July 25, 2008

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

Re: File S7-13-008

The Association for Financial Professionals (AFP) welcomes the opportunity to provide comments on the Securities and Exchange Commission's (SEC) proposed rules for nationally recognized statistical rating organizations.

The membership of AFP includes more than 16,000 financial executives employed by over 5,000 corporations and other organizations. Our members represent a broad spectrum of financial disciplines and their organizations are drawn generally from the Fortune 1000 and middle-market companies in a wide variety of industries, including manufacturing, retail, energy, financial services, and technology. The proposed rules are of critical importance to our members, as they are responsible for managing the issuance of short and long-term debt, in addition to directing the investment of corporate cash and pension assets for their organizations.

Since 2002, AFP has been a vocal advocate for the reform of the credit ratings industry. During that time, we conducted two surveys that found that both issuers of corporate debt and investors of corporate cash and pension assets believe: 1) the information provided by credit rating agencies is neither timely nor accurate, 2) the rating agencies are primarily serving the interest of parties other than investors, and 3) the SEC should increase its oversight of rating agencies and takes steps to foster greater competition in the market for credit rating information. In April of 2004, AFP and treasury associations from Europe also issued the *Code of Standard Practices for Participants in the Credit Rating Process*, which preceded the *Code of Conduct Fundamentals for Credit Rating Agencies* issued by the International Organization of Securities Commissions (IOSCO). We have also testified before Senate and House committees on a number of occasions and submitted many comment letters to the SEC on its proposed rules.

While AFP believes that the *Credit Rating Agency Reform Act of 2006* and the SEC rules implementing the act made significant strides toward removing barriers to competition the SEC had imposed, our comments on those proposed rules recommended the SEC ban additional conflicts of interest that had obvious potential to affect the objectivity and accuracy of credit ratings. Recent disruptions in credit markets provide strong empirical evidence that the rules do not go far enough to address these conflicts of interest. Further, AFP recommended that NRSROs be required to confirm certifications from Qualified Institutional Buyers (QIB) in writing on an annual basis, retain the written confirmations, and notify the Commission if a QIB withdraws or does not re-confirm its certification. The experience of the past year makes it likely that at least some QIBs that certified an NRSRO at its time of application would not be willing to do so today. The withdrawal of one or more QIB certifications would serve as valuable information in helping market participants (investors and issuers) determine which NRSROs are providing credible and reliable ratings.

AFP believes that credit rating agencies are vital to the efficient operation of all segments of capital markets. As such, it is our hope that the recent crisis in the subprime and structured finance market will serve as a trigger for long-needed reform and not as a point of singular focus for the current debate. We urge the SEC to use the current momentum for rating agency reform to address the concerns of all participants in capital markets, including issuers of and investors in corporate and municipal debt, not just those directly impacted by the subprime crisis. Failure to fully consider these market participants will not only squander an opportunity, but will potentially harm those market participants through unintended consequences of changes focused solely on the structured finance market.

The SEC has asked for comments on a wide range of topics and issues surrounding the oversight of credit rating agencies and amendments and additions to its NRSRO rules. AFP continues to believe competition in the credit rating agency market, coupled with an appropriate amount of regulation, oversight, and enforcement, is the best way to improve the reliability and credibility of credit ratings and restore confidence in the credit rating agency industry.

AFP offers the following comments on the proposal:

Rule 17g-5: Prohibition on Conflict of Interest Related to Rating an Obligor or Debt Security where Obligor or Issuer Received Ratings Recommendations from the NRSRO or Person Associated with the NRSRO

The Commission has proposed prohibiting an NRSRO from issuing a credit rating for an issuer or security when the NRSRO offered recommendations to an 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." While AFP understands and agrees with the rationale for such a prohibition and supports the proposed rule, we believe it is critical that the Commission further clarify what would be considered permissible feedback from an NRSRO to an issuer.

It is imperative that the rules not prohibit conversations between issuers and rating agencies prior to requesting a credit rating or when making decisions that could subsequently affect existing credit ratings. When considering an acquisition, recapitalization, change in dividend policy, or other corporate finance activity, issuers frequently discuss the alternatives being considered with rating agencies to understand the likely impact on credit ratings. Understanding the potential impact on a credit rating that could result from a capital structure decision or other corporate initiatives allows companies to more accurately estimate the cost of new debt and the overall cost of capital to the issuer. This knowledge allows the issuer to optimize its capital structure for the benefit of all stakeholders. The Commission should clarify that this type of dialogue between an issuer and an NRSRO does not constitute a prohibited recommendation, but rather is a permitted form of feedback from the NRSRO to an issuer.

Rule 17g-5: Prohibition on Conflict of Interest Related to the Participation of Certain Personnel in Fee Discussions

Rule 17g-5: Prohibition of Conflict of Interest Related to Receipt of Gifts

The Commission has proposed that NRSRO staff with responsibility for participating in determining ratings or developing or approving rating methodologies be prohibited from participating in discussions surrounding fees. The Commission notes that "While the incentives of the persons discussing fees could be based primarily on generating revenues for the NRSRO, the incentives of the persons involved in the analytical process should be based on determining accurate credit ratings. There is a significant potential for these distinct incentive structures to conflict with one another where persons within the NRSRO are engaged in both activities."

In the Association's May 12, 2007, comment letter on the proposed rules implementing the *Credit Rating Agency Reform Act of 2006*, AFP recommended the following:

- NRSROs should be required to establish distinct and absolute separation between rating analysts and credit rating agency staff responsible for generating revenue from credit ratings, rating assessment services, corporate governance reviews, or other ancillary services offered by the credit rating agency.
- The Commission should bar analyst compensation from being linked in any way to revenue generated from credit ratings or any ancillary services. The potential for a credit rating agency or individual analyst to abuse the market power associated with NRSRO recognition to boost revenue or personal earnings is obvious.

<u>AFP continues to support the prohibition on rating analysts, rating committee members, and others involved in the ratings process from participating in discussions surrounding fees. Further, we strongly encourage the Commission to prohibit the compensation of rating analysts, rating committee members, and others involved in the ratings process from being linked directly to revenue generated from the credit ratings or ancillary services that they participate in providing.</u> We strongly believe that these conflicts of interest are so potentially harmful that they cannot be managed through disclosure and should be strictly prohibited. We do not recommend that NRSRO staff be prohibited from benefiting from overall corporate profitability, as we recognize that this type of compensation is expected in today's workplace and a critical tool in attracting the qualified staff that is critical to restoring faith in credit ratings.

AFP also supports the prohibition on the receipt of gifts in excess of $25 by a credit analyst who participates in determining or monitoring credit ratings, or a person responsible for approving credit ratings. The potential for such gifts, if left unchecked, to taint the objectivity, credibility, and reliability of credit ratings is clear.

Rule 17g-2: A Record of Rating Actions and the Requirement that they be made Publicly Available

The Commission has proposed requiring an NRSRO to make and retain a record showing all rating actions (initial rating, upgrades, downgrades, and placements on watch for upgrade or downgrade) and the date of such actions identified by the name of the security or obligor. The Commission has proposed that this record be made publicly available on the NRSRO's corporate Internet Web site in an interactive data file. This requirement would apply to all currently rated securities or obligors as well as to all future credit ratings. <u>AFP supports this proposal.</u>

Since our first survey on this topic in 2002, AFP has argued that the best path to more credible and reliable credit ratings is a more competitive market. *The Credit Rating Agency Reform Act of*

2006 removed a major hurdle to improved competition by providing an easier path for new rating agencies to enter the market. One of the other prerequisites of a competitive market is the wide availability of information about the quality and price of all competing products. Requiring that all market participants be given access to this information in a timely manner, without causing undue harm to any NRSRO's business model (e.g., subscription services), will be a meaningful step in furthering competition in the credit ratings market.

The Commission has proposed that these records be made publicly available no later than six months after a rating action. It is certainly desirable that all market participants have access to this information as early as possible to allow them to make informed decisions about which NRSROs are issuers of credible and reliable ratings. However, the Commission should strongly consider the input of those NRSROs with a subscription-based model when determining the appropriate delay before making rating actions publicly available. It is important that the Commission not inadvertently codify the issuer-pays model as the only viable business model, as this would significantly erode the potential benefits of a competitive market.

Rule 17g-2: A Record of Material Deviation from Model Output

The Commission is proposing to require NRSROs to record the rationale for any material difference between the credit rating implied by a model and the final credit rating issued. The Commission has proposed this requirement where "a quantitative model is a substantial component in the process of determining the credit rating." AFP supports this proposal.

We also urge the Commission to consider whether there are instances where a deviation from a qualitative component of an NRSRO's published methodology should be recorded in the same fashion. While it would be difficult to determine deviation from those parts of a methodology that are subjective in nature, it is not difficult to determine when a qualitative component of a methodology was not used at all. For example, if an NRSRO's published methodology relies upon significant interaction with an issuer's management and the NRSRO is not granted access to management or access to management is limited, as in the case of an unsolicited rating, the resulting rating would be missing a "material component" of the methodology. Recording the rationale used to address the omission of this component of the published methodology "would make it easier for the Commission to review whether the procedures were followed."

Rule 17g-2: Records Concerning Third-Party Analyst Complaints

The Commission is proposing to add a requirement that an NRSRO retain records of any complaints regarding the performance of a credit analyst in determining credit ratings. The Commission believes that this information would be helpful in reviewing how NRSROs address conflicts interest that could impair the integrity of their credit rating processes. AFP supports this proposal.

The Commission gives as an example a situation where an NRSRO responds to a complaint from an issuer "that an analyst is too conservative by removing the analyst from the responsibility of rating the securities" of the issuer and "assigning a new analyst that is more willing to determine credit ratings desired" by the issuer. Clearly, behavior by issuers or NRSROs such as that outlined above would lead to ratings that are neither credible nor reliable.

It is important to recognize, however, that there are also legitimate reasons for an issuer to request a change in the analyst assigned to the company, which could include inadequate knowledge of the issuer's industry, lack of familiarity with the type of security being rated, or generally poor performance. AFP believes that disclosure, rather than prohibition, of such requests or complaints is an appropriate way to address the potential for rating manipulation.

Form NRSRO: Enhanced Ratings Performance Measurement Statistics on Form NRSRO

The Commission is proposing amendments to Rule 17g-2 to improve the quality of information available to market participants to assess the credibility and reliability of credit ratings. The first amendment would require the disclosure of separate sets of default and transition statistics for each asset class of credit rating. The Commission is also proposing that these statistics be broken our over one, three and 10-year periods. The amendments would also replace the phrase "downgrade and default rates" with "ratings transition and default rates" to clarify that both downgrades and upgrades should be included in reported performance statistics. Finally, the Commission is proposing that default statistics be reported relative to a security's initial rating and must show defaults that occur after a credit rating is withdrawn. <u>AFP supports each of these proposals.</u>

As previously stated, improving the quality of information available to market participants is a critical step in creating a more competitive market for credit ratings. Recent experience has demonstrated that the meaning of credit ratings can vary significantly from asset class to asset class and over different periods of time, so the availability of performance measurements for each of these asset classes and time frames is critical to the ability of market participants to make informed decisions. Readily available information, accompanied by the improved market access for new competitors that was accomplished by the *Credit Rating Agency Reform Act of 2006*, will stimulate competition, improve transparency and allow investors to determine which credit rating agencies are truly capable of issuing credible and reliable ratings.

Form NRSRO: Enhanced Disclosure of Ratings Methodologies

The Commission currently requires that a rating agency applying to register as an NRSRO provide information regarding the procedures and methodologies used by the firm to determine credit ratings. This information must be "sufficiently detailed to provide users of credit ratings with an understanding of the procedures and methodologies." At present, the information must include "descriptions of the NRSRO's policies for determining whether to initiate a credit rating; the public and non-public sources of information used in determining credit ratings, including information and analysis provided by third-party venders; and the quantitative and qualitative models and metrics used to determine credit ratings." The Commission is proposing to require that NRSROs disclose how frequently credit ratings are reviewed, whether the methodology used for reviewing ratings is different from the methodology used for determining an initial rating, whether changes made to the methodology for determining initial ratings are applied retroactively to existing ratings, and whether a changes made to the methodology for either initial ratings or rating reviews are incorporated into the other methodology. <u>AFP supports this proposal</u>.

Each of these additional pieces of information will add transparency and credibility to the credit rating process, allowing investors to evaluate the diligence with which each NRSRO scrutinizes existing ratings and rating methodologies. As recent market events have reinforced, ratings that

are not maintained based on an effective methodology cannot be considered credible and reliable. Market participants should have access to information that allows them make a proactive assessment of an NRSRO's surveillance process rather than discovering that it is flawed through adverse events.

Rule 17g-3: Report of Credit Rating Actions

The Commission is proposing that NRSROs be required to provide an additional annual report of the number of credit rating actions (e.g., upgrades, downgrades, placements on watch for an upgrade or downgrade) during the fiscal year in each class of credit ratings for which the NRSRO is registered with the Commission. The Commission has indicated that "large spikes in ratings actions within a class of credit ratings could indicate the processes for determining the ratings may be compromised by inappropriate factors." The Commission goes on to state that while a large number of actions in a particular class of assets could be the result of "macroeconomic factors broadly impacting the rated obligors or securities," this could also "be a signal that the process for rating and monitoring ratings in the impacted class has been compromised by improper practices such as failing to adhere to disclosed and internally documented ratings procedures and methodologies, having prohibited conflicts, failing to establish reasonable procedures to manage conflicts, or engaging in unfair, coercive, or abusive conduct." AFP supports this proposal.

AFP is encouraged that the Commission is looking for ways to more easily identify the existence of conflicts of interest and unfair, coercive or abusive practices. It is our hope that if the Commission identifies this type of activity now or at any time in the future, it will be fully prepared to immediately respond by taking appropriate enforcement action against any NRSRO that has failed to establish, monitor or adhere to procedures to prevent these practices. We urge the Commission to exercise the full authority granted to it by the *Credit Rating Agency Reform Act of 2006* by placing limitations on, suspending, or revoking the registration of any NRSRO that has been shown to have condoned or failed to prevent such activities. If the Commission believes it lacks such authority, is unclear about the process that it would follow for revoking, suspending or limiting a registration, or would be hesitant to act due to questions about the regulatory or capital markets impact of such a revocation, we strongly urge that this be addressed proactively rather than when such a situation arises.

Proposed New Rule 17g-7: Special Reporting or Use of Symbols to Differentiate Credit Ratings for Structured Finance Products

The Commission is proposing that an NRSRO "be required to publish a report describing how the credit ratings procedures and methodologies and credit risk characteristics for structured finance products differ from those of other types of rated instruments such as corporate and municipal debt securities" each time it publishes a credit rating for a structured finance product. Alternatively, an NRSRO "would be allowed to use ratings symbols for structured finance products that differentiated them from the credit ratings for other types of debt securities." The proposal is intended to make investors aware "that there are different rating methodologies and risk characteristics associated with structured finance products." AFP opposes this proposal.

In AFP's *Code of Standard Practices for Participants in the Credit Rating Process*, which was published in April 2004, AFP and other global finance associations stated that "regulators should

not prescribe methodologies that CRAs may use, but require that each CRA document and adhere to its chosen, published methodologies." We believe that the enhanced disclosure of ratings methodologies proposed by the Commission should provide sufficient detail for each asset class of credit rating for which a credit rating agency is seeking NRSRO registration to allow market participants to make an informed decision about the veracity of all published ratings, not just those of structured finance products.

As previously mentioned, the reform of the credit ratings market should not be unduly focused on the structured finance market. Market participants deserve a full understanding of methodologies for ratings of all asset classes and rating variations. The procedures and methodologies submitted by rating agencies seeking NRSRO registration should address any unique aspects of the rating process for not only structured finance products, but also corporate and municipal debt and unsolicited ratings. If the published methodologies meet these criteria and are readily accessible to investors, AFP believes it is unnecessary and burdensome to require an NRSRO to publish the proposed report on differences in methodologies and procedures each time it issues a rating. Users of credit ratings must take some responsibility for understanding how a rating was developed to determine whether it meets their needs.

AFP also opposes any requirement that rating agencies be required to use different ratings symbols for structured finance products. The *Credit Rating Agency Reform Act of 2006* stated that "neither the Commission nor any State (or political subdivision thereof) may regulate the substance of credit ratings or the procedures and methodologies by which any nationally recognized statistical rating organization determines credit ratings." We believe that mandating different symbols for different asset classes encroaches on the independence of each rating agency's methodologies. Further, it is unnecessary if the methodology and procedures submitted for each asset class for which a rating agency is seeking NRSRO registration are sufficiently detailed to inform market participants. These published methodologies and procedures, coupled with an explanation of any symbol or quantitative measure used in assigning ratings for each asset class and the enhanced ratings performance measurement statistics proposed by the Commission, will allow a prudent investor to make an informed decision about whether to rely upon a rating.

We appreciate the opportunity to comment on the proposed rules. If you have any questions, please contact Jeff A. Glenzer, CTP, Managing Director, at (301) 961-8872.

Sincerely,

James A. Kaitz
President and CEO