such requirements may create a hardship for small CRAs, the CFA Institute Centre does not support such an exemption. In its Research Objectivity Standards (“ROS”), the CFA Institute Centre calls for reporting structures that “ensure that research analysts do not report to, and are not supervised or controlled by... another department of the firm that could compromise the independence of the analyst.” It also calls on

firms to implement procedures that prevent other functions within the firm “from reviewing, modifying, approving, or rejecting research or recommendations on their own authority.”⁷

(d) Prohibiting Conflicts of Interest Related to Receiving Gifts

We support restrictions on the monetary value of gifts or other perquisites a credit analyst can receive from the party being rated or those related to the securities being rated in order to curtail the “buying” of ratings through gifts. Monitoring these activities could easily be part of the duties expected of the compliance officer. And while we believe the \$25 limit on gifts does not meet the test of a material gift that might impair the objectivity of an analyst, we also believe that a limit of twice that amount would also be unlikely to meet the material test.

B. Recordkeeping—Amendments to Rule 17g-2

(a) Public Record of Rating Actions

We have long supported efforts to develop XBRL for the financial reporting area for public companies and generally support the development of a format that allows investors the ability to receive and compare information efficiently. However, we have a number of concerns about the proposed amendments that would require NRSROs to make records of rating actions publicly available through the NRSRO’s Web site in an XBRL Interactive Data File.

First, the proposed time lag for making information publicly available from the NRSRO would not meet the stated goal of the proposal to make “it easier for persons to analyze the actual performance of the credit ratings the NRSROs issue in terms of accuracy in assessing creditworthiness.” In order to do this, current and prospective investors in companies or in specific rated issues need information on current ratings in a timely fashion. As proposed, the NRSRO would be allowed up to six months after the date of the rating action to make its record publicly available. In any event, any such public filing that is made by the NRSROs should clearly be marked “historical” so that inexperienced users of the NRSRO’s web site do not mistake it for current data.

We also have additional concerns surrounding the proposal that this information be filed in an XBRL format. Specifically, we encourage a longer review be considered for this aspect of the proposal so as to develop greater clarification of the Commission’s short- and longer-term expectations in this area. Usually, XBRL documents contain information as of a point in time and are not constantly updated. However, given the number of different classes of securities (e.g., preferred, senior debt, sub-debt, etc.) to which NRSROs assign ratings for a number of issuers, NRSROs need guidance on how to meet their obligation under this proposal. For example,

- Is the NRSRO required to file a single document with all ratings for all companies and related history? Or
- Should the NRSRO instead file a separate instance document for each action for the company (e.g., similar to a XBRL tagged press release?)

⁷ This language is found in Standard 4.0. While it relates specifically to research in an investment banking environment, the principles are equally applicable in this instance.

Should the SEC decide to require the reporting of information through XBRL, an approved taxonomy related to the required fields will need to be developed. This taxonomy will need to incorporate tags for descriptions of the company, facts about the rating and descriptions of issues associated with the rating. The more complete that the information is regarding the issuance of a rating, the greater level of transparency that will be derived. In order to provide investors with the greatest benefit, the format of all required information should be consistent, so that users do not need multiple applications to access and analyze the data.

In order to ensure comparability, we suggest that the SEC or its assigned taxonomy standard setter (possibly XBRL US) work with NRSROs and users of the information to determine these tags. In addition, an ongoing maintenance plan will need to be developed. Given the uncertainty of the scope of the historical data that will be required, we question the use of XBRL and suggest exploration of other formats that may be more suitable for accessing and sorting the number of lines that may exist.

We believe more information is required before there can be an accurate assessment of the potential costs of using XBRL in this area. The scope of the instance document—one for all or one for each activity—will greatly impact the amount of time to issue the first document and to provide updates. Given the historical nature of most of the information, we recommend that the Commission develop a central storage database for assessing accuracy and compliance.

(b) Record of Material Deviation from Model Output

We strongly support the proposed requirement that the NRSRO issuing a rating make a record for the reasons for material differences between a credit rating implied by a quantitative model and the actual rating issued. As explained in the release, this would only occur where “a quantitative model is a substantial component of the credit ratings process for the type of obligor or security being rated and the output of the model would result in a materially different conclusion if the NRSRO relied on it without making an out-of-model adjustment.” The NRSRO would bear the responsibility for determining what is a “substantial component” and what is a “material” difference. We agree that this is an important means of providing SEC examiners and internal NRSRO auditors with the means to reconstruct the process used by the NRSRO in determining the rating.

(c) Record of Complaints Against Third-Party Analysts

Similarly, we support the proposed amendment that would require the NRSRO to retain records of complaints against credit analysts related to the assignment of ratings as a way to better reveal the pressures that arrangers or others wield when dissatisfied with a rating. The release also notes that the mere existence of this rule may in and of itself deter NRSROs from succumbing to such pressures.

(d) Record of Communications Relating to Monitoring

Requiring NRSROs to maintain a record of internal and external communications related to “monitoring” seems entirely appropriate, especially given that the monitoring of credit ratings appears to have been more problematic than the initial assigning of one. Extending the record-keeping requirements to the monitoring phase should help address this. With respect to the question raised in the release, we recommend replacing the word “maintaining” with “monitoring” as an appropriate clarification to the rule.

C. Amendments to the Instructions for Form NRSRO

(a) Disclosure of Enhanced Ratings Performance Measurement Statistics

The SEC is proposing to require NRSROs to publicly disclose raw data that the marketplace would need to apply credit ratings performance metrics.

In particular, a proposed amendment would require NRSROs to disclose “separate sets of default and transition statistics for each asset class of credit rating” for which an NRSRO is seeking registration, or is already registered, “and any other broad class of credit ratings issued by the NRSRO.” It would also require NRSROs registered in a certain class of credit ratings, “when generating the performance statistics for that class to include credit ratings of any security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage -backed securities transaction.”

A second amendment would require that the class-by-class disclosures of performance statistics and ratings be broken out into periods of one, three and ten years.

A third amendment would focus on what ratings actions are required to be included in performance measurement statistics by replacing the term of “downgrades and default rates” with “ratings transition and default rates.” This change is intended to signal that upgrades, as well as downgrades are to be included in the statistics

Finally, a proposed amendment would require an NRSRO to disclose “defaults relative to the initial rating and incorporate defaults that occur after a credit rating is withdrawn.” The intent of this amendment is “to prevent an NRSRO from manipulating the performance statistics by not including defaults when generating statistics for a category of credit ratings (e.g., AA) because the defaults occur after the rating is downgraded to a lower category (e.g., CC) or withdrawn.”

In general, the CFA Institute Centre supports all of these amendments and believes they may be useful to investors’ decisions.

D. Differentiation in Credit Ratings for Structured Finance Products—New Rule 17g-7

We strongly support Commission efforts to require rating agencies to differentiate ratings for structured finance products from both corporate and commercial paper ratings. Investors need to be alerted to the fact that structured finance products carry a number of underlying risks that are different or not associated with corporate debt and money market instruments.

As we have stated previously, we strongly believe that many investors in fixed income instruments need the additional information that alerts them to differences in the structure, cash flow, and volatility.⁸ Accordingly, different analysis is required to provide investors with the information they need in order to make informed investment decisions. This required differentiation and associated clarification/education is a major step forward for the investing public.

⁸ See June 12, 2008 Press Release by CFA Institute Centre, “Investors Will Benefit From SEC’s Rating Agency Reform.

In the past, we have suggested use of a rating nomenclature/categorization to help investors recognize the differences. In light of the proposed new rule's intent to address this goal, we believe this clarification should come both through the use of different symbols for structured products, and the availability of an accompanying report. The purpose of the different symbol is to ensure that investors are aware that these instruments mature differently from more traditional corporate or sovereign debts. By making an accompanying report available, the NRSROs would help investors make such inquiries.

Conclusion

As reflected in our comments above, we strongly support aspects of the Commission's proposals to address NRSRO activities. We believe that this call to increase NRSROs' accountability—through enhanced disclosure and rules to manage their conflicts of interest—will serve the important step of starting to restore investor confidence in the system.

We appreciate the opportunity to comment on these proposals. If you have questions about any of the positions taken in this letter or would like additional information, please do not hesitate to contact Kurt Schacht at 212.756.7728 (kurt.schacht@cfainstitute.org) or Linda Rittenhouse at 434.951.5333 (linda.rittenhouse@cfainstitute.org).

Sincerely,

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