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APPROACHES TO IMPROVING CREDIT RATING AGENCY REGULATION

HEARING

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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APPROACHES TO IMPROVING CREDIT RATING AGENCY REGULATION

Tuesday, May 19, 2009

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS,
INSURANCE, AND GOVERNMENT
SPONSORED ENTERPRISES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 2:08 p.m., in room 2128, Rayburn House Office Building, Hon. Paul E. Kanjorski [chairman of the subcommittee] presiding.

Members present: Representatives Kanjorski, Ackerman, Sherman, Capuano, McCarthy, Baca, Scott, Klein, Perlmutter, Donnelly, Wilson, Foster, Minnick, Grayson, Himes; Garrett, Castle, Royce, Biggert, Hensarling, Gerlach, Neugebauer, and Jenkins.

Ex officio present: Representative Bachus.

Chairman KANJORSKI. This hearing of the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises will come to order. Pursuant to committee rules, each side will have 15 minutes for opening statements. Without objection, all members' opening statements will be made a part of the record.

Today we meet to examine the operations of credit rating agencies and approaches for improving the regulation of these entities. Given the amount of scrutiny that these matters have garnered in recent months, I expect that we will have a lively and productive debate.

The role of the major credit rating agencies in contributing to the current financial crisis is now well documented. At the very best, their assessments of packages of toxic securitized mortgages and overly complex structured finance deals were outrageously optimistic. At the very worst, these ratings were grossly negligent.

In one widely reported internal e-mail exchange between two analysts at Standard and Poor's in April of 2007, one of them concludes that the deals "could be structured by cows and we would rate it." I therefore fear that in many instances the truth lies closer to the latter option, rather than the former possibility.

Moreover, if we were to turn the tables today and rate the rating agencies, I expect that most members of the Capital Markets Subcommittee would agree that during the height of the securitization boom, the rating agencies were AA, if not AAA failures. Clearly, they flunked the class on how to act as objective gatekeepers to our capital markets.

Along with the expressions of anger, outrage, and blame that we will doubtlessly hear today, I hope that we can also explore serious proposals for reform. Unless we can find a way to improve the accountability, transparency, and accuracy of credit ratings, the participants in our capital markets will discount and downgrade the opinions of these agencies going forward.

One could hope that the agencies would do a better job in policing themselves. But if past is prologue, we cannot take that gamble. This time their failures were not in isolated, case-by-case instances. Instead, they were systemic problems across entire classes of financial products and throughout entire industries. Stronger oversight and smarter rules are therefore needed to protect investors and the overall credibility of our markets.

As a start, the rating agencies must face tougher disclosure and transparency requirements. For example, investors receive too little information on rating methodologies. The financial crisis has illustrated the danger flawed methodologies pose to the system. If methodologies remain hidden, there exists no check by which to expose their weaknesses.

In addition to establishing an office dedicated to the regulation of rating agencies within the Securities and Exchange Commission, oversight must also focus more intently on surveillance of outstanding ratings. The industry has done an inadequate job of downgrading debt before a crisis manifests or a company implodes. Moreover, we must examine how we can further mitigate the inherent conflicts of interest that rating agencies face.

In this regard, among our witnesses is a subscriber pay agency. This alternative model is worthy of our consideration. At one time, all rating agencies received their revenues from subscribers, but they evolved into an issuer pay model in response to market developments. I look forward to understanding how a subscriber pay agency succeeds in today's marketplace.

Additionally, the question of rating agency liability is of particular interest to me. The First Amendment defense that agencies rely upon to avoid accountability to investors for grossly inaccurate ratings is generally a question for the courts to determine, but Congress can also have its say on these matters. Much like the other gatekeepers in our markets, namely lawyers and auditers, we could choose to impose some degree of public accountability for rating agencies via statute. The view that agencies are mere publishers issuing opinions bears little resemblance to reality, and the threat of civil liability would force the industry to issue more accurate ratings.

In sum, the foregoing financial crisis requires us to reevaluate how rating agencies conduct their business, even though we enacted the Credit Rating Agency Reform Act just 3 years ago. As this Congress considers a revised regulatory structure in a broader context, this segment of our markets also needs to be examined and transformed. By considering proposals aimed at better disclosure, real accountability, and perhaps even civil liability, we can advance that debate today and ultimately figure out how to get the regulatory fit just right.

Now, I will recognize the gentleman from New Jersey for 5 minutes.

Mr. GARRETT. And I thank the chairman for holding this important hearing today.

I believe it is critical, as he says, that this subcommittee conduct proper oversight of the credit rating agencies and examine all of the issues surrounding the role that they played, if any, in the lead-up to the Nation's current situation.

I would like to thank all the witnesses of the panel attending. Unfortunately, we don't have a representative from the SEC. That's the government agency tasked with overseeing and regulating the NRSROs here with us to testify.

And so I feel it's essential that before this committee does formally consider any regulatory reforms regarding the rating agencies, that we should at some point hear directly from the SEC, as to what, if any, additional powers or changes they see necessary.

Over the past decade, we have seen a large increase in the role that credit rating agencies have in determining the creditworthiness of financial institutions and different type of securities. Whether it is corporate, municipal, or structured finance, any entity seeking to assure investors of the quality of the debt must receive a good grade from one of these entities.

And so investors have become increasingly, and too often solely, reliant on the use of these ratings in determining the safety and soundness of an investment. This situation, like many of the other problems of this financial crisis, has, in large part been created by government policy itself.

For literally hundreds of Federal and State government statutes and regulations, there are specific government requirements mandating certain grades from approved agencies. It is this formal requirement that provides an implicit stamp of approval, if you will, to the investors.

When an investor sees that the government has required a specific grade to make a "safe investment," it basically reinforces the belief that any investment attaining such a grade is a safe investment.

But to its credit, the SEC recognizes this problem, as well, and they are moving to address it. So in December of last year, the SEC proposed several new rules, one of which would reduce the reliance on the NRSROs' ratings in the SEC's regulations.

I believe it was Commissioner Casey who had it right when she said, "These requirements have served to elevate NRSRO ratings to a status that does not reflect their actual purpose, much less the limitations of credit ratings."

So Congress really should try to follow suit and reexamine all the areas where statutes mandate the ratings of NRSROs. Credit ratings are only one piece of the puzzle—I think we'll hear that from the panel—in determining creditworthiness. Investors must be encouraged to do their own due diligence in evaluating issuer credit quality.

Now, one of the other areas that needs to be addressed is increased competition within the industry, and I hear from the panel that they may be amenable to that, as well.

The 2006 Act made a number of significant improvements to the process. Unfortunately, the law was just beginning to be implemented at the time when the financial system started to hemor-

rhage; and the very worthwhile goals of the 2006 laws, as far as fostering more competition, enhancing transparency, and increasing accountability may still be achieved.

So two things I do not think Congress or the SEC should do are to eliminate specific types of pay models or prescribe exact analytics that NRSROs must use. This would go against the intent of the legislation by providing a further reduction in competition and increasing investor reliance on the ratings.

In regards to competition, a recent rule issued that also runs contrary to the goals of 2006 is from the Fed, the requirement that any securities used as collateral in their Term Asset-Backed Securities Loan Facility, the TALF, must have an A-1 rating from a major NRSRO. So this major NRSRO term is entirely new and refers to the Big Three rating agencies.

While I assume that the Fed added this requirement due to the perceived better quality of the Big Three firms, I would remind the Fed that the Big Three rated Lehman, unfortunately, as A-1 on the day of bankruptcy.

Another area in which I would like to see increased competition is the manner in which credit quality is determined.

And I know that some of my friends on the committee would like to demonize credit default swaps as a horrific gambling bet made by fat cats smoking cigars and sitting in luxurious boardrooms, but the fact of the matter is, credit default swaps are actually additional measures of assessing the creditworthiness of different corporations or securities, and during the height of the financial panic and collapse of many major firms, credit default swaps provided a more accurate gauge or risk that some of the credit rating agencies.

So in conclusion, Mr. Chairman, I believe that the government must continue to wean investors off being solely reliant on credit ratings and encourage them to conduct their own more due diligence.

I do greatly appreciate the chairman holding this very important hearing, and I look forward to all the witnesses' testimony today.

Thank you.

Chairman KANJORSKI. Thank you very much, Mr. Garrett.

You have heard the bells. We have about 5 minutes remaining on the first vote. There are three votes. We estimate it will take us about 25 minutes.

So we will stand in recess until we complete those votes and reassemble here immediately thereafter.

[recess]

Chairman KANJORSKI. The committee will reconvene.

I now recognize the gentleman from New York, Mr. Ackerman, for 3 minutes.

Mr. ACKERMAN. Thank you, Mr. Chairman.

This is not the first time that the committee has explored the role and the future of credit rating agencies in our financial system.

Time and again, we have heard from the agencies that their ratings were really sound, despite the billions of dollars in losses that investors realized on so-called AAA rated mortgage-backed securities.

I would disagree with them. For mortgage-backed securities to collateralized debt obligations and the structured finance market, the bond markets, the types of products that receive inaccurate ratings in the markets in which those products were traded are far too vast to support the argument that the overly favorable ratings of 2006 and 2007 were just a fluke. Clearly, a systemic approach to the ratings process is needed.

Mr. Castle and I have introduced legislation that would institute such an approach. The bill, H.R. 1181, would require the SEC to promulgate rules that would determine the types of structured finance investments that are eligible to receive NRSRO ratings from credit rating agencies that have been designated as nationally recognized statistical rating organizations.

The bill also defines the credit rating agency to which NRSRO-rated finance products must adhere. You cannot accurately predict performance of newer products that have no long-term track records. That doesn't mean that you can't sell them.

To be clear, we do not want to stifle creativity, and nothing in our bill restricts the ability of originators to continue to securitize less predictable or riskier products.

The legislation permits NRSROs to continue to provide ratings for securities that do not meet the proposed NRSRO criteria, as long as they are not designated as NRSRO ratings. These, you know, are the ratings upon which pension fund managers, who are collectively tasked with managing the nest eggs of millions of Americans, rely.

I'm also concerned by the assertion of many of the credit rating agencies that their ratings are mere opinions, and therefore, are protected by the First Amendment.

Of course, I might be more inclined to support the agencies' position if the companies didn't have an implied government license, and by their financial relationships with issuers. In my view, the often inappropriately favorable ratings that the agencies assign to products issued by their clients amounts to nothing more than paid advertisements and endorsements, not an expression of opinion.

I hope that the subcommittee will continue to work towards restoring transparency and objectivity to the credit rating agencies, as the future of our financial markets depends upon it.

I look forward to hearing from our expert witnesses, and I yield back the balance of my time.

Chairman KANJORSKI. The Chair recognizes Mr. Bachus for 3 minutes.

Mr. BACHUS. I thank the chairman.

It's not normally my tendency to be overly critical, but I'm going to make an exception in this case.

I think surely everyone now recognizes that the credit rating agencies have failed, and failed spectacularly and broadly. Inaccurate rating agency risk assessments are one of the fundamental factors, in my opinion, in the global financial crisis, and effective correction action must address these shortcomings.

As Mr. Ackerman alluded to, the rating agencies say that these assessments or ratings are opinions, predictive opinions, and I think from a legal standpoint, that's true. But in the real world, that's not reality.

The SEC special examination report of the three major credit rating agencies uncovered significant weaknesses in their rating practices for mortgage-backed securities, and also called into question the impartiality of their ratings.

As the SEC report detailed, the rating agencies failed to accurately rate the creditworthiness of many structured financial products. Investors and the government both over-relied on these inaccurate ratings, which undoubtedly contributed to the dramatic collapse of the United States and its financial market, or near-collapse.

In order to avoid future meltdowns, we must return to a time where the rating agencies are not deemed a valid substitute for thorough investor due diligence. My own view is that while the SEC report did not address municipal securities, the rating agency practices were also significant factors in the problems that plagued municipal issuers.

The Federal Government must also share the blame for fostering over-reliance on rating agencies. The Federal Reserve's recent designation of certain rating agencies as major nationally recognized statistical rating organizations implies a government stamp of approval that does not exist.

What we have is what I would call, and others have called, a government-sanctioned duopoly. I think that's a mistake.

As we move forward with regulatory reform proposals, the committee should consider removing from Federal laws, regulations, and programs all references that require reliance on ratings. The SEC also should take action to remove similar references in its own rules as quickly as possible.

At a minimum, the committee should consider changing NRSROs from nationally recognized to nationally registered statistical rating organizations, to further reduce the appearance of government support or approval.

As Mr. Garrett said, I think credit swap derivatives have been an accurate predictor of credit risk, and more so than credit ratings, and the credit ratings have become almost—well, I won't go into all that, but what I would say, this should give us caution in discouraging the use of credit default swaps, and it's critical that this committee doesn't restrict these CDS contracts in the marketplace as we consider broader regulatory reform.

Let me close by saying, to say what has occurred in the marketplace since 2006 has been volatile and frightening is an understatement. Correcting inadequacies of the credit rating process is absolutely essential to restoring investor confidence.

There must be further changes in the current rating system to respond to very serious concerns expressed by investors, market participants, and policymakers alike.

I look forward to hearing from the witnesses concerning these matters.

Thank you, Mr. Chairman.

Chairman KANJORSKI. Thank you, Mr. Bachus.

Next, we will hear from Mr. Castle for 2 minutes.

Mr. CASTLE. Thank you, Mr. Chairman.

Credit rating agencies occupy a very important place in the world of finance, as we all know. Therefore, I think this committee needs

to more fully understand things about the industry and its practices.

Our present circumstance leads us to many questions.

How did the agencies repeatedly miss the mark on structured finance products only to have to lower ratings or watch a record number of these products default?

What experience in history did the agencies have with some of the products they were rating, and even if their ratings were accurate, were subsequent downgrades made public fast enough?

What about the relationship the agencies have with company management, representatives of the same businesses or products they are engaged to rate?

Investors, governments, broker dealers, investment banks, and others all rely upon credit rating agencies to more precisely understand credit risk. They have to do a first-rate job, Mr. Chairman. However, in some instances, they are the problem, or at the very least, part of the problem, and need to become part of the solution.

I recently joined Representative Gary Ackerman, who just spoke to this, and reintroduced legislation that proposes reforms for the industry.

Under H.R. 1181, credit rating agencies would only be able to give an official rating to asset-backed securities that have been sufficiently tested with a proven track record or where their performance can be reasonably predicted.

The SEC would have the authority to strip nationally recognized statistical rating organizations of their NRSRO designation if the rating agency fails to comply with provisions set forth in the legislation.

We need to address this problem as part of our efforts to reform the financial system to ensure financial products are adequately examined and restore investor confidence.

I thank you, Mr. Chairman, and I yield back.

Chairman KANJORSKI. The gentleman from California, Mr. Royce, is recognized for 2 minutes.

Mr. ROYCE. Thank you, Mr. Chairman.

You know, the extent to which our entire financial system was and continues to be dependent upon the grades issued by NRSROs is really remarkable. Rating agency grades are incorporated into hundreds of rules, laws, and private contracts, and that affects banking, insurance, mutual funds, and it affects pension funds.

By making the agencies' opinions count toward determining whether banks had an adequate amount of capital in essence gave their opinions a quasi-official status, basically, from the government.

And considering how badly the rating agencies misjudged the risks in recent months, the quasi-official treatment of their opinions should be reevaluated.

The Federal Government's over-reliance on the rating agencies compounds the market-wide perception that these ratings are in some way more than just opinions, and are, in fact, the best indicators of risk.

This signal to the market lessens the perceived need for counterparty due diligence that a well-functioning market requires.

Both our over-reliance on the major rating agencies and the poor performance of these entities during the recent market downturn has led me to believe that major reforms to the industry are needed.

I believe Congress should focus on encouraging alternative tools to assess potential gains or losses, which would enable consumers and institutions to better comprehend investment risk.

Further, Federal regulators should reevaluate their dependence on these ratings before the Federal Government is asked, once again, to dedicate another $13 trillion due to the economic consequences of this lack of foresight.

And Mr. Chairman, again, I thank you for this important hearing, and I yield back the balance of my time.

Chairman KANJORSKI. Thank you very much, Mr. Royce.

Mr. Capuano, for 3 minutes.

Mr. CAPUANO. Thank you, Mr. Chairman.

Mr. Chairman, first of all, thank you for having this hearing, and I'm looking forward to both this testimony and actually moving some legislation further in the year.

I haven't been able to go through all the testimony here before me, but I know there has been a lot of talk by some that somehow the freedom of speech amendment allows people to say and do anything they want, and I would respectfully disagree.

I consider myself a major defender of the First Amendment, and I would do whatever I can to maintain the freedom of speech. However, I don't think freedom of speech applies when you are getting paid. When you are getting paid, you should be held to a higher standard. And if you want freedom of speech, stop getting paid, write an op-ed in the paper, not a problem. Say whatever you want. People can listen to you, or not listen to you. That's all well and good.

But when your words can and do, number one, ask people to rely on you and, number two, move markets, I do think you should be held to—I think it's unequivocal that you should be held to a certain standard. What that standard is, I think that's fair.

I don't think it's fair to say that people can't be wrong. Everybody can and is wrong, on a regular basis, and it is a hard thing to distinguish between what is simply an appropriate and fair and reasonable error of judgment versus some other action that might require some reaction.

So anyway, I'm looking forward to this hearing, Mr. Chairman. I thank you very much for doing this, and I actually look forward to being able to improve the market for investors and to make it so that people can actually rely on the opinions of the credit rating agencies.

Chairman KANJORSKI. Thank you very much, Mr. Capuano.

The gentleman from Texas, Mr. Hensarling, is recognized for 2 minutes.

Mr. HENSARLING. Thank you, Mr. Chairman.

We know there are a number of causes of our Nation's economic turmoil. Most have their genesis in flawed public policy.

To state the obvious, the three major credit rating agencies missed the national housing bubble. This doesn't necessarily make

them duplicitous, doesn't necessarily make them incompetent, but it does make them wrong—very, very wrong.

Unfortunately, many investors, due to legal imperatives or practical necessity, relied exclusively on ratings from the three largest CRAs, without performing their own conservative due diligence.

We now know that the NRSRO term has been embedded in our law, approximately 10 Federal statues, approximately 100 Federal regulations, roughly 200 State laws, and around 50 State rules.

I believe the failure of the credit rating agencies would not have generated the disastrous consequences that it did had the failure not been compounded by further misguided government policies which effectively allowed the credit rating agencies to operate as a cartel.

By adopting the NRSRO system, the SEC has established an insurmountable barrier to entry into the rating business, eliminating market competition among the rating agencies. People assumed, wrongly, that the government stamp of approval meant accurate ratings.

Now, we took a step in the right direction with the Credit Rating Agency Reform Act of 2006, but it was too little, too late.

There's a vitally important lesson we must all learn regarding implied government backing. We have seen the results from the government stamp of approval on Fannie Mae and Freddie Mac. We now see the results, the impact of denying a competitive market for credit rating agencies.

We must certainly consider this in a development of a potential systemic risk regulator designating specific institutions as too-big-to-fail, creating a self-fulfilling prophecy.

Outcomes in the market cannot and should not be guaranteed by the government. It causes people to become reliant, dependent, and engage in riskier behavior than they otherwise would.

When people believe that the government will perform their due diligence for them on the front end, or will bail them out on the tail end, this is very dangerous for the investor, and disastrous for the Nation.

I yield back the balance of my time.

Chairman KANJORSKI. The gentleman from Georgia is recognized for 2 minutes.

Mr. SCOTT. Thank you very much, Mr. Chairman.

This is a very important and timely hearing.

As we continue to monitor the current economic climate we're in, and look towards solutions and improvements that can be made, I believe that this hearing is very, very timely, as the credit rating agencies did in fact play a considerable role in what has transpired, what will also impact, what transpires in the near future.

Once our financial institutions achieve the desired quality grade on a product, it pays the agency for the rating. This process, as some claim, is rife with conflict, as they believe the agencies are acting as the market regulators, the investment bankers, and as a sales force, all the while claiming to be providing independent opinions. That's it, the problem in a nutshell.

As these organizations are extremely important to the financial world, we should realize they did have a role to play in where we

are now, but I also want to more intently focus on finding some consensus on how to move forward.

These organizations determine corporate and government lending risk, and are an integral part of our financial services sector, and as such, I want to ensure we take all issues into account, including conflicts of interest, as well as the international finance world, in reforming just how we rate financial products.

More examination of these agencies is indeed in order, to evaluate the need for improvement, as many have complained that the rating agencies did not adequately assess the risky nature of mortgage-backed securities.

The credit rating agencies have grown more powerful over the years, maybe more powerful than anyone had really intended.

However, I do look forward to the witnesses' testimony and how their review of and opinions on this subject will shape the committee's further review of this issue.

Thank you, Mr. Chairman.

Chairman KANJORSKI. Thank you very much, Mr, Scott.

We will now hear from the gentlewoman from Kansas, Ms. Jenkins.

Ms. JENKINS. Thank you for holding this hearing today, Mr. Chairman.

I am by no means an expert on the topic of credit rating agencies, so I'm certainly glad that we have this opportunity to learn more about this issue.

The credit rating agencies' role in the economy is a straightforward one. They are to provide independent analysis of the quality of various financial assets.

These agencies, led by Standard and Poor's and Moody's, for quite some time have been relied on by the capital markets to provide independent, meaningful analysis. Investors relied on the supposedly independent ratings, giving these agencies, for investment decisions, where a AAA rating had become the stamp of approval inferring that the investment was a safe one.

Over time, the original business model, where agencies were paid by the investors, was replaced with a model where the agencies were paid by the issuers themselves. Some would say this led to an inherent conflict of interest that led to the financial collapse that we have been witness to.

Others have said that, over time, the agencies became little more than a mirror of the market's assessment of risk of a particular bond, providing minimal additional value.

The question can also be asked whether ratings replaced investor due diligence.

Thank you, Mr. Chairman. I yield back the remainder of my time.

Chairman KANJORSKI. Thank you very much.

And now we will hear from the gentleman from California, Mr. Sherman, for 2 minutes.

Mr. SHERMAN. Thank you.

Most entities will eventually work in their own interest. Patriotic speeches and appeals to patriotism only go so far.

This is an industry that gave AAA to Alt-A, and is as responsible for where we are now as anyone else playing on Wall Street.

Two things create this self-interest. The industry is picked by the issuer, and believes it cannot be sued by the investor. One of those two needs to change.

Now, the public accounting forms are picked by the issuer, but they're subject to lawsuits. The auditing firm that audited WorldCom doesn't exist anymore. And in the old days, they were general partnerships, so 100 percent of all the partners' personal equity would be gone. That provided even more incentive to provide for a good audit.

If we're not going to force the firms to renounce any First Amendment arguments as a condition for doing business on Wall Street, then we need to end the system where they're picked by the issuer. Otherwise, there will be a race to satisfy the issuer by providing the highest ratings to the issuer and we'll get AAA on Alt-A. It won't be mortgages next time, it'll be some other kind of bond. And we'll be back here in another economic crisis.

We don't allow the pitchers to pick the umpires. If we did, the strike zone would go from the ground to well above the head. We cannot allow the issuers to pick the bond-rating agencies or the credit rating agencies unless we're going to then bring in trial lawyers with instant replay cameras. That would assure that the umpires wouldn't cater to the pitchers, if they were subject to lawsuits and instant replay. But one of those two things needs to change, or the fear of God will prevent us from being in this situation with mortgages for a few years, but we'll be back here in another semi-depression with some other kind of credit instrument.

I yield back.

Chairman KANJORSKI. Thank you very much, Mr. Sherman.

I will now introduce the panel, and I want to thank you all for appearing before this subcommittee today.

Without objection, your written statements will be made a part of the record. You will each be recognized for a 5-minute summary of your testimony.

First, we have Mr. Robert Auwaerter, principal and head of the Fixed Income Group, Vanguard.

Mr. Auwaerter.

STATEMENT OF ROBERT F. AUWAERTER, PRINCIPAL AND HEAD OF THE FIXED INCOME GROUP, THE VANGUARD GROUP

Mr. AUWAERTER. Mr. Chairman, and members of the subcommittee, thank you for the opportunity to testify at this important hearing.

I am the head of the Fixed Income Group at Vanguard, which is the world's largest mutual fund company.

Credit ratings provide a useful purpose in the financial markets for the small investor. They act as a way to provide a standardized way for investors to do an initial screen of potential investment choices. For institutional investors, they provide instructions to their managers on how to limit risk.

They also serve a constructive purpose in government regulations, the most prominent being SEC Rule 2-A(7) governing money market funds.

Their NRSRO ratings protect investors by limiting the funds' ability to chase higher yields through riskier securities based on

the funds' own subjective assessment. While NRSRO ratings serve as an objective and necessary qualification for buying a security, on their own, they are not sufficient to warrant an investment.

Importantly, credit ratings are a starting point. Investors must do their own analysis when determining the appropriateness of an investment.

Investors choose Vanguard to invest on their behalf in part because of our ability to employ significant resources toward assessing credit risk in our bond portfolios. In total, Vanguard has 25 senior credit analysts with over 400 years of cumulative industry experience.

It's important to recognize that in order to avoid the mistakes of the past, 100 percent perfection and accuracy in ratings cannot be the goal. However, we believe there's need for further regulation of credit rating agencies.

The focus of these efforts should be on improving the transparency and reliability of credit ratings, while at the same time controlling disclosing the conflicts of interest that exist in all credit rating agency business models.

For example, the ratings process for corporate borrowers must address the need to protect material non-public information from being disseminated.

Currently, issuer-paid credit rating agencies will take material, non-public information, such as management forecasts, into account in the ratings assessment process.

We are concerned that proposals which force full disclosure of all credit rating material from corporate issuers, including non-public information, to all potential credit rating agencies will, in the end, end up limiting disclosure to all credit rating agencies. Under this scenario, we would expect credit ratings to become less reliable, not more reliable.

However, on the other hand, we're in favor of greater and more frequent disclosure by issuers of municipal and structured finance securities. Structured finance, and for that matter, municipal ratings, are impaired by a lack of transparency of key credit rating determinants by the issuer of the security. We would like to see greater transparency and disclosure from the issuers to the investors as a feature of improved regulations.

Regardless of the business model, the ratings product must be subject to very high standards of independence, diligence, and accountability. For that reason, Vanguard supports an increase in the authority of the SEC to provide appropriate oversight of the NRSROs.

Improved regulations and oversight should focus on transparency and reliability of the ratings process. The NRSROs should be subject to regular audits that test compliance to internal procedures, the independence of rating actions, and the diligence of the ratings process.

The goal of these should not be to regulate the actual ratings, but rather, the process by which the rating agencies derive these ratings.

The NRSRO designations should also be limited to CRAs that are in compliance with strict regulatory requirements. There's opinion out there that by inducing greater competition to the CRA market-

place, rating quality will automatically improve. While competition itself can be constructive, it may come at a significant cost.

By artificially leveling the playing field, inducing many new participants, the market will be littered with a wide dispersion of credit ratings for issuers in structured finance transactions.

It's very important in designating a credit rating agency as an NRSRO that the SEC determines there is sufficient analytical and operational resources to perform an appropriate level of independent credit analysis. By definition, NRSROs should have a wide market appeal, and should not be niche rating agencies focusing on narrowly defined segments of the market.

Importantly, under these new rules, the ability to pull an NRSRO designation would provide a powerful incentive for compliance.

Regulators should finally consider creation of a standing advisory board comprised of key rating agency constituents. It could serve an important role in providing feedback on new product types, ratings performance, and regulatory proposals to both the credit rating agencies and the appropriate regulators.

In summary, we think the credit rating agencies serve a useful purpose in the market and in government regulations, and we support an increase in authority of the SEC to provide oversight to ensure that credit rating agencies have the appropriate resources and procedures to deliver a ratings product that meets very high standards of independence, diligence, and accountability.

Thank you.

[The prepared statement of Mr. Auwaerter can be found on page 54 of the appendix.]

Chairman KANJORSKI. Thank you very much, Mr. Auwaerter.

Next, we will hear from Mr. Robert Dobilas, president and chief executive officer of Realpoint, LLC.

Mr. Dobilas.

STATEMENT OF ROBERT G. DOBILAS, PRESIDENT AND CHIEF EXECUTIVE OFFICER, REALPOINT, LLC

Mr. DOBILAS. Thank you for the opportunity to participate in this hearing.

The rating agency legislation passed by Congress in 2006 was an important step forward. It greatly improved the regulatory process by which a rating agency can receive a national designation from the SEC, and it has in fact increased the number of competitors.

But given the worldwide collapse of the credit markets, and the loss of trillions of dollars by individuals, companies, and governmental entities, it is now clear that Congress needs to take further action addressing the conflicts of interest which have arisen in the context of having rating agencies paid by the corporations whose debt they are evaluating.

As the Congressional Oversight Panel has stated, the major credit rating agencies played an important and perhaps decisive role in enabling and validating much of the behavior and decisionmaking that now appears to have put the broader financial statements at risk.

Realpoint uses a different business model than S&P, Moody's, and Fitch. We are an independent, investor-paid business, which

means our revenues come from investors, portfolio managers, analysts, broker dealers, and other market participants who typically buy a subscription to our services.

We produce in-depth monthly rating reports on all current commercial mortgage-backed securities. Moody's, S&P, and Fitch, on the other hand, are paid by the issuers of the securities. They are paid substantial upfront fees on a pre-sale basis by the corporations selling securities or investment banks which are underwriting the sales. The fees can exceed $1 million in a single transaction.

In a word, the results of the issuer-paid business model have been miserable. The SEC recently published data showing that Moody's has had to downgrade 94.2 percent of all the subprime residential mortgage-backed securities it rated in 2006. This is the equivalent of a major league baseball player striking out 19 out of 20 times at bat. We see a similar trend developing now in the CMBS market.

In contrast, Realpoint's ratings were lower from the outset, and have proven to be more stable than those of the issuer-paid agencies. Even during these unprecedented times, downgrades at Realpoint are less than 30 percent on all current CMBS transactions, and have generally taken place 6 to 12 months sooner than the corresponding rating actions taken by other rating agencies.

The core problem with the issuer-paid system, and the most important message I would like to leave with the subcommittee today, is that the integrity of the rating process is undermined by the pervasive practice of rating shopping.

When an issuer decides to bring a new security to market, it generally begins the process by providing data to the three rating agencies. The three rating agencies are more than willing to provide preliminary levels on ratings, knowing that the issuer will tend to hire the agencies that provide the highest ratings.

We hear a lot about complexities of modern finance, but the rating process is hardly complex. The solution is equally simple, and it only takes one step. Let all the designated rating companies have the same information and prepare their own pre-sell ratings, regardless of whether or not they are ultimately paid by issuers or by investors.

In our view, there is simply no better or more straightforward way to enhance the integrity of the ratings process than to share the information with all agencies which the SEC has deemed as worthy of being a nationally recognized agency. In fact, the SEC has already proposed precisely such a rule, through an amendment to its fair disclosure rules.

The public benefits of taking this simple step are immediate and manifestly obvious.

Last year, the Federal Reserve began implementing the Term Asset-Backed Securities Loan Facility, or TALF Program. Initially, the ratings component of TALF was limited to Moody's, S&P and Fitch.

We are pleased to learn that the Federal Reserve is now taking steps to increase the number of rating agencies eligible to participate in this program. As a matter of fact, we just learned that Realpoint and DBRS are now part of the TALF program.

We believe that this will increase competition and lead to more accurate ratings behind the taxpayer guarantees which stand behind these programs.

TALF and other comparable programs utilize the standard industry practice of requiring two ratings in order for securities to be deemed suitable collateral. There is likewise no valid public policy reason for not insisting that at least one of these ratings be an independent investor-based rating.

In this manner, the TALF program serves not only as a catalyst for restarting the securitization market, but as a vanguard to reform the credit rating industry.

A mandate to have TALF and other government assisted programs utilize the ratings of at least one independent rating agency would enhance investor confidence in those programs and set the stage for ultimately resurrecting reliable ratings in the private sector.

In short, the American taxpayers should not be subject to the same failed rating shopping syndrome I described earlier.

In conclusion, the integrity of the ratings process is deeply flawed, but this is not a complex problem, and, in fact, it is not that different from when we were all in high school and everyone sought out the teachers who were known as easy graders.

We simply need to put an end to the rating shopping process that encourages issuer-paid rating agencies to inflate their ratings.

Thank you very much for your time.

[The prepared statement of Mr. Dobilas can be found on page 58 of the appendix.]

Chairman KANJORSKI. Thank you very much, Mr. Dobilas.

We will now next hear from Mr. Eugene Volokh, Gary T. Schwartz professor of law at UCLA School of Law.

Mr. Volokh.

STATEMENT OF EUGENE VOLOKH, GARY T. SCHWARTZ PROFESSOR OF LAW, UCLA SCHOOL OF LAW

Mr. VOLOKH. Mr. Chairman, members of the committee, thanks very much for having me here.

I was asked to provide an objective First Amendment analysis of the free speech issues raised by regulation of, and liability for, the speech of ratings agencies.

I am a scholar of the First Amendment. I am not a scholar of commercial law. And I will try to stick to what I think the First Amendment law sets forth, without opining on what I think is sound financial policy here.

So my first point is that the ratings issued by rating agencies are, generally speaking, speech of the sort that is presumptively protected by the First Amendment. They are predictive opinions based on factual investigation, and based on some degree of expertise.

In that respect, they are quite similar to the work product of investment newsletters, or, for that matter, of the financial pages of well-respected newspapers. Those, too, offer predictive opinions based on factual investigation with some degree of expertise on the part of the author.

Now, those, too, are for-profit entities, or at least they try to be for-profit entities. This does not strip them of First Amendment protection. The First Amendment protection has long been understood as covering for-profit entities. In fact, otherwise, newspapers, magazines, movie studios, all of them would be constitutionally unprotected.

To be sure, rating agencies are particularly, or at least were particularly respected, and their speech was found particularly valuable, but the fact that speech is especially valuable generally does not diminish the scope of First Amendment protection that is offered it, and the fact that people rely on that speech, generally speaking, does not diminish the scope of First Amendment protection.

So, generally speaking, the First Amendment is presumptively in play here. That is not just my view. That is the view of the Federal circuit courts that have considered this issue in the related context of libel lawsuits by the ratees against the rating agencies. The Sixth and the Tenth Circuits have spoken to this very issue, and have said this speech is generally protected by the First Amendment.

Now, to be sure, not all such speech ends up being protected by the First Amendment. So, for example, if an agency is actually paid to issue a favorable report, not just issue a report, but issue a favorable report, that would probably make it commercial advertising, which is much less protected under the First Amendment, much as if a newspaper were paid to write a favorable article about a company—which I believe is considered quite unethical in newspapers, though I am told that it is not uncommon in fluff entertainment magazines and the like—that would presumably be commercial advertising.

The fact, though, that there is a payment being made not for the positive review, but a payment being made by a company to the subject of the review, does not make the review commercial advertising. Newspapers routinely take advertising from the very same companies whose products they review, and there is some degree of possible pressure to bias the reviews in this respect. If you want to keep getting advertising from Ford, you may want to write positive reviews of Ford, counteracted by the desire to maintain the value of the newspaper's own brand. But generally, while that risk may lead some papers to be very careful about such practices, those payments do not strip speech of full protection.

Likewise there are certain situations in which a company may be hired specifically to give personalized advice to an investor, much like an accountant or a lawyer or a psychotherapist or what have you could be hired to give personalized advice to a client. That would presumably fit the speech into the category of professional-client speech, which is much less protected. And that might, in fact, describe what some rating agencies do in certain circumstances. There are some cases in which rating agencies have been found to do just that.

But, generally speaking, the fact that they are professionals who offer expert commentary does not make them subject to this kind of restriction. So long as they are speaking to the world at large, and they are not addressing their advice to the personalized cir-

cumstances of a particular person whom they are counseling, their speech generally remains fully constitutionally protected.

So such speech would likely be protected categorically to the extent it is treated as a matter of opinion, and would likely be protected under the *New York Times* v. *Sullivan* actual malice standard, to the extent that it implies specific, verifiable facts. That means that it wouldn't be judged by a negligence standard, but rather by whether the ratings agencies knew the statements were false or likely to be false. Again, there is lower court case law on that very point.

So those, I think, are the constraints in direct regulation or litigation against rating agencies.

However, say that the government chooses to say, we will give some special status to certain agencies on condition that, for example, they don't take money from the companies that they rate, or that they only take money from subscribers, and if they don't want to be subject to those conditions, they are free to express their opinions but they will not get this special government-provided status.

That kind of restriction on agencies that are given this specialized status as a condition of getting that status would probably be constitutionally permissible.

Thank you.

[The prepared statement of Professor Volokh can be found on page 123 of the appendix.]

Chairman KANJORSKI. Thank you very much.

We will now hear from Mr. Stephen W. Joynt, president and chief executive officer of Fitch, Incorporated.

Mr. Joynt.

STATEMENT OF STEPHEN W. JOYNT, PRESIDENT AND CHIEF EXECUTIVE OFFICER, FITCH RATINGS

Mr. JOYNT. Thank you, Chairman Kanjorski, Ranking Member Garrett, and members of the committee.

I would like to spend just a few minutes summarizing my prepared statement.

Nearly 2 years has passed since the onset of the credit crisis. What began as stress focused on the global capital markets has evolved into a more severe economic slowdown.

An array of factors have contributed to this, and these have been broadly analyzed by many market participants, the media, and within the policymaking and regulatory communities.

During this time, the focus of Fitch Ratings has been on implementing initiatives that enhance the reliability and transparency of our ratings. More specifically, we are vigorously reviewing our analytical approaches and changing ratings to reflect the current risk profile of securities that we rate.

In parallel, we have been introducing new policies and procedures, and updating existing ones, to reflect the evolving regulatory frameworks within which the credit rating agencies operate globally.

I have provided details in my written statement, so I would like now to move on to the primary focus of today's hearing: where do we go from here?

As this committee considers this important topic, we would like to offer some perspective on a number of the important issues.

Transparency is a recurring theme in these discussions, and at Fitch, we are committed to being as transparent as possible in everything we do. But transparency also touches on issues beyond the strict control of rating agencies.

All of Fitch's ratings, supporting rationale, and assumptions, and related methodologies, and a good portion of our research, are freely available to the market in real time, by definition, transparent. We do not believe that everyone should agree with all of our opinions, but we are committed to ensuring that the market has the opportunity to discuss them.

Some market participants have noted that limits on the amount of information that is disclosed to the market by issuers and underwriters has made the market over-reliant on rating agencies, particularly for analysis and evaluation of structured securities.

The argument follows that the market would benefit if additional information on structured securities were more broadly and readily available to investors, thereby enabling them to have access to the same information that mandated rating agencies have, in developing and maintaining our rating opinions.

Fitch fully supports the concept of greater disclosure of such information. We also believe that responsibility for disclosing such information should rest fully with the issuers and the underwriters, and not just with the rating agencies. Quite simply, it's their information and their deals, so they should disclose that information.

A related benefit of additional issuer disclosure is that it addresses the issue of rating shopping. Greater disclosure would enable non-mandated NRSROs to issue ratings on structured securities if they so choose, thus providing the market with greater variety of opinion, and an important check on perceived ratings inflation.

The disclosure of additional information, however, is of questionable value of the accuracy and reliability of the information is suspect. That goes to the issue of due diligence.

While rating agencies have taken a number of steps to increase our assessments of the quality of the information we are provided in assigning ratings, including adopting policies that we will not rate issues if we deem the quality of the information to be insufficient, due diligence is a specific and defined legal concept. The burden of due diligence belongs with issuers and underwriters.

Congress ought not to hold rating agencies responsible for such due diligence, or requiring it from others. Rather, Congress should mandate that the SEC enact rules to require issuers and underwriters to perform such due diligence, make public the findings, and enforce the rules they enact.

In terms of regulation more broadly, Fitch supports fair and balanced oversight and registration of credit rating agencies and believes the market will benefit from globally consistent rules for credit rating agencies that foster transparency, disclosure of ratings, and methodologies, and management of conflicts of interest.

We also believe that all oversight requirements should be applied consistently and equally to all NRSROs.

One theme in the discussion of additional regulation is the desire to impose some more accountability on rating agencies. Ultimately,

the market imposes accountability for the reliability and performance of our ratings and research. That is, if the market no longer has sufficient confidence in the quality of our work, the value of Fitch's franchise will be diminished and our ability to continue to compete in the market will be impeded.

While we understand and agree with the notion that we should be accountable for what we do, we disagree with the idea that the imposition of greater liability will achieve that. Some of the discussion on liability is based on misperceptions, and while those points are covered in my written statement, it's worth highlighting that the view that the rating agencies have no liability today is unfounded.

Rating agencies, just like accountants, officers, directors, and securities analysts may be held liable for securities fraud, to the extent a rating agency intentionally or recklessly made a material misstatement or omission in connection with the purchase or sale of a security.

Beyond the standard of existing securities law that applies to all, fundamentally, we struggle with the notion of what it is that we should be held liable for. Specifically, a credit rating is an opinion about future events, the likelihood of an issue or issuer that they will meet their credit obligations as they come due.

Imposing a specific liability standard for failing to accurately predict the future, that in every case strikes us as an unwise approach.

Congress also should consider the practical consequences of imposing additional liability. Expanded competition may be inhibited for smaller rating agencies by withdrawing from the NRO system to avoid specialized liability. All rating agencies may be motivated to provide low security ratings just to mitigate liability.

In closing, Fitch has been and will continue to be constructively engaged with policymakers and regulators, as they and you consider ideas and questions about the oversight of credit rating agencies. We remain committed to enhancing the reliability and transparency of our ratings, and welcome all worthwhile ideas that aim to help us achieve that.

Thank you.

[The prepared statement of Mr. Joynt can be found on page 70 of the appendix.]

Chairman KANJORSKI. Thank you very much, Mr. Joynt.

We will now hear from Mr. Alex Pollock, resident fellow, American Enterprise Institute.

Mr Pollock.

STATEMENT OF ALEX J. POLLOCK, RESIDENT FELLOW, AMERICAN ENTERPRISE INSTITUTE

Mr. POLLOCK. Thank you, Mr. Chairman, Ranking Member Garrett, and members of the subcommittee.

As many of the members said in their opening statements, in the housing and mortgage bubble of our 21st Century, the government-sponsored credit rating agency cartel turned out to be a notable weakness. The regulatory NRSRO system made the dominant rating agencies into a concentrated point of possible failure, which then failed.

Considering this history, Deven Sharma, the president of S&P, has rightly said that we need to, in his words, "avoid inadvertently encouraging investors to depend excessively on ratings."

Let me add, we certainly need to avoid intentionally encouraging investors to depend excessively on ratings, and to treat them as one of many inputs.

As Congress made clear in the 2006 Credit Rating Agency Reform Act, greater competition in the credit rating agency sector was a key objective, and indeed, this is the right strategy.

At the beginning of 2005, I published an essay entitled, "End the Government-Sponsored Cartel in Credit Ratings," and that still summarizes my view.

I do think there has been significant progress in the right direction by the SEC since the 2006 Act, for example, registering Realpoint as an NRSRO, but we can go further.

In the ideal case, as Congressman Bachus said, we would get rid of all statutory and regulatory references to "NRSROs." I don't know if that is doable.

I would also strongly support his suggestion of replacing the meaning of "R" as "recognized" with "registered," so that we had only nationally registered rating agencies. That would be a step in the right direction.

As I remember, we talked about that in 2005–2006, maybe even had it in bills at one point, but it didn't make it into the final Act.

Now, what everybody in financial markets wants to know is the one thing that nobody can know, namely, the future. So Wall Street continually invents ways to make people confident enough to buy securities, in spite of the fact that they can't know the future. These assurances, as has been said, are, of course, opinions, and the credit rating agency ratings are an extremely important form of such opinions.

In the course of financial events, some such opinions will inevitably prove to be mistaken, some disastrously mistaken, as has been evident in the 21 months since the beginning of the financial panic in August 2007.

We would all like to have infallible knowledge of the future. Can't we somehow "assure" credit ratings which are "accurate," to borrow terms from a current bill in the Senate? Can't we guarantee having models which are right?

And the answer is, no. No rating agency, no regulatory agency, no modeler with however many computers, can make universally correct predictions of future events.

The worst case would be to turn the SEC, through the regulation of ratings process, which could easily turn into regulating ratings, into a monopoly rater, which would also suffer from the same lack of ability to predict the future. So would any—to touch on a separate topic—so-called systemic risk regulator, should we make what I believe to be the mistake of creating one.

But having more credit rating competitors, especially those paid by investors, in my view, increases the chances that new insights into credit risks and how to conceptualize, analyze, predict, and measure them, will be discovered.

It will also reduce the economic rents to the present dominant rating agencies, and should we create this increased competition,

we should expect and welcome greater dispersion of ratings. That will tell us we're getting different points of view, and whether ratings are concentrated around a mean or dispersed would be very important information for investors.

A particularly desirable form of increased competition, as others have said, is from rating agencies paid by investors, which do have a superior alignment of incentives. A frequent objection to competition in credit ratings is that there would be a so-called race to the bottom, but this does not apply at all to the logic of investor-paid ratings.

In my view, all regulatory bodies, not just the SEC, all regulatory bodies whose ratings supported over-reliance on the government-sponsored ratings cartel should develop and implement ways to promote the pro-competitive objective of the 2006 Act, and all regulatory rules concerning rating agencies from all regulators, not just the SEC, should be consistent with encouraging competition from the investor-paid model.

I have previously proposed that a group of major institutional investors, maybe Vanguard, should set up their own rating agency, capitalized and paid for by these investors, working from their point of view. It continues to seem to me likely the market would demonstrate a preference for the ratings of such an agency, and a successful competitor would find ways to distinguish itself by creating more valuable ratings, perhaps, as suggested by our colleague, Rob, in his testimony, by superior ongoing surveillance.

In sum, Mr. Chairman, competition in the rating agency sector has made some progress since the 2006 Act, and greater competition remains, in my opinion, not only an essential, but also an achievable objective.

Thanks again for the opportunity to be here.

[The prepared statement of Mr. Pollock can be found on page 84 of the appendix.]

Chairman KANJORSKI. Thank you very much, Mr. Pollock.

I now recognize the gentleman from Colorado, Mr. Perlmutter, to introduce our final witness.

Mr. PERLMUTTER. Thank you, Mr. Chairman.

It gives me great pleasure to introduce my friend, Greg Smith, who is general counsel of the Colorado Public Employees' Retirement Association, of which I was a member.

Greg is the co-chairman of the Council of Institutional Investors. He is also the chair of the subcommittee which deals with the credit rating agencies. He has a background in business and commercial matters, having represented pension plans, as well as a variety of business interests over the years.

He holds a Bachelor of Science degree from the University of Colorado, and a law degree from the University of Denver.

And we look forward to his testimony.

Thank you.

STATEMENT OF GREGORY W. SMITH, GENERAL COUNSEL, COLORADO PUBLIC EMPLOYEES' RETIREMENT ASSOCIATION

Mr. SMITH. Thank you very much. Thank you, Chairman Kanjorski, Ranking Member Garrett, Congressman Perlmutter. I appreciate the kind words.

I am here to speak on behalf of the Colorado Public Employees' Retirement Association, a pension fund with more than $29 billion in assets, which is responsible for the retirement security of over 430,000 plan members and beneficiaries.

I greatly appreciate the opportunity to be heard and talk about what I believe is the right direction for credit rating agency reform. My brief remarks will include an overview of how Colorado PERA uses credit ratings, a suggestion on how the Securities and Exchange Commission can provide better oversight of the ratings industry, and views on the need to strengthen NRSROs' accountability for their ratings.

Credit ratings are an important and sometimes mandated tool for many market participants, including pension funds. Most institutional investors do not rely exclusively on ratings. This holds true for Colorado PERA, as well as most of our peers. Ratings are a part of the mosaic of information that we consider during the investment process.

Initially, we define our risk tolerance and we determine what percent of allocation is necessary to stay within that range. Ratings serve as a first cut to identify securities for further consideration and analysis. Without such a tool, we and many other investors would have no initial way to screen the tens of thousands of new instruments available for investments each year.

Because of their significance in the capital market, and their status as financial gatekeepers, we believe NRSROs must be held to a high standard of quality, transparency, and independence. Congress and the SEC must work to strengthen and extend oversight in several areas, ranging from disclosure to policies to methodologies.

My written testimony provides more detail, but I would like to highlight a few suggestions for action here.

Like many institutional investors, we encourage the SEC to expand its proposal regarding the delayed disclosure of credit rating actions and credit rating histories, to include all outstanding credit ratings, regardless of whether or from whom the NRSRO received its compensation.

Similar to the provisions governing auditors, NRSROs should be required to disclose business relationships and should be prohibited from providing ancillary services. They should also publicly disclose fee schedules and the amount of compensation received for individual ratings and from individual clients.

A mandatory 1-year waiting period should be in place for any NRSRO employee seeking a position with a client. And the SEC should strengthen the current responsibilities and requirements pertaining to NRSRO compliance officers. That's their internal compliance officers.

At a bare minimum, more detailed information regarding NRSROs' rating methodologies should be made available publicly and in a user-friendly model.

Providing the SEC with the additional authority and resources, however, will not itself create an adequate system of checks and balances. The market must have a path of recourse. Where these financial gatekeepers fail to adhere to the reasonable industry standards, they should be held accountable for those failures.

Expressions of concern regarding the business viability of NRSROs in the event a private right of action were recognized by legislation are premised on the contention that NRSROs would become guarantors of the performance of the instruments that they rate, or would somehow become liable in the event a particular rating has changed and the value of the instrument is negatively impacted.

While this premise serves the interests of those desiring to maintain a lack of accountability, the reality is that no market participant is seeking that form of accountability.

Rather, we are seeking to have these officially sanctioned gatekeepers held to a reasonable industry standard for the process and methodology that is employed, including the adequacy of the diligence and the unbiased nature of the conclusions.

The threat presented to NRSROs by a private right of action is in essence no different than that presented to other participants in the marketplace, including institutional fiduciaries like my organization.

We, like others, are responsible for the process we adhere to. Our honesty and our lack of conflicts of appearances of conflicts of interest in the discharge of our responsibilities is imperative to our success.

We protect our organization from liability by creating a robust process and strictly monitoring our adherence thereto. We see no legitimate barriers to such a risk management approach by the NRSROs.

Thank you for the opportunity to be here. I look forward to your questions.

[The prepared statement of Mr. Smith can be found on page 89 of the appendix.]

Chairman KANJORSKI. Thank you very much, Mr. Smith.

Let me start off with my first question to you.

When you buy a security, how deeply do you look into the security? Do you do due diligence to see how the security was supported, what the pool was made up of, and who the participants are in the mortgages?

Mr. SMITH. Absolutely. We look—we drill as far as we can drill. We look at who the issuers are, obviously, what their creditworthiness is—

Chairman KANJORSKI. Issuers being the underwriters, or the individuals who have mortgages?

Mr. SMITH. Well, it depends on what kind of instrument we're talking about, but if we're talking about mortgage-backed securities—

Chairman KANJORSKI. Mortgage-backed securities.

Mr. SMITH. —mortgage-backed securities, we would attempt to go back to where the mortgages are, but that's a difficult thing for us to do. There's—

Chairman KANJORSKI. Well, if you cannot do that, then where do you get the information on whether or not you should buy that type of security, except that it is rated AAA?

Mr. SMITH. What we do as a large institution is, we go out and buy the research from the very people who are issuing the ratings,

so we try and drill into it by buying that research from the rating agencies themselves.

Chairman KANJORSKI. So they not only rate the security, they get paid to sell you the materials they use to rate the particular security?

Mr. SMITH. There are certainly research relationships where we purchase research from the very institutions that issue ratings, yes, sir.

Chairman KANJORSKI. Very good.

Mr. Fitch, how many people does your organization employ? I am sorry. Mr. Joynt. That is a Freudian slip, sir.

Mr. JOYNT. I think our present employee count globally is about 1,900.

Chairman KANJORSKI. 1,900. And you are one of the three largest in the world; is that correct?

Mr. JOYNT. Yes.

Chairman KANJORSKI. And how many employees would you have had, say, in 2002?

Mr. JOYNT. 2002. I would be guessing. We had—

Chairman KANJORSKI. About the same amount?

Mr. JOYNT. No. It would have been much less. Fitch grew by both growing on its own and merging with other, smaller rating agencies, so we made some acquisitions of Bank Watch Rating Agency, Duff and Phelps Rating Agency, GIBCA. So it's very hard to answer the question. But I would say we may have been half that size in 2002.

Chairman KANJORSKI. Half that size. Okay.

How many of those people are involved as analysts in mortgage-backed securities?

Mr. JOYNT. In mortgage-backed securities, I can get you that answer. I don't have that answer off the top of my head, globally how many—

Chairman KANJORSKI. Would you be much different than one of the other three major rating agencies that showed a profit, or an income in 2002 of $3 billion and then in 2006, $6 billion? Had your revenue changed as much as that over that 3- to 4-year period?

Mr. JOYNT. Well, our revenues have grown both through combining with these other rating agencies and growth on our own. The size of our company is much—is smaller than the other rating agencies. Our revenue base would be less than $1 billion.

Chairman KANJORSKI. $1 billion?

Mr. JOYNT. Less than that, $600 million or $700 million. That would be at its peak. So we're smaller than the other two.

Chairman KANJORSKI. Now, in your testimony, it seemed to say that you are really only giving an opinion here, and you should not be held for doing the due diligence that would support that opinion. Is that correct, substantially?

Mr. JOYNT. In the technical way, or legal way that due diligence is described, yes, that's correct. We do a lot of thoughtful research and analysis.

Chairman KANJORSKI. Do you do a professional analysis and present a professional study? I think I saw in your written testimony that it is non-professional. Is that correct?

Mr. JOYNT. I'm not sure I know the—I believe that we're highly educated and do thoughtful analysis. How you would describe professional, I think we act very professionally. If that's a legal sort of characterization, I'm not sure.

Chairman KANJORSKI. Okay. Well, do you think it is the responsibility of a rating agency to practice due diligence?

Mr. JOYNT. No.

Chairman KANJORSKI. It is not?

Mr. JOYNT. No.

Chairman KANJORSKI. Categorically not. So what would—

Mr. JOYNT. Due diligence, the way I understand it—

Chairman KANJORSKI. Under law.

Mr. JOYNT. —as a legal term, yes. I'm not a lawyer, so—

Chairman KANJORSKI. Right. Well, what would you say, just off the cuff, not based on studies, that if the first payment of a mortgage was not made, and if there were no records or support documents of income level, what likelihood would that reflect on the likelihood of default or failure of that type of a mortgage?

Mr. JOYNT. I would think that would be pretty poor.

Chairman KANJORSKI. That would be a poor operation?

Mr. JOYNT. I would think so.

Chairman KANJORSKI. Would you be surprised that a 1998 study of major insurance companies showed that mortgage securities that were AAA rated by the three major agencies, not all rating, but in various amounts, that only 3 percent had a failure as a result of defaulting on payments, particularly the first payment. Moreover, in 2000, only 4 percent failed that defaulted on the first payment. But in 2007, 15.6 percent of the mortgage holders failed to make the first payment on the mortgage. Would you find that remarkable, if those figures came to your attention?

Mr. JOYNT. Yes. Similar to—I'm not an expert, of course, on mortgage finance, but having said that, I think we all recognize that the origination of riskier and lower quality mortgages accelerated during the period of the mid-2005, 2006, and 2007. I think we all now see that more clearly.

We also have gone back and studied mortgages and securities that we have rated, and feel like there was a significant incidence of poor origination and maybe significant fraud in the origination.

Chairman KANJORSKI. My time has run out. I just want to get this last question in, if I may.

Assuming those facts that I have related to you are correct, what system would you recommend so that kind of information could be made available and brought to the attention of Mr. Smith and his pension fund when he is making a purchase of securities?

Mr. JOYNT. Very clearly, we have stated that we think all the disclosure that can be made by anybody in the market that helps educate all investors, and not just rating agencies, but all investors, should be supported.

So I would be in support—

Chairman KANJORSKI. Well, who is the agent or the person who should be responsible to make that report? Not you, because you are not responsible for due diligence.

Mr. JOYNT. I would think the issuer of the securities and/or their underwriter should be presenting the information that supports the—

Chairman KANJORSKI. And nobody is to check the authenticity or what material has been presented to anyone? In other words, liars get to keep their lies and get to benefit from their lies; is that correct? We have no checks and balances in our system?

Mr. JOYNT. No, I would not suggest that. So there are checks and balances—

Chairman KANJORSKI. What is a check and balance? If I'm the guy who is issuing the pool, and 15 percent of the mortgages in my pool have failed to pay the first payment on their mortgage, who is supposed to tell Mr. Smith about that problem?

Mr. JOYNT. There should be some kind of check in the system, some kind of expert—

Chairman KANJORSKI. Well, knowing the system, is there?

Mr. JOYNT. —that can underwrite or re-underwrite those securities, those individual loans.

It has not been our expertise. We have not developed expertise to underwrite individual loans in these securities.

Chairman KANJORSKI. So it is not my fault, it is Mr. Garrett's fault, is that what you are saying?

Mr. Garrett, you are recognized for—

Mr. GARRETT. I missed that point. What was my fault?

Chairman KANJORSKI. I just blamed it on you.

Mr. GARRETT. I know. I was blamed in the last election for a lot.

I thank the panel for your testimony.

Mr. Pollock, in your testimony, you said an astounding thing. You said we would all like to have infallible knowledge of the future, so we can somehow assure credit ratings are accurate. Can't we guarantee having models that are right?

Well, apparently, you haven't been coming to these hearings, because we already are coming up with a model. It's called a systemic risk regulator, and that individual or individuals is going to be able to do what the credit rating agencies and investors and everybody else have not been able to do, and that is predict the future for all these.

Any comment?

Mr. POLLOCK. I think your point is absolutely right, Congressman.

Mr. GARRETT. Mr. Pollock or somebody else mentioned this earlier. As far as the regulator right now, and we had a discussion earlier today on this matter with regard to who regulates the rating agencies, the SEC, and that they're out there doing the audits and what have you.

Does anyone on the panel have any comments on the SEC? And my opening comments was, I wish we would have them here, maybe in a future hearing have them here, as them being the arbiter or the regulator of the industry?

You can say something nice about the SEC, if you're worried.

Mr. AUWAERTER. I think with the SEC, they are the proper regulator. I question whether they have the resources to do it right now, to go out to the agencies and determine that the processes are working right.

Mr. GARRETT. Mr. Smith?

Mr. SMITH. I think also that in the 1996 Act, or I'm sorry, the 2006 Act, there were some restrictions put on the SEC that I think they're committed to doing a better job of regulating credit rating agencies if they're given the full range of powers to do so.

Mr. GARRETT. And I'll just throw out the one idea. Is there anyone else out there—I mean, banks have to deal with credit issues all the time, so should we switch this over to bank creditors, the banking regulators, to look at this? Does anybody suggest that?

Mr. Pollock?

Mr. POLLOCK. I just have a comment, if I may, on the banking regulators.

Of course, what has happened historically is, increasingly, the banking regulators have outsourced the credit judgment to the credit rating agencies, notably, as I think someone mentioned in an opening statement, through the so-called Basel II capital requirements, which not only outsourced the credit decision but also the capital requirement decision to the ratings.

I think you have to say on behalf of the rating agencies, a lot of them commented that was a bad idea, and it was a bad idea.

Mr. GARRETT. Just very quickly, and then I'll go to Mr. Dobilas on this—if I'm pronouncing it correctly—Mr. Pollock, since we can't get an all-seeing, all-knowing person out there, and my question for the panel if we have enough time will be, what do we really need, what does the—and sir, this is along your line of questioning—what do the agencies really need to be looking at in order to make these proper determinations?

First—saying even if we do away with regulations, it really comes down to whether you have someone out there, whether they are a regulator or not a regulator, coming up with a methodology to try to do the best they possibly can to predict the future, and then my question following that, Mr. Dobilas, will be, how come, according to your testimony, you said that—you alluded to the fact that even in the midst of this, Realpoint has been able to issue accurate credit downgrades 6 to 12 months sooner than your largest competitors. How were you able to evaluate it better?

Mr. POLLOCK. One important point is who is making a decision to hire the credit rating agency. An investor-paid rating agency has to convince investors that its ratings are worthwhile buying.

Mr. GARRETT. Okay.

Mr. POLLOCK. That's a really good check and balance, right there.

Mr. GARRETT. I'm sure the credit rating agency would say that there's a separate—there's a Chinese wall through on that.

Mr. DOBILAS. I guess Alex is stealing some of my thunder here, but I think you have to understand the basic difference between subscriber and issuer paid.

We are paid by investors, and they have cancellation rights. We actually are very proactive in our methods with regards to surveillance and transparency.

Issuer-paid agencies today make a lot of their money upfront when a deal is initially hired.

Subscriber-paid agencies have more of a focus on the surveillance process, on an ongoing basis, meaning we review every CMBS

transaction, every single month, and have a detailed review. What we try to do is be fully transparent to investors.

Mr. GARRETT. And you would suggest, and you don't work there, that the Big Three don't have the same modeling; is that, in essence?

Mr. DOBILAS. They do not have the same basic philosophy when it comes to surveillance. Their major emphasis has always been on the pre-issue, the new issue marketplace. That's where they make most of their money.

The surveillance model wouldn't be in existence today if the rating agencies were doing a good job on the surveillance side. Monthly surveillance, we listen to investors, investors are our clients.

I started in the rating agency business about 15 years ago, and I can tell you, there has been really no major changes with regards to clarity and transparency to investors until Realpoint came along on the CMBS side. We are offering a different business model to investors, which investors are very supportive of.

We don't want to tell them what the right answer is, but we want them to understand fully what our analysis is and how we got to that analysis. By underwriting all of the underlying commercial properties, showing them our underwriting, you know, they're seeing something that they have never seen before, and it proves to be a more reliable rating than the reactive ratings of our counterparts.

Mr. GARRETT. I appreciate that. I need to better get my arms around the differences, but I appreciate the testimony. Thanks.

Chairman KANJORSKI. Thank you very much, Mr. Garrett.

We will now hear from Mr. Ackerman.

Mr. ACKERMAN. Thank you, Mr. Chairman.

Mr. Joynt, if I may read from your testimony two lines:

"A Fitch rating is our opinion about the future financial capacity of a company or other issuer to pay its debt. It is not a statement of fact or a professional judgment." It's your opinion. You're entitled to your opinion.

There are 300 million Americans. Do you know how many have opinions? I would say about 300 million.

My cousin, Sheldon, has opinions. He has opinions on everything. He is not a professional, either, and sometimes his statements of fact aren't.

You get paid sometimes, I understand, $1 million by clients for your opinion, and the reason you get paid so much money for your opinion is because some people think that this is a professional judgment. And you get paid because you are something that is called an NRSRO. My cousin Sheldon isn't.

My cousin Sheldon can't put AAA on some company that they're going to market. Nobody would pay him 2 cents for his opinion.

You get paid that much money because you have a government franchise from the SEC. Of the 300 million people, plus I don't know how many entities in America, I understand there are only 10 so designated by the government, and the reason is, then people rely on that, because they think this now has the government's imprimatur to issue very professional statements based on some expertise that you have.

Now, if these are only your opinions, which you may think are better than Sheldon's, would you be adverse to putting a warning on your ratings, much like on cigarette cartons, that says, "This rating is not a statement of fact," which is what you say, "nor is it a professional judgment, and it's just as good as my cousin Sheldon's," and put that in a box?

Mr. JOYNT. Not knowing your cousin Sheldon, I wouldn't reference him, but I suppose I would respond this way. We try to be very clear about what the ratings are intended to mean and what they're not intended to mean, so they're not an all-purpose recommendation of anything, they're—

Mr. ACKERMAN. But the point I'm making is there's a difference in Cousin Sheldon's free speech, coming from a guy called Cousin Sheldon, who has no other credentials and isn't 1 of 10 entities or people in America who have been selected by the government to represent themselves as nationally recognized.

Once you're nationally recognized, and you bear this franchise, given so rarely by the government, you get to charge $700 billion, last year is what I think you said—$700 million, I get carried away—$700 million to people who value the fact that you bear that franchise and Cousin Sheldon doesn't.

So there's a responsibility there for the exercise of your speech, which is not free, it's $700 million worth of charges. That's different than Cousin Sheldon's free speech.

Mr. JOYNT. I believe one of the reasons why we receive remuneration for what we do is because, over a period of time, many participants in the capital markets, including large, sophisticated institutional investors, have learned to develop our opinion across a wide range of ratings and research that we do—

Mr. ACKERMAN. People make life-changing decisions based on your rating. It is not something that is casual. If it's something that people rely on, that they think that we have empowered the SEC to license you, in effect, to exercise the world's greatest judgment and tell people what the best judgment in the world can say, shouldn't you bear a responsibility?

You can't just say, "I'm not a doctor, but I play one on TV," or "I'm not a professional, but I play one in the marketplace."

Mr. JOYNT. I believe we feel quite accountable and responsible for the quality of the work that we do, and we work very hard to make sure that we're educated in what we're doing and undertaking, you know—

Mr. ACKERMAN. I'm sure that Cousin Sheldon feels the same way, but the problem is if that is just your opinion, why don't we just strip away the fact that you have a government license to operate, that you have been franchised as 1 of only 10 entities in the country that's qualified to make that non-professional, non-statement of fact judgment?

Mr. JOYNT. I know in my—and I have been—I think it's wise for you to think in that way. I believe that NRSROs were designated and ratings were used for constructive purposes, including in each of these regulations at the time they were put in place.

All I have suggested is people think about changing the regulations or the recognition of rating agencies, that it be thought about over time, carefully, and consistently. There was a constructive rea-

son why they were used, and so rather than just creating a sort of a blanket change, I think it would be more constructive to not throw the baby out with the bathwater, to carefully consider it over time. I think that's exactly what the SEC is doing right now, for many of the regulations that they have.

Mr. ACKERMAN. Mr. Volokh gave us a brilliant treatise on the First Amendment, much of which I subscribe to wholeheartedly.

Newspapers don't have to have a license. They have a First Amendment right. It's not like if the country decided, and we decided we're going to license newspapers, and only license 10 of them. There would be a big difference in the world, in our interpretation of free speech.

And newspapers are self-policing. They make their own rules, and put advertisement over something that's an advertisement, not required by any law or rule. It's their own judgment to do so.

Your industry, the credit rating industry, does not have the sense of integrity that those other purveyors of free speech, the real purveyors of free speech have, and they self-police and say, "This is an ad."

Why don't you just say, "This is an advertisement, it's AAA. It's my endorsement."

You endorse products, is what you do, for a price, like a baseball player endorses sneakers.

Mr. JOYNT. So, Mr. Ackerman, I might also add that at the recent SEC hearings last month, when confronted with the same question, both Standard and Poor's and Moody's, I believe, responded that they thought it was wise that the rating agencies be taken out of regulation.

And so I was asked my opinion at that time, because I had a different view, which was I thought that should be thought about carefully. So because I think there are constructive reasons to be designated NRSROs and using ratings, and also I believe that without designating anyone, the present incumbents would be more likely to be used by investors for the good reasons that they're used right now, in referencing ratings, and I think it might inhibit competition and diversity of opinion—

Mr. ACKERMAN. Let me just say, because my time has expired, and the chairman has been very generous, that free speech cannot be charged for. You don't charge anybody for exercising free speech.

If you want to exercise free speech, you shouldn't have a government license, and if you have a government license, and are only one of a few designated to have that, there's nothing wrong with paying for the license. You pay for a fishing license. And the price you pay, or the price you should pay, is the price of being responsible in the marketplace, to be held accountable by people who feel they might have been misled by your endorsement of a product that should not have been endorsed.

I yield back the balance—I guess I have no balance. Thank you, Mr. Chairman.

Chairman KANJORSKI. Do not push it, Mr. Ackerman.

[laughter]

Chairman KANJORSKI. The Chair now recognizes Mr. Bachus for 5 minutes.

Mr. BACHUS. Thank you. Thank you, Mr. Chairman.

Mr. Ackerman, your Cousin Sheldon, what does he do, what line of work is he in?

Mr. ACKERMAN. Last I heard, he was with the Department of Sanitation.

Mr. BACHUS. All right, then.

[laughter]

Mr. BACHUS. That pretty much sums it up.

I ask the panel, do any of you plan to rely on Congressman Ackerman's Cousin Sheldon for risk assessment? Probably not, right?

Let me ask you this. Mr. Joynt, first of all, let me say this: I admire you for being here. It's my understanding that S&P and Moody's were not invited, but you were. That sort of leaves you out on the point.

I want to ask you, just ask you some questions, just to try to understand where we go from here, as you said.

If the debt issuers don't pay for these risk assessments—I mean, individual investors can't pay for them, so who would pay for them? Is there a practical—and I know people have talked about conflicts of interest. But who would fill that gap if the issuers did not?

Mr. JOYNT. So, investors now receive—pay for research, but they receive the benefits—all investors, retail investors, institutional—receive the benefit of the public and transparent nature of the rating agencies that come from the issuer-paid ratings.

I don't believe that there would be enough payment, sponsorship, organization of investor payment for the ratings to support the kind of staffs that we now have in place to do what I think is, you know, quite a deep and educated job in analyzing securities.

So I believe somehow we would lose the benefit of the positive of what with have now in the form of, at least, Fitch.

Mr. BACHUS. Yes. And I ask the other panel members, and the law professor—this may be outside your field, but other than the professor—who—you know, we all say there appears to be a conflict when an issuer pays for it, but who else would pay for it? I mean, is there a practical substitute?

Mr. SMITH. Well, as I said earlier, from the institutional investors' perspective, we buy the research and we get some of the benefit there, but that doesn't solve the issue, and the issue, I think you're getting to is, who is going to pay for the determination by whatever gatekeeper it is, whether or not a particular instrument meets capital requirements, etc., and I don't have a good answer for you.

I don't think that turning to an investor-pay model instead of an issuer-pay model really fills all of the need that there is for making this determination. There's going to have to be something else that's identified, or else we're going to have to make credit ratings something we can actually rely on.

I think that can be accomplished. I think it could be accomplished through transparency and accountability, and when there's a price to be paid for not just being wrong in that the instrument didn't perform as it was expected to—I don't expect them to predict the future; I think that's a red herring—what we expect them to do is create a robust process, free of conflicts, free of bias, and carry out that process consistently throughout all the products, and put

the product out there for us to buy. And it seems pretty straightforward.

Mr. BACHUS. Anyone else?

Mr. DOBILAS. Yes, I would like to comment.

You know, I would like to make a distinction, too, in saying that I only speak for CMBS.

You know, when we look at a subscriber-paid model, it works very well in the surveillance arena. Now, on the new issue side though, I have to say there is a real problem with the issuer-paid model. And that really isn't a problem that can't be solved, but it's going to need a long-term approach. It's going to need somebody to set the example and show investors what subscription-paid models can do in that arena, and somebody is going to have to absorb the cost, because when you do look at these new issue deals, there's a very large cost structure involved for a rating agency when they do go in to rate a new issue security.

On the CMBS side, you have to visit every property, you have to underwrite those properties, you have to travel. You know, somebody is going to have to pick up those expenses.

But I do think that if investors can see the light at the end of the tunnel, they will wean themselves of, you know, the dependency on those two, you know, new issue ratings, but somebody is going to have to step in in the interim and make sure that the playing field is equal, and investors will eventually buy those analyses.

Realpoint, we were looking at offering a very cost-effective—

Mr. BACHUS. Let me thank—I mean, I appreciate that, and I think, really, though, we're saying, I'm not sure how we do that.

Mr. POLLOCK. Congressman, if I could comment on that, the rating agency world I picture is one that has both investor-paid and issuer-paid competitors in it. I don't think there is any chance that the issuer-paid agencies are going to go away. They are going to still be there. There is a large set of free riders in the public who get the ratings, and they'll continue to get the ratings, but there will be competitive pressure for quality from the investor-paid models.

We should say, of course, the ratings, as I said in my testimony, are very valuable to all sellers of fixed-income securities, because they're a great part of the ability to move those securities, and they'll have an interest in making sure such ratings are available.

Mr. BACHUS. And I think part of that answer, if you expand, and you don't—you know, these nationally recognized, I think, people have relied on that as somewhat of a guarantee, and we need to expand that number.

But also, I mean, I would have to say that we also—you know, there have to be some qualifications for registration.

Can I ask one other question? I know you have gone over with everybody else.

Mr. Joynt, is the problem—you have mentioned fraud. Obviously, that can be a problem, when they fail to disclose information. But how about expertise, I mean, or competence? I mean, that, on occasion, you know, there probably just wasn't the competence there, because of the complexity. Is that true?

Mr. JOYNT. So for mortgage-backed securities, I would say the accelerated environment and pace of origination and the change to broker origination, and usage by financial firms, which happened quite quickly in large volumes in that period of 2005 and 2006, I think, contributed a lot to a change in the basic competence of the origination of the mortgage process, and so the need to have checks on that arose quickly. The checks probably weren't in place. The reliance, therefore, on the historical data, of what defaults and delinquencies had occurred in the past compared to what actually was happening or about to happen, especially with the weakest-quality mortgages, would indicate to me that all the competence, up and down the chain, was not there.

Mr. BACHUS. Let me ask you this. Not you, S&P, you know, Moody's, what is the rate of just saying, "We decline to rate, we don't have the expertise?"

Mr. JOYNT. So I think the philosophy of the three largest rating agencies has been to say, "Let us collect the information. Let's see if we can rate something. We probably can analyze it best and offer some kind of analysis or opinion to investors."

So there have been occasions where Fitch, particularly, declined to rate some securitizations, because we were uncomfortable with the structure or the credit enhancement level that we would think was appropriate for the given rating wasn't appropriate. In the case of SIVs, the special investment vehicles, we were uncomfortable rating the junior capital notes.

And so there have been instances where rating agencies declined to rate, but if there's something that we're uncomfortable about the analysis, we probably would be assigning, in many cases, lower ratings, and less frequently, unable to assign any rating.

Mr. BACHUS. Okay, thank you.

Mr. JOYNT. There have been some.

Chairman KANJORSKI. Thank you very much, Mr. Bachus.

And now we will hear from Mr. Sherman for 5 minutes.

Mr. SHERMAN. Thank you, Mr. Chairman.

Responding in part to the gentleman from Alabama, I think it's important not who pays the credit rating agency, but who selects the credit rating agency. And I'll give you a baseball analysis on that.

Imagine a baseball league in which the league pays the umpires, but the home team gets to select anybody they want to be the umpire. That's going to be a home team that's going to win a lot of games.

In contrast, imagine a baseball league where the home team has to give $100 to the umpire, each umpire, but the league sends out the umpires. Those are going to be umpires who are answerable to the league, whose livelihood depends upon the league thinking they're doing a good job.

As long as issuers are selecting the credit rating agency, then the way to be successful as a credit rating agency is to make the issuers happy, and then conceal from the public that the way to be successful is to make the issuers happy. It's who selects, not who pays.

Now, one approach we could have to all this is to try to make the credit rating more reliable. The other, and I think our first wit-

ness kind of took this approach—I'm sure I'm over-simplifying—we could just tell everybody how unreliable these credit ratings are, and tell them not to rely upon them, or only as a first step.

Now, Vanguard has the advantage of hiring, what did you say, 30, 40 different credit analysts. I won't ask you whether it's 30 or 40.

Investors ought to be allowed to invest directly in debt instruments, without hiring a team of 40 people. They should be able to rely on the credit rating.

And even—and I have all my money at Vanguard. But when I even—and so I'm relying on your analysts, but not entirely, because I have to compare your funds to other funds that tell me they get better yields. But then I look, and I see which fund invests more safely. Well, how can I determine that?

I could rely upon your name, although there are some big names on Wall Street that have tanked recently. I don't know which names are good and which aren't. Or, I can rely upon the fact that your bond funds are mostly AA and partially AAA, and somebody else's high-yield fund—as a matter of fact, that's what distinguishes your high-yield fund from the lower-yield funds.

Professor, you said if somebody gathers information, analyzes it, and expresses their opinion, that would be protected by the First Amendment. I would add, that's what my doctor does, but boy, if he's wrong, I'm going to sue him.

But more to the point, that's what accountants do and that's what legal opinions do, in offering materials, private placement memorandums, SEC regulations. I think I'm the only CPA up here.

And what does, when you look in the offering materials, or financial statements, and then there are two paragraphs, usually, written by the auditors. They say, "In our opinion, the attached financial statements accurately reflect, according to generally accepted accounting principles."

So I'll ask you to respond for the record, how the credit rating agency is different from the accounting firm, both in public offerings and in private placement memoranda, but also, you have, if there's a tax advantaged investment, you usually have an opinion letter from a tax counsel, saying, "Here are what the tax consequences are."

I have been the auditor. I have been the tax counsel. And in every case, I knew I would get sued if I was wrong. Otherwise, you would be—well, I would have—my professionalism would have restrained me, but I have colleagues that would have issued just about any kind of opinion.

What I'll ask you to respond to orally—those other questions are for the rating—is, is there any constitutional bar to us saying, certain credit rating agencies will register with the SEC, and as part of that registration, should they choose to register, they have to waive the right not to be sued for their negligence?

Mr. VOLOKH. Before I answer, could I ask, what is it that they get out of the registration? Is it that they have to be registered in order to—

Mr. SHERMAN. No. Anybody can register, but then the—well, the SEC then says, "If you want to issue a debt instrument, you must get one of our registered SROs to rate you." But, of course, you can

go out and hire 12 other people, even—what was the cousin? Sheldon. And you could even get Sheldon, and you could, you know, you got free speech. You can talk all you want about your offering. But you have to pick one from our panel if you want to sell it.

Mr. VOLOKH. Sure. Let me speak in order to both of the matters that you raised.

The first is the status of professional client speech and to what extent these rating agencies are the equivalent of a doctor or a lawyer or an accountant—

Mr. SHERMAN. Well, in this case they would be registered professional agencies. If you didn't want to be a professional—I see that Fitch is saying it's not a professional judgment—but the SEC would say you can't register unless you want to be a professional.

Mr. VOLOKH. Got it. So if somebody wants to go out there and convey their opinion and have other people pay for the opinion, they are free to do so, but if they want a special government imprimatur that allows an issuer of bonds to include that opinion as part of its issue, they have to comply with certain things.

I tried to speak to that in some measure in my remarks, and I think that, generally speaking, that would be constitutionally permissible if, going forward, the government were to say, as a condition of getting this particular special government benefit, we demand that you comply with certain kinds of accounting procedures or that you not take any money from the organization that you are rating, or even that you agree to be liable under a negligence standard, then I think as a condition—

Mr. SHERMAN. I have to try to squeeze in one more question. That is, I'm going to propose that the SEC identify which credit rating agencies are qualified. In fact, they have already identified 10, but which are qualified for particular categories of debt instruments.

And then, every issuer, when they want to take an issue public, of debt, they call the SEC and the SEC assigns one at random, the same way the league assigns a team of umpires.

Mr. Joynt, this would mean that you would never have to please an issuer. As a matter of fact, if you regard it as a really tough rater, that might be fine, because it would improve your image with the SEC.

That would change your business model. It would allow perhaps other competitors to emerge, in that having a big name like your company does wouldn't matter as much as being rated as qualified by the SEC.

Do you see—what disadvantage do you see to someone like myself who would like to invest $10,000 or $20,000 in debt instruments and get a rating that I can rely on?

Mr. JOYNT. I guess I would come back to try to understand the goal of diversifying that widely among market participants. From our personal interest, of course, we spent a lot of time building up our professionalism and our global reputation. I think we serve investors well as a global rating agency, able to rate a wide variety of things.

If there was—

Mr. SHERMAN. Well, you would be qualified in all the different categories, or maybe there should just be one or two categories.

Mr. JOYNT. So then the question turns to what I mentioned earlier, which is on what basis would the SEC or anyone choose among the rating agencies, and if it was just a random sort of rotation, I suppose that would be just adjusting the market shares of as many participants joining the system, is what it would be.

So there would be—I think many people would try to join. There would be 20, 30, 50 different rating agencies. It would certainly impact the business dynamics of the existing rating agencies, including—

Mr. SHERMAN. But then I would get a rating from an agency that the SEC thought was qualified to do the job. That rating agency would be absolutely unaffected by the desires of the issuer. What's not to like?

Mr. JOYNT. So, I believe that we're unaffected by the desires of the issuer today, so that the difference between your statement and mine is that—

Mr. SHERMAN. Look, I have never been in your profession, but my doctor seems to care whether I'm pleased as a patient. When I was a lawyer, I wanted to please my clients. When I was a CPA, I wanted to please my clients. I want to please my constituents.

You're the only—you don't even claim to be a professional, but you claim a level of professionalism so high that you don't care about the business effects to your enterprise of what you do, and in particular, you don't care about whether you please the people who can decide whether to give you the next $1 million contract.

Mr. JOYNT. But our—

Mr. SHERMAN. So you're claiming a level of professionalism I never aspired to, while disclaiming being a professional.

Mr. JOYNT. Our credibility comes from building our reputation, not just with issuers, but with investors, regulators, and everyone, over a long period of time, so keeping the proper balance and being independent and doing a thorough job is very important—

Mr. SHERMAN. I could have bought that last year, but now I have seen Alt-A get AAA, and I'm not buying it.

I'll yield back.

Chairman KANJORSKI. Thank you very much.

I will now recognize Mr. Neugebauer for 5 minutes.

Mr. NEUGEBAUER. Thank you, Mr. Chairman.

Mr. Smith, have you ever used credit default swaps to insure any of the securities, debt securities that you bought to provide additional protection for the organization that you represent?

Mr. SMITH. In fact, we have not.

Mr. NEUGEBAUER. You have not?

Mr. SMITH. No.

Mr. NEUGEBAUER. And why is that?

Mr. SMITH. Because we judge them to not be something we wanted to invest our beneficiaries' money in. We did not participate in that field.

Mr. NEUGEBAUER. I think in your testimony, Mr. Joynt, that you didn't—you criticized proposals to replace ratings with bond spreads or CDS spreads, because you think the market prices, by definition, are inherently volatile than a fundamentally driven credit rating.

When you were looking at your ratings and kind of, you had your story and you were sticking to it, were you monitoring the spreads on some of the credit default swaps to say, "Hmm, there's some risk premiums there that other people think are there, that we're not recognizing." I mean, did the bell go off for somebody?

Mr. JOYNT. Yes. We would take all market inputs, prices, CDS spreads, anything into account when trying to think about the risks that we analyzed. Individual analysts would receive market price information and spreads. Our central credit policy group would monitor CDS prices, and in fact go back to analysts and individual groups and say, "Have you thought about and seen what's happening with these prices?"

So I would say we're aware of, it's an important factor, it's an influence, and just to respond to what you originally suggested, we see value in market prices for investors to reflect and think about the risk. I believe those are more volatile than fundamental analysis. They are influenced by market events, volatility, liquidity. And so I think they are complementary.

So yes, we use them to help think about the fundamental analysis, as well.

Mr. NEUGEBAUER. So when those risk premiums started going up, at what point did you start changing? In other words, if I went back and looked at a security that you rated and I started looking at the risk premium in that CDS, when would you have said, "You know, maybe we don't have this rated right?" As opposed to—I mean, how much did the premium—well, how much premium increase would I see before I saw a rating change?

Mr. JOYNT. I can't answer that question specifically, but I should say that there have been times when market spreads have widened out, and contracted back, and it wasn't reflective at all of the fundamental credit risk of a company, and there have been times when market spreads have widened out and subsequently the company's performance has proved to be weaker, ratings were changed subsequently, as well.

So I mean, there are good examples with the auto companies in the past 10 years, where their credit has weakened and ratings have weakened, and where market spreads have been dramatically different than what the fundamental analysis might have said at the time.

So it's a wide range, I would say to you.

Mr. NEUGEBAUER. I wonder what the difference of the analysis that the people who were taking on those risks for, you know, a relatively small amount of money. You have to be right on those, because they're taking a relatively small premium for a fairly large risk. I mean, so what did they know that you didn't know?

Mr. JOYNT. I'm not sure how to react to that. There's—whomever was selling or buying protection, there would have been two people thinking two different things about that risk at that price. So one might have been thinking, "That was a great trade, I'm glad I got this premium," and another was thinking, "I'm glad I shed that risk."

So—also, the CDS market is a synthetic and a derivative market. It's not physical securities. So the people who trade or act in that market aren't necessarily—they can act with leverage and volumes

that might indicate they have much greater rewards than holding physical securities or risks.

Mr. NEUGEBAUER. Well, the issuers are taking a real risk. I mean, it's not synthetic, it's real. If there's a default on that security, they have to—there's performance.

Mr. JOYNT. No, that I understand, but they don't own physical securities.

Mr. NEUGEBAUER. Some of them do.

Mr. "Dobilas"—am I saying that right?

Mr. DOBILAS. No, but that's okay. It's "Dobilas."

Mr. NEUGEBAUER. "Dobilas." You would think somebody with a name like Neugebauer could pronounce that, wouldn't you?

So, in your particular business, you do not do any issue ratings on new issues. When do you start coverage?

Mr. DOBILAS. Since the NRSRO designation, you know, we are eligible to do new issue, but we would have to fall under the same model, being paid by the issuer, you know, and be sort of a hybrid rating agency.

Most of our subscription-based business is all—well, actually all of our subscription-based business is paid for by investors.

We tend to pick up the deal as soon as the information is available to the public. We're not actually privy to the post-sale information that the hired NRSROs have access to.

So usually, it is 30, about 30 days or after the first payment of the bond that we have access to all the information, enough information to do a detailed analysis on.

One of our recommendations is definitely to open up that post-sale analysis and allow all NRSROs to have access to that information, so we can, in a timely manner, prepare an analysis that can be available to investors for direct purchase, as opposed to having a reliance, or over-reliance on issuer-paid ratings.

That way, if, again, an investor felt it necessary to get more information or additional information, it is available to them.

Mr. NEUGEBAUER. So one of the—would one of the ideas be that companies before, that are thinking about issuing, whether they have selected your firm or not to rate the issuance, that you be given the same amount—the same information that they're giving to the rating agency that they have selected to do that; so if I'm one of your subscribers, and somebody comes out and says, "This is a AAA," so that's one opinion, and then I call your firm up, and you say, "No, Randy, we think that's an A?"

Mr. DOBILAS. Yes, we think more opinions at the post-issuance, you know, level, the better. Let the investors really know what kinds of risks are out there, don't limit it to just two rating agencies.

Mr. NEUGEBAUER. But you're not privy to the information that, say, if Fitch has been selected, you do not get the same information up front until after issue; is that what you're saying?

Mr. DOBILAS. That is what I'm saying. Now that we are a registered NRSRO, though, we can actually join Fitch and, you know, bid on deals in the same pre-sale analysis that they do.

Mr. NEUGEBAUER. You can bid on it, but if you don't get the bid, or do you get the information?

Mr. DOBILAS. No. We're not privy to share that information with our clients at this time. Both Regulation AB and FD sort of prohibit that from happening.

Mr. NEUGEBAUER. Prior to issue, if you have not been selected?

Mr. DOBILAS. Correct.

Mr. NEUGEBAUER. So you can't issue your opinion on that until after issuance?

Mr. DOBILAS. About 30 days after issuance, and we can't even use the data if we did take a look during the bidding process. It's a separate group. We can't—

Mr. NEUGEBAUER. Is that one of the solutions?

Mr. DOBILAS. We think the solution is definitely make that information available and disclose it to any registered NRSRO. There's a lot of private information in that data, so you need to regulate that somehow, and we think having a NRSRO designation, you know, would be, again, all the regulation you need to make sure that information stays private, and then allow the rating agencies to analyze that information and prepare their analysis.

And we think having—again, there's no getting rid of issuer-paid models or no getting rid of subscriber-paid models, and necessarily, I don't think one is better than the other. I think the fact is, having more opinions at that post-issuance is in the best interests of investors.

Mr. NEUGEBAUER. Last question, to the panel.

Under Mr. Sherman's proposal, if somebody else chooses, is there some validity to, if you are all equally competent, that a third party would choose—in other words, you would be in a pool and a third party gets to pick who that is?

Mr. DOBILAS. I guess if I could just jump in again, you know, the Federal Reserve, it's interesting, because they're faced with that now with regards to the TALF Program.

And I should also just commend the Federal Reserve, because the level of analysis they did on the rating agencies that participated in TALF was very detailed and analytic and quantitative in nature, a very, very thorough process. But they're faced with sort of a similar distinction now.

I do not think it's necessarily a bad thing to take that out of the issuer's hands and have a trustee, for instance, be hired to randomly select the rating agencies. The only thing you would want to avoid at all costs is stifling competition and quality, more quality than competition.

You know, you wouldn't want to see the industry just result in, you know, just, "Hey, I have a deal coming up in a month, you know, we'll just hang in there and put out a rating." You know, you definitely want an evolution of transparency for investors.

Chairman KANJORSKI. Thank you, Mr. Neugebauer.

We will now have Mr. Capuano for 5 minutes.

Mr. CAPUANO. Thank you, Mr. Chairman.

Gentlemen, I want to be clear. I have my problems with the way credit agencies work, credit rating agencies work, but I absolutely agree that there is a role for them in the free market world.

Let me ask you, my problem is trying to figure out a way to get the credit rating agencies to be independent, so that their judgment can be trusted. I can't believe any of you really believe that credit

rating agencies' judgments, right now, is trusted by anybody in their right mind. It isn't. And I want to get to a point where it is.

Let me ask you, what are the consequences when a rating agency gets it wrong?

Mr. Joynt, I think, I may as well just start with you. And I apologize. I don't mean to pick on you. But—

Mr. JOYNT. That's all right.

What's the question?

Mr. CAPUANO. What are the consequences if a rating agency gets it wrong? What are the consequences to your business if you get it wrong?

Mr. JOYNT. So we put out our rating and our research, and if we get it wrong, it means we would have been changing our opinion quickly, downgrading the rating substantially, and having a surprisingly different rating result or credit result—

Mr. CAPUANO. But do you lose an investment? Does anybody go to jail? Does anybody lose a license? Anything?

Mr. JOYNT. So investors that would have purchased those securities—

Mr. CAPUANO. I know what they get. What are the consequences to your company if you get it wrong?

Mr. JOYNT. So they would not be interested in using our services, if we consistently got it wrong.

Mr. CAPUANO. That's fair and reasonable, but that goes to Mr. Pollock's comment, which I thought was very good, of a cartel.

Now, Mr. Pollock, you would agree that a cartel doesn't necessarily have to be just three or just 10, a cartel could be 100, if they operated as such; is that incorrect?

Mr. POLLOCK. Congressman, it would be really hard to run a 100-member cartel, but I think the key about what happens to the credit rating agency, which is an excellent question, is whether the credit rating agency is judged by the content and value of its ratings, or whether the rating agency is operating by providing a regulatory value, which is what the old system had. Professor Frank Partnoy has discussed this at length, that when you convey a required license, you are conveying the fact that, "I'm just passing on this regulatory license I have," whether your ratings have content or not.

I'm not saying the ratings don't have content, but that there is a regulatory value which is different from the content value, and the more we could move the market toward what happens to rating agencies being based on the informational, intellectual value of the rating, the better we would do.

Mr. CAPUANO. Content, qualitative analysis, analytical analysis, not opinion, and understanding that, at some point, there's always opinion. I get that.

If that's the case, I have a proposal, at least when it comes to municipal bonds, to simply require agencies to base their opinion on the ability to repay that debt. And yet, the industry thinks that's some kind of a major problem, and opposes the bill.

It simply says, "Base your opinion on the sole factor of whether that city, town, county, or State can repay the debt." Where's the problem if that's all we're asking? Simply base your credit rating on that. Where's the problem with that?

[no response]

Mr. CAPUANO. Good. Nobody has one. So you're all in favor of the bill? Mr. Chairman, I guess we can mark that one up next week.

Again, let me ask another question. At Enron, there were consequences for a lot of people. Several people went to jail from the company. Arthur Andersen, at the time one of the top two largest accounting firms in the world, went out of business.

What happened to the credit rating agencies that rated Enron's financial status?

Mr. DOBILAS. I guess I just want to make a point.

They're still in business. You know—

Mr. CAPUANO. Bingo.

Mr. DOBILAS. —but in a subscription-based service like Realpoint on the secondary side, I mean, we would be out of business, too. Our clients would just walk away. I mean—

Mr. CAPUANO. I get it. And that's one of the things I'm trying to get at. I think that is one of the key factors.

I don't understand why I have to accept the fact that issuer-paid business will continue to go on forever. I mean, again, if that's the case, big red stamp on the front of this, you know, "Endorsed by us," as opposed to, "Endorsed for you."

And I guess the last factor I have is, we talk as if somehow credit rating agencies are just out there doing God's work, and that's it. Most, up until recently, most of the large investors, up until the last 5 years, were institutional investors. Now we get hedge funds, private equity firms, and all that, and different problems we're trying to deal with.

But most institutional investors are required to invest only in certain rated stock, or actually prohibited from investing in other stock. That's a captive audience. That means your rating is critical.

As we see here right now, one of the biggest problems I have, or the biggest disagreements I have, probably maybe the only one, at the moment, of major import, with account administration is the proposal on this public-private investment program. I hate it. I hate it for lots of different reasons.

One reason I hate it is, in this program, it says you can only buy AAA-rated bonds. Excuse me? You rated them AAA. They went bad. They're now junk, toxic, whatever words we're not using this week. And yet we can only invest in those. I'm missing something. Your ratings matter.

And as far as the free speech goes, let me be very clear. You have every right to say anything you want. Go right ahead. You don't have a right to sell it. You don't.

And I understand, I'm a lawyer, lawyers will disagree, and you know much more about the First Amendment than I do. I know one thing. You can't be running down the halls screaming, "Fire," and you can't be running down the halls saying, "There is no fire. Don't worry about it. Don't worry about that smoke that you see over there. Calm down." Well, you can, but you're going to be held liable for it.

Now, we will find out whether the courts have completely gone completely nuts, which on occasion they do, and then luckily we get Presidents who get to appoint members of that court. I don't know where they're going to come down. But there is no rational person

who can step back from the actual, maybe some of the specific cases, to say that you should have a right to sell and to move a market on the basis of, "Don't worry about this fire."

Or, as a lawyer, one of the things I'm taught, don't ask questions you don't know the answers to, or don't ask questions you don't want to hear the answers to.

Now, I don't know that any—have any of you ever been rated? Have you ever worked for a company that was rated? Any of you?

Mr. POLLOCK. Yes, I have, Congressman.

Mr. CAPUANO. Okay. I have, as well. And let me tell you something. My job, when you were rating me—actually, Fitch wouldn't do it—I don't know if—probably still not. I only had two to pick from, two, because the rest of you weren't in business. Fitch was the only one.

And by the way, now that we're talking 10, just as a point of information, how much business is there that is controlled by S&P and Moody's? What's their share of the market, about?

Mr. POLLOCK. About 80 percent.

Mr. CAPUANO. About 80 percent, and Fitch is probably 10, give or take?

Mr. JOYNT. I think 13.

Mr. CAPUANO. Okay, 15. So that leaves, you know, 5 to 10 percent of the market to the other seven. I would suggest that we're not at non-cartel type of competitive market yet.

I understand some of the concerns you have, and I want to be clear. I have been one of the leading critics of the way credit rating agencies work. I'm not out to put you out of business. That's not what I want. I actually think I want you to be there. I want a strong, independent voice to help make—allow the market to make thoughtful judgments on investments. I think that's a good thing.

I want independent auditors. I want independent lawyers. I think some of the lawyers have gotten away with murder, too. But we need independent, thoughtful, credit rating agencies who are not beholden to the people that they're working for.

And with that, I'm actually just hoping that you help us find the way to get there, because otherwise, you're going to leave it up to us, and believe me, maybe I'm wrong, but I think this year, we're going to do it.

So you have two choices. Either let us do it and not have any input, or help us do it the right way.

Thank you, Mr. Chairman.

Chairman KANJORSKI. Thank you, Mr. Capuano.

Mr. Volokh, one question that I had. You mentioned that the First Amendment privilege was argued and decided in two circuit courts within the United States. However, I would imagine the defense of First Amendment privilege was used in cases, say, in Europe or Asia, and since they do not have the benefit of the First Amendment over there, do you recall any specific cases? Was there liability held that was not recognized as a defense?

Mr. VOLOKH. You know, I have a hard enough time keeping up with American law. I can't claim any real expertise as to foreign law. They don't have the First Amendment, and our free speech regime and our free speech history is notoriously much more protec-

tive of speech across a wide range of contexts than in Europe or certainly in Asia.

My sense, also, is that, at least from what I have heard, we also have a much more aggressive tort liability system in the United States than there, so it may be that there was no free speech protection for you, but there are also no legal causes of action.

In fact even in the United States, until recently, the dominant rule, and perhaps today still is the dominant rule, that just as a matter of tort law, there is generally only recklessness or knowledge-based liability, not negligence liability, in speech that's said to the public at large in these contexts.

But I don't know much about foreign precedents in this. My guess is they're not going to be terribly enlightening.

Chairman KANJORSKI. I think I hear a lot of lawyer boots running down the hall right now to buy steamship tickets. I am being facetious, relating it to ambulance chasing.

Mr. Joynt, are you aware of any cases that are pending in Europe or suggested to be—

Mr. JOYNT. I think also, like you suggested, that the tort prevalence in Europe is lower than it is here. I believe the rating agency, credit rating agency industry has just been thought about and reviewed in Europe by the European Parliament, and they chose not to move forward with some kind of expanded or specialized liability, but, you know, so easily, the SEC could inform you about why they chose not to do that, and how it might inform your judgment in this matter.

Chairman KANJORSKI. Thank you very much.

I did not realize you had come in, in the meantime, Mr. Royce, and here I am taking some of your time. So we will give you a little of whatever is left. I will recognize you for 5 minutes.

Mr. ROYCE. Mr. Chairman, I thank you for this hearing.

I only have one question, but I think we have to get past the point of the hard-wiring of these rating references that exist in statutes, because we have set up a regulatory agency, or a cartel out of this, and I think that a lot of the problems, you know, Von Meese has had this theory, after he looked at the cartel arrangements in Europe, and all of them were drawn from a government franchise or a government-enabled or created cartel.

And so if you could figure out a way to get this back to a market-based system where the regulators are not using these scores to determine whether banks are adequately capitalized, then you begin to signal that this isn't the score that you key off of.

Right now, we certainly see, while the credit ratings issued by the NRSROs are intended to be opinions, as you discussed, and of course protected as opinions by the First Amendment, it appears that the treatment of these ratings by market participants is way beyond opinions. It seems that, you know, as Schwazerman, Steve Schwazerman of the Blackstone Group said, the grades issued by rating agencies, he said AAA has almost a religious connotation in finance, and if you call it a AAA, you don't have to analyze it. That's why it's a AAA—as he stated.

So one of the more egregious abuses of these grades occurred when AIG used their AAA rating to sell abstract derivatives based on nothing more than junk mortgages.

So to what extent do you believe the reliance upon the major credit rating agencies by Federal regulators encourages the belief that these ratings are more than just opinions? That would be my first question to the panel.

And from a regulatory standpoint, how can we lessen the dependence upon NRSRO grades?

Mr. POLLOCK. If I could start, Congressman, I fully agree with your point that the regulatory treatment raises these ratings to beyond opinions, whereas what they really are is, indeed, opinions.

And secondly, it would be very good, as I suggested in my testimony, to set all regulators, not only the SEC, to try to lessen the mandating of ratings in their regulations and to increasing competition in this sector.

Mr. ROYCE. Thank you, Mr. Pollock.

Mr. AUWAERTER. Congressman, I think in the case of that discussion that you quoted about AAA securities being almost religious and the investor didn't have to do any analysis, that was errors on the part of the investor. They abrogated their fiduciary duties.

I think regulations—excuse me—ratings have a place in regulation, sort of as a minimum standard, but it's still incumbent upon the investor to do the work.

For example, in Rule 2-A(7), the regulations regarding using a credit rating agency set a minimum floor, and that's a minimum hurdle that, I, as a money fund portfolio manager, have to get over, but I am still required, under the SEC rules, to do my own independent analysis.

What we get concerned about at Vanguard, in particular in the case of money market funds, is that you have a small money market fund that doesn't put the proper resources in, doesn't do their own homework, and they just say, "Okay, we don't have to rely upon a rating agency, we just make a subjective assessment, and we end up being the best house in a block that's burning down."

Mr. ROYCE. Thank you.

Any of the other members on the panel?

Mr. JOYNT. I'm not sure you were here earlier when I had mentioned that the recent SEC hearings, that SEC—S&P and Moody's both had suggested that removing ratings from regulation in that way would be something they think would be okay with them.

So I'm not here representing a different, an industry view. I happen to think that the reason ratings are used in regulation in many places is because when they were put in there, it was deemed constructive and helpful, so that was just one example there.

So I suggest if we're going to go back and think about their usage now, because of the way we perceive rating agencies as being overrelied upon, that it just be done carefully and sort of individually, not in a blanket kind of way, because there must have been some good reasons.

Mr. ROYCE. Would you agree with getting them out of statutes, and would you agree with Alex's point?

Mr. JOYNT. I think it depends. I think the use of ratings as a basic benchmark in 2-A(7) is a constructive use. If there was an alternative, then I think that could be used.

In other cases, maybe the ratings' usefulness is not as great as it was originally intended for.

Someone cited the number of regulations that are used, including State ones, and it's 200 in the States and 50, and I think they ought to be looked at individually.

I think the SEC is doing that right now, I believe, so looking at least at the ones that they use for net capital rules for broker dealer and other things.

Mr. ROYCE. Any other responses?

Mr. DOBILAS. I would just echo that, as well. I think what ratings really do is, you know, give you a minimum standard. I think that is really important.

I think it also enables small investors and small upstart companies to get into the field without adding, you know, a staff of 40, you know, individuals, who are going to try to rate the securities.

What we're really there to do is provide, you know, again, I hate to beat a dead horse, but an opinion on credit, and identify possible risks within the deal, and I think some of those statutes were meant to, you know, ensure there is some sort of analysis done.

I mean, we ran into problems when we relied too heavily on broker dealer research. Ratings were supposed to be seen as more independent, and, you know, give you that basic sense of security in the sense of opinions.

Mr. ROYCE. Mr. Smith?

Mr. SMITH. I think that my answer would be along the lines of what's going to come in place of them, and I don't mean to be flippant by that at all.

I mean that there has to be something, some measuring stick for us to know what the insurance company can hold as reserve capital for their obligations, or what the money market can have in its portfolio and continue to represent itself as same as cash type of an investment. What tool are we going to use to fill that need?

And really, these regulations, in my view, came about to allow insurance companies and banks and so forth to not just have to hold cash. We wanted to look for what's secure enough that we can rely that it's always going to be there, but it doesn't have to be cash. You can make just a little bit of a margin, a little bit of money on it on the edges, and you don't have to flat-out hold cash.

That's really how this all started. That's where we started identifying, well, as long as it's AAA, then you can hold it and meet your capital requirements with your AAA-rated instruments. And—

Mr. ROYCE. And we're still left with the reality that AIG used their AAA rating to sell abstract derivatives based on nothing more than junk mortgages.

Mr. SMITH. Absolutely, and that's because the AAA rating is unreliable, and that's what we have to get back to, to me, to say, well, we're not going to call it AAA anymore, fine. That's fine. What are we going to use as our measuring stick to identify what those entities can hold, unless we're going to make them hold cash, which I don't think is going to be productive for everybody. How are we going to measure it now? How are we going to define it now? If we're not going to define it by terms of these credit ratings, how are we going to define that?

Mr. ROYCE. Any further commentary?

[no response]

Mr. ROYCE. Thank you. Thank you, Mr. Chairman.

Chairman KANJORSKI. Thank you, Mr. Royce.

The gentleman from Alabama seeks recognition?

Mr. BACHUS. Thank you. Yes, please.

Chairman KANJORSKI. You are recognized.

Mr. BACHUS. You know, one thing, we received word, I guess just today, or the last day or so, that the regulators are going to expand the number of companies who can issue opinions on the CMBS market and TALF, which is—at least, I think they're moving in the right direction.

And I know, Mr. Pollock, you have pointed out that you felt like that was—they were going too much to endorse certain companies or create a duopoly.

Mr. POLLOCK. Yes, sir.

Mr. BACHUS. So I do commend the agencies for doing that.

Mr., and it was "Dobilas," is that—I heard you and Mr. Neugebauer; is that right?

Mr. DOBILAS. That's perfect.

Mr. BACHUS. Is that what you came down with?

Mr. DOBILAS. Yes.

Mr. BACHUS. On Page 4 of your written testimony, you say, even in the midst of the unprecedented economic conditions, that Realpoint was able to issue accurate credit downgrades 6 to 9 months sooner than your largest competitors.

Mr. DOBILAS. Correct.

Mr. BACHUS. How were you able to evaluate the creditworthiness so far in advance of the other rating agencies, and can you give us an example of this?

Mr. DOBILAS. Sure. Our emphasis is really on, you know, surveillance of these bonds. You know, our company is a small company compared to the Big Three, and I would label us as a niche company into CMBS securities. We have approximately 50 employees. All 50 are dedicated to the review and surveillance of the underlying collateral.

And I think a big difference is, we have monthly surveillance, and we try to be fully transparent to our investors.

So, we gather information on a monthly basis. We analyze information. We see trends happening. And we're very proactive with regards to our ratings and those trends.

You know, at one point, before Realpoint became an NRSRO, every rating agency subscribed to our service as a research provider for the basic surveillance capabilities we offered.

When we got the NRSRO, you know, that's when things changed a little bit, and again, we lost some market share, you know, at that time.

But the most part is, we have monthly surveillance, we do a very good job with regards to understanding data, understanding market trends, and we have to service our clients, who are the investors.

The investors really don't want to know 6 months after the fact that a security has gone bad, and we try to provide that service through better quality and better service.

Mr. BACHUS. Do you think that some of the other rating agencies that lag behind, were they seeing the same data, or do you think it was—

Mr. DOBILAS. They were seeing the same data, and I don't think all rating agencies on the surveillance front are equal, in the sense I think some rating agencies do a much better job at surveillance than others, but they—we were all seeing the same amount of information and data. It's when do you process that information.

If you're focused on the new issue markets, and getting into that business, and all your energy and resources are there, you're really not going to focus too much on surveillance, especially in a busy market. And again, not all rating agencies have that same focus.

You know, I would like to stick up for Fitch in this sense, and say they have a very good surveillance program, and were seeing a lot of data, and again, their ratings, you know, have not seen the increases that Moody's and S&P have.

Mr. BACHUS. So they did a better job?

Mr. DOBILAS. They did a better job.

Mr. BACHUS. Okay. That's some good news.

Mr. Joynt, do you have some—

Mr. JOYNT. Yes. It's nice to be endorsed by someone.

Mr. BACHUS. Thank you. Maybe that will get in a newspaper article tomorrow. You'll be rewarded for being sent out here all by yourself.

Thank you.

Chairman KANJORSKI. Thank you very much.

I assume Mr. Garrett has no further questions, and I have 100 questions, but you all have been here very long and tediously. We appreciate it. I think it was very helpful to the committee. I think we had some interesting questions.

And maybe I should, Mr. Joynt, thank you, because it was a bit of courage on your part to come forward and put your head out there, and you must really trust the operators of the guillotine.

Mr. JOYNT. I'll come again if asked.

Chairman KANJORSKI. That is very good. And we will welcome you back.

Thank you all very much. We appreciate it. And the Chair notes that some members may have additional questions for the panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for members to submit written questions to these witnesses and place their responses in the record.

Mr. BACHUS. Mr. Chairman?

Chairman KANJORSKI. Yes, sir?

Mr. BACHUS. S&P and Moody's at some later time, I guess, and maybe Sheldon, the cousin, will be called before the committee?

Chairman KANJORSKI. Well, if you would like, we are going to try. We have a host of hearings. You know how many issues lie in our subcommittee. But I would be perfectly willing to find the time, if you will cooperate with us.

Mr. BACHUS. I will. I would like to hear from all three.

Chairman KANJORSKI. We will work on that.

Before we adjourn, the following will be made part of the record of this hearing: A letter from the Association for Financial Professionals. And there being no further business before the committee, without objection, it is ordered that the letter be made a part of the record.

The panel is dismissed and the hearing is adjourned.
[Whereupon, at 5:12 p.m., the hearing was adjourned.]

A P P E N D I X

May 19, 2009

OPENING STATEMENT OF
CHAIRMAN PAUL E. KANJORSKI

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

HEARING ON APPROACHES TO IMPROVING CREDIT RATING AGENCY REGULATION

MAY 19, 2009

Today, we meet to examine the operations of credit rating agencies and approaches for improving the regulation of these entities. Given the amount of scrutiny that these matters have garnered in recent months, I expect that we will have a lively and productive debate.

The role of the major credit rating agencies in contributing to the current financial crisis is now well documented. At the very best, their assessments of packages of toxic securitized mortgages and overly complex structured finance deals were outrageously optimistic. At the very worst, these ratings were grossly negligent.

In one widely reported internal e-mail exchange between two analysts at Standard and Poor's in April 2007, one of them concludes that the deals "could be structured by cows and we would rate it." I therefore fear that in too many instances the truth lies closer to the latter option rather than the former possibility.

Moreover, if we were to turn the tables today and rate the ratings agencies, I suspect that most Members of the Capital Markets Subcommittee would agree that during the height of the securitization boom the rating agencies were double-A, if not triple-A failures. Clearly, they flunked the class on how to act as effective gatekeepers to our capital markets.

Along with the expressions of anger, outrage, and blame that we will doubtlessly hear today, I hope that we can also explore serious proposals for reform. Unless we can find a way to improve the accountability, transparency, and accuracy of credit ratings, the participants in our capital markets will discount and downgrade the opinions of these agencies going forward.

One could hope that the agencies would do a better job in policing themselves. But if past is prologue, we cannot take that gamble. This time their failures were not in isolated, case-by-case instances. Instead, they were systemic problems across entire classes of financial products and throughout entire industries. Stronger oversight and smarter rules are therefore needed to protect investors and the overall credibility of our markets.

As a start, the rating agencies must face tougher disclosure and transparency requirements. For example, investors receive too little information on rating methodologies. The financial crisis has illustrated the danger flawed methodologies pose to the system. If methodologies remain hidden, there exists no check by which to expose their weaknesses.

In addition to establishing an office dedicated to the regulation of rating agencies within the Securities and Exchange Commission, oversight must also focus more intently on surveillance of outstanding ratings. The industry has done an inadequate job of downgrading debt before a crisis manifests or a company implodes. Moreover, we must examine how we can further mitigate the inherent conflicts of interest that rating agencies face.

In this regard, among our witnesses is a subscriber-pays agency. This alternative model is worthy of our consideration. At one time, all rating agencies received their revenue from subscribers, but they evolved into an issuer-pays model in response to market developments. I look forward to understanding how a subscriber-pays agency succeeds in today's marketplace.

Additionally, the question of rating agency liability is of particular interest to me. The First Amendment defense that agencies rely upon to avoid accountability to investors for grossly inaccurate ratings is generally a question for the courts to determine, but Congress can also have its say on these matters. Much like the other gatekeepers to our markets, namely lawyers and auditors, we could choose to impose some degree of public accountability for rating agencies via statute. The view that the agencies are mere publishers issuing opinions bears little resemblance to reality, and the threat of civil liability would force the industry to issue more accurate ratings.

In sum, the ongoing financial crisis requires us to reevaluate how rating agencies conduct their business, even though we enacted the Credit Rating Agency Reform Act just three years ago. As this Congress considers a revised regulatory structure in the broader context, this segment of our markets also needs to be examined and transformed. By considering proposals aimed at better disclosure, real accountability, and perhaps even civil liability, we can advance that debate today and ultimately figure out how to get the regulatory fit just right.

FOR MORE INFORMATION, call:202-225-4465 • www.house.gov/garrett

EMBARGOED UNTIL DELIVERY
Tuesday, May 19, 2009

Contact: Erica Elliott
Phone: 202-744-2693

Garrett Statement on Credit Rating Agencies for Financial Services Hearing

(Washington, DC)– **Rep. Scott Garrett (R-NJ) released the following opening statement for today's House Financial Services Subcommittee on Capital Markets hearing entitled "Approaches to Improving Credit Rating Agency Regulation":**

"Thank you, Chairman Kanjorski, for holding this important hearing today. I believe it is critical that this subcommittee conduct proper oversight of the credit rating agencies and examine all of the issues surrounding the role they played in the lead up to our nation's current financial crisis.

"I would like to thank all of our witnesses for attending today. Unfortunately, we do not have a representative from the Securities and Exchange Commission, the government agency tasked with overseeing and regulating Nationally Recognized Statistical Rating Organizations (or NRSROs), here to testify. I feel it is essential that, before this committee formally considers any regulatory reforms regarding the rating agencies, we hear directly from the SEC as to what, if any, additional powers they need.

"Over the past decade, we have seen a large increase in the role that credit rating agencies have in determining the creditworthiness of financial institutions and different types of securities. Whether it is corporate, municipal or structured finance, any entity seeking to assure investors of the quality of its debt must receive a good grade from one of the rating agencies.

"Investors have become increasingly, and too often, solely reliant on the use of these ratings in determining the safety and soundness of any investment. This situation, like many of the other problems of this financial crisis, has in large part been created by government policy.

"In literally hundreds of federal and state government statutes and regulations, there are specific requirements mandating certain grades from the approved agencies. It is this formal requirement that provides an implicit stamp of approval to investors. When investors see that the government is requiring a specific grade to make a "safe investment," it reinforces the belief that any investment attaining such a grade is "safe."

"To its credit, the SEC recognizes this problem as well and they are moving to address it. In December of last year, the SEC proposed several new rules, one of which would reduce the reliance of NRSRO ratings in the SEC's regulations. I believe SEC Commissioner, Kathleen Casey, had it right when she said, "These requirements…have served to elevate NRSRO ratings to a status that does not reflect the actual purpose, much less the limitations, of credit ratings."

"Congress should follow suit and re-examine all of the areas where statute mandates the ratings of a NRSRO. Credit ratings are only one piece of the puzzle in determining creditworthiness. Investors must be encouraged to do their proper due diligence in evaluating issuer credit quality.

"One of the other areas that need to continue to be addressed is increased competition within the rating agency industry. The 2006 act made a number of significant improvements to the NRSRO designation process. Unfortunately, the law was just being implemented at the very time our financial system started to hemorrhage. The very worthwhile goals of that law such as fostering more competition, enhancing transparency, and increasing accountability can still be achieved.

"Two things I do not think Congress or the SEC should do are eliminate specific types of pay models or prescribe exact analytics that the NRSROs must use. This would go against the intent of the legislation by further reducing competition and increasing investor reliance on ratings.

"In regards to competition, a recent rule issued that also runs contrary to the goals of the 2006 Act is the Federal Reserve's requirement that any securities used as collateral in their Term Asset-Backed Lending Facility (TALF) must have an A-1 rating from a MAJOR NRSRO. This MAJOR NRSRO term is entirely new and refers to the big three rating agencies. While I will assume the Fed added this requirement due to the perceived better quality of the big three's ratings, I will remind the Fed that the big three rated Lehman Brothers A-1 the day of its bankruptcy.

"Another area in which I would like to see increased competition is the manner in which credit quality is determined. I know many of my friends on the committee like to demonize credit default swaps as horrific gambling bets made by fat cats smoking cigars and sitting in their luxurious boardrooms. However, credit default swaps are actually additional measures of assessing the creditworthiness of different corporations or securities. And, during the height of the financial panic and collapse of many major firms, credit default swaps provided a more accurate gage of risk than the ratings from the credit rating agencies.

"In conclusion, I believe the government must continue to wean investors off being solely reliant on credit ratings and encourage them to conduct more due diligence. I greatly appreciate the Chairman holding this important hearing today and look forward to witness's testimony."

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Testimony of Robert F. Auwaerter
Principal and Head of the Fixed Income Group
The Vanguard Group

Before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises

Committee on Financial Services
United States House of Representatives

Approaches to Improving Credit Rating Rating Agency Regulation

May 19, 2009

Mr. Chairman and Members of the Subcommittee: Thank you for the opportunity to testify at this important hearing on examining the need for further regulation of the credit rating agencies. My name is Robert Auwaerter, and I am the Head of the Fixed Income Group at the Vanguard Group, a mutual fund company based in Valley Forge, Pennsylvania. Vanguard is the world's largest mutual fund family, managing approximately $1 trillion for more than 24 million investor accounts. I am responsible for the management of $514 billion of money market and bond fund assets.

Credit ratings provided by credit rating agencies (CRA) serve a useful purpose in the financial markets. For the small investor, credit ratings provide a standardized way for investors to do an initial screen of potential investment choices for credit risk. For institutional investors they provide a consistent way to set investment parameters for credit risk, whether for use in internal management, or in the form of instructions for external investment advisors.

They also serve a constructive purpose in government regulations. The most prominent example of this is their use in the Securities and Exchange Commission Rule 2a-7 governing money market mutual funds. Nationally Recognized Statistical Rating Organization (NRSRO) ratings provide an independently established baseline for money market fund investments and are a valuable assurance to investors that money market fund investments are not subject to unnecessary risk. Independent third-party credit ratings protect investors by limiting the fund's ability to chase higher yields through riskier securities, based on their own subjective assessment. While NRSRO ratings serve as an objective and necessary qualification for buying a security, they are not sufficient on their own to warrant an investment.

Credit ratings are a starting point. Investors must do their own analysis when determining the appropriateness of an investment. Investors choose Vanguard to invest on their behalf in part because of our ability to employ significant resources toward

assessing credit risk in our fixed income portfolios. In total, Vanguard has 25 Senior Credit Analysts with over 400 years of cumulative industry experience.

It is important to recognize that in the efforts to avoid the mistakes of the past, 100% perfection and accuracy in ratings cannot be the goal. Ratings will change over time. It is not reasonable to fully anticipate every development that impairs a business model, or foresee changes in management priorities.

Vanguard believes that there is a need for further regulation of credit rating agencies. However, the focus of these efforts should be on improving the transparency and reliability of credit ratings, while at the same time, controlling and disclosing the conflicts of interest that exist in all credit rating agency business models.

Credit rating agencies provide a critical service in several different markets. For example, the ratings process for corporate borrowers such as industrial and utility companies and financial institutions must address the need to protect material non-public information from being disseminated. Currently, issuer-pay credit rating agencies will take material nonpublic information (management forecasts) into account in the ratings assessment process. The nature of the direct relationship between the corporate issuer and the rating agency governs this disclosure and protects against unwanted dissemination of material nonpublic information. We are concerned that proposals that force full disclosure of all credit rating material from corporate issuers, including nonpublic information, to all potential credit rating agencies, will end up limiting the disclosure to all credit rating agencies. Under this scenario, we would expect credit ratings to become less reliable, not more reliable.

On the other hand, we are in favor of greater and more frequent disclosure by issuers of municipal and structured finance securities. With structured finance securities, over reliance on quantitative models based on outmoded assumptions that did not take into account changes in the economic environment and the failure to use qualitative judgment played important roles in the problems in this part of the market. Structured finance, and for that matter municipal, ratings are impaired by a lack of transparency of key credit rating determinants by the issuer of the security. We would like to see greater transparency and disclosure from the issuers to the investors as a feature of improved regulations.

On the NRSRO Designation

Rating agencies provide a key public service. Regardless of the business model, the ratings product must be subject to very high standards of independence, diligence, and accountability. To serve the public interest, ratings cannot pander to either issuer or investor concerns. For this reason, Vanguard supports an increase in the authority of the SEC to provide appropriate oversight of the NRSROs.

Improved regulations and oversight for NRSROs should focus on the transparency and reliability of the ratings process. The NRSROs should be subject to regular audits that test compliance to internal procedures, the independence of rating actions, and the diligence of the ratings process. The goal of these audits should not be to regulate the actual ratings, but rather the process by which the rating agencies derived these ratings.

The NRSRO designations should be limited to CRAs that are in compliance with strict regulatory requirements. There is an opinion that by inducing greater competition into the CRA marketplace, ratings quality will automatically improve. While competition itself can be constructive, it may come at a significant cost. By artificially leveling the playing field and inducing many new participants, the market will be littered with a wider dispersion of credit ratings for issuers and structured finance transactions. It is very important that in designating a credit rating agency as a NRSRO, the SEC determines that there is sufficient analytical and operational resources to perform appropriate level of independent credit analysis. By definition, NRSRO's should have a wide market appeal and should not be niche ratings agencies focusing on narrowly defined segments of the market.

The government should not seek to remove the NRSRO designation from all regulations. The designation itself did not force an overreliance on ratings, instead the reliance on ratings stems from the market's need to baseline credit risk. The problem with the existing NRSRO process is the ineffectiveness of current NRSRO oversight. Having new rules, with the ability to pull a NRSRO designation, provides a powerful incentive for compliance.

Non-NRSRO Rating Agencies

Non-NRSRO unregulated credit rating agencies can exist in harmony with the NRSRO process. Subscribers that appreciate their value-added will elect to pay for their services. Customers that do not appreciate the value proposition should not be forced to subsidize their existence in the name of competition. If new rules focus on improving the transparency and disclosure to investors, non-NRSRO rating agencies will have adequate information to make ratings assessments, without forcing an 'even playing field' with NRSRO rating agencies.

Standing Advisory Board

The regulators should consider the creation of a standing advisory board comprised of key rating agency constituents. It could serve an important role in providing feedback on new product types, ratings performance, and regulatory proposals to both the credit rating agencies and the appropriate regulators.

Summary

In summary, credit ratings serve a useful purpose in the marketplace and in government regulations. It is important that there be improvements in both their transparency and reliability. Vanguard supports an increase in the authority of the SEC to provide oversight of the NRSROs. It must use that oversight to ensure that the credit rating agency has the appropriate resources and procedures to deliver a ratings product that meets very high standards of independence, diligence, and accountability.

STATEMENT

of

ROBERT G. DOBILAS

PRESIDENT & CEO

REALPOINT, LLC

at the

HEARING

on

APPROACHES TO IMPROVING CREDIT RATING AGENCY REGULATION

before the

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES

of the

FINANCIAL SERVICES COMMITTEE

U.S. HOUSE OF REPRESENTATIVES

May 19, 2009

Washington, DC

Thank you for the opportunity to participate in this hearing on "Approaches to Improving Credit Rating Agency Regulation." By way of background, Realpoint is the most recent company to be designated by the SEC as a Nationally Recognized Statistical Rating Organization. We were designated for asset-backed securities and, within the structured finance market, our specialty is rating commercial mortgage-backed securities (CMBS). Realpoint has approximately 50 employees and is located in suburban Philadelphia.

I would like to begin by commenting favorably upon the legislation passed by the Congress in 2006, which was designed to improve the regulatory procedures whereby rating agencies could be given national designation by the SEC. Under the rules implementing the Credit Rating Agency Reform Act of 2006, we found the application process to be straightforward and the staff of the agency to be both professional and helpful. The Commission is continuing to propose and adopt additional rules under that Act, but, as will be discussed more fully in the course of my testimony, Realpoint is of the view that both Congress and the financial regulatory agencies need to step in once again to address the glaring failures by the major credit rating agencies which are at the heart of the current credit crisis. Actions taken by the prior and current Administrations have stabilized the situation, but lack of confidence in credit ratings continues to eviscerate the financial markets.

The CMBS market amply demonstrates the depth of this free-fall. At the height of the market, total securitizations were in the range of $150-200 billion per year. Since June, 2008, however, there have been no new issuances, and very few CMBS transactions are under consideration at this time. At the same time, there are over $150 billion of securitized commercial mortgages coming due between now and 2012.

In light of the coming wave of refinancings, it is essential that the CMBS market be reconstituted and the Term Asset-Backed Securities Lending Facility (TALF), which has recently been expanded to cover CMBS, will certainly help. In our view, however, unassisted investors both here and abroad will not return to the market until confidence in ratings has been restored through meaningful governmental intervention. The key will be to use the TALF program not just as a catalyst for restarting the market, but to use that government program as a vanguard to reform the credit rating industry.

There is no need to spend any time on causal concerns. As noted in the recent Report on Regulatory Reform of the Congressional Oversight Panel, the "major credit rating agencies played an important—and perhaps decisive—role in enabling (and validating) much of the behavior and decision making that now appears to have put the broader financial system at risk."[1] The SEC examination of issuer-paid ratings likewise found that the ratings were not merely inaccurate, but that there were serious questions about the "integrity of the ratings process as a whole."[2]

Realpoint's Business Model

Your letter of invitation asked us to describe our business model and how it differs from the issuer-pay model. Realpoint operates as an independent, subscriber-paid business which, incidentally, is how Moody's, S&P and Fitch operated for the first 75 years they were in business. This means our revenues are derived from investors, portfolio managers, analysts, broker/dealers and other market participants who pay on a quarterly or other

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1 Special Report on Regulatory Reform of the Congressional Oversight Panel (January 29, 2009) at Page 40.

2 Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies by the Staff of the Securities and Exchange Commission (July, 2008).

recurring basis for our services. These services, based on post-sale data, consist of in-depth, monthly ratings reports on all current CMBS transactions (over 700). These reports include analytical performance summaries, "watch-list" alerts and other information about a rated security or the underlying collateral for that security such as the property-level reports for CMBS.

The principal difference, of course, is that the larger firms such as Moody's, S&P and Fitch are now issuer-paid rating agencies. As such, they are paid substantial, up-front fees on the sales event by the corporations which are issuing the securities or by investment banking companies which are underwriting the transaction. Another major difference is that our monthly reports provide ongoing surveillance of the CMBS real estate securities, properties, loans and markets.

In the issuer-paid model, the compensation and the attention is focused almost exclusively on the pre-sale situation. The SEC recently published data showing that Moody's has had to downgrade 94.2 percent of all the subprime residential mortgage backed securities it rated in 2006. We see this trend repeating itself in the CMBS market for all three of the major rating agencies. This is the equivalent of major league baseball players striking out in 19 of 20 at bats.

Realpoint's initial ratings and ongoing analyses have been consistently lower and more stable than those of the issuer-paid rating agencies. Even during these unprecedented times, downgrades at Realpoint stand below the 30 percent level and have occurred six to 12 months sooner than the corresponding rating actions taken by our larger competitors.

The Issuer-Paid Rating Agency Bidding and Selection Process

The core problem and the most important message that I would like to leave with the Subcommittee today, is that the integrity of the ratings process is undermined by the pervasive practice of "shopping" for preliminary ratings. When issuers solicit a bid from a rating agency for new-issue rating work, the issuer requires the rating agency to provide preliminary ratings as part of that bidding process. Unlike corporate bonds and general obligation municipal bonds, which may be rated using publicly-available financial information, an initial issuance of CMBS and other structured finance bonds is rated by an agency using privately-held information disclosed on a selective basis. As a consequence, the issuer or arranger of structured finance bonds has the ability to control the ratings process of a new issue by awarding the rating contracts and its very substantial fees to rating agencies that provide favorable preliminary ratings.

The issuer generally begins the "rating shopping" process of selecting its issuer-paid rating agencies by providing data (property information and existing mortgage loan terms) to selected rating agencies. These companies then analyze the largest properties and a sample of the other properties, to provide preliminary feedback regarding proposed tranches, i.e., the subordination level attachment points, for the securities to be backed by the pool. An agency that provides unfavorable preliminary response (namely a lower rating profile) risks not being hired by the issuer.

Since higher ratings generally equate to lower borrowing costs, there is a strong inclination for the issuer to select the NRSROs that provide favorable preliminary feedback to rate the new issue. The issuer then provides these NRSROs with the remainder of the information with which to develop the final tranches. In short, the current practice of

obtaining undisclosed preliminary ratings, coupled with the current reliance on issuer-paid credit ratings, fosters "ratings-shopping" and a lack of independence, accountability and integrity with respect to the new-issue ratings.

Potential Benefits from the Availability of Pre-Sale Independent Ratings

We hear much about the complexities of modern financial instruments and this is certainly the case in many instances, but the process by which the public seeks to learn the value of debt instruments, namely credit ratings, is not complex. I have just described how it works and it is not at all complicated – the parties which control the information control the end result.

The solution is equally simple and it only takes one step – let all the designated rating companies have the same information and prepare their own pre-sale ratings and reports regardless of whether or not they are ultimately paid by the issuer of the securities. This information is almost always available on a *post-sale* basis and thus the only step which the Congress or the federal regulators have to take is to mandate that issuers simultaneously disclose the information provided to its solicited rating agencies to all other SEC designated rating agencies on a *pre-sale* basis.

By requiring issuers to simultaneously disclose to all SEC-designated agencies the same information that the issuer provides to its hired rating agencies, investors will have the opportunity to receive pre-sale ratings and ratings reports from other agencies which were not hired by and who can thus be independent of the issuer. In our view, there is simply no better and more straightforward way to enhance the integrity of the ratings process than to share the information with all the agencies which the SEC has deemed of sufficient stature to be Nationally Recognized Statistical Rating Organizations.

In fact, the SEC has already proposed precisely such a rule through an amendment to its Fair Disclosure rules (Regulation FD).[3] That regulation prohibits companies from selectively disclosing material information, but it allows disclosure to a rating agency for the purpose of developing a credit rating that will be made publicly available. Realpoint supports the Commission's proposals since it would permit a company like ours to prepare pre-sale reports for the investment community. The public benefits of having six or seven independent and qualified credit ratings, rather than just the two selected and paid by the parties selling the securities, are obvious, immediate and manifest.

Specific legislation accomplishing this goal is likewise simple, and could be crafted in one paragraph as follows:

> EQUAL DISCLOSURE REQUIREMENTS.— Not later than 90 days after the date of enactment of this Act, the Securities and Exchange Commission shall revise the regulations relating to the term "Nationally Registered Statistical Rating Organization" to require: "Any issuer, underwriter, sponsor, depositor, servicer or trustee providing information to an NRSRO being solicited or paid for a credit rating for a security or money market instrument, shall simultaneously disclose such information to all NRSROs designated to develop credit ratings for that particular product."

In order to be meaningful, it is essential that the issuer-provided information also be provided in the same manner and with the same search, access and other capabilities, as it is being made available to the paid rating agency during the pre-sale process. For surveillance purposes, it is likewise critical that trustee, servicer or special servicer information also be provided simultaneously to the other eligible rating agencies, at the same time and in the

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3 Re-Proposed Rules for Nationally Recognized Statistical Rating Organizations, Release No. 34-59343 (February 2, 2009), 74 Fed. Reg. 6485 (February 9, 2009), File No.: S7-04-09 [herein, "Re-Proposing Release"], Proposed Amendments to Rule 17g-5(a)(3)(iii)(B).

same manner, and with the same search, access and other capabilities as it is being made available to the issuer-paid agency.

The SEC has also proposed and we agree that the delivery of this information can be easily effectuated through a password-protected website. This is a well-established market mechanism and is used every day by investment banking firms to disseminate confidential information in merger and acquisition transactions. Doing so in the ratings context would allow every SEC designated agency sufficient time to review and analyze pre-sale information and provide pre-sale reports and ratings for each tranche of the new issue it wishes to rate. Having this information equally and more broadly shared will also allow the surveillance function to be conducted on an even more effective basis throughout the entire life cycle of the bond.

Disclosures

You have also asked about disclosure practices regarding ratings methodologies and, in this regard, many market observers have taken the position that requiring credit rating agencies to provide investors with access to their internal procedures and methodologies would constitute effective corrective action. At Realpoint, we do not believe it makes much sense to shift the burden from the rating agency's analysis of the debt issue to the public's analysis of which rating agency has the best debt analysis system. One difficulty will be to implement a uniform means by which these complex (not to mention proprietary) systems are to be made readily available and understandable in Chinese, Russian and the languages of the many other countries where investors desire to purchase dollar-denominated securities.

An issuer-paid rating agency can be paid seven to10 basis points and these fees typically exceed one million dollars for a new issue. The assignment is to produce an

accurate rating from the standpoint of the investor and, once again, this is a very simple policy goal. Investors want to know if the bond is AAA or some lower grade; they are not interested in comparing different methodologies, or whether one version produces a real AAA while another results in a lesser version of AAA.

The same point applies to the question of whether ratings should be switched to numerology or whether there should be unique disclosure requirements for issuers of structured finance products such as carrying an "sf" addendum. The investment community does not want a new system; investors just want the old system to be restored to its former credibility.

Lastly on the disclosure issue, it has also been suggested by some that another "easy" answer is to have all rating agencies make their ratings publicly available in some type of time-sensitive comparability format. This simply does not work for the subscriber-based business model since selling this information is the primary source of our revenues. Realpoint and other companies like it are able to produce independent and reliable bond-rating analysis because certain investors are willing to pay for it and these subscribers rightly believe that the information for which they are paying is not made freely available to others. Not only would disclosure requirements of this type undermine competition from the subscriber-paid companies, but some have argued that the mandate to make proprietary information freely available to the public may constitute a form of government taking.

Again, the point should not be to make investors self-generate debt evaluation because the major rating agencies have failed to do the work for which they were paid. A person using the professional services of reputable companies should be able to do so without

having to consult a historical cross-comparison chart. There is no reason that SEC-designated rating firms should be an exception to this rule.

If we do not produce accurate ratings at Realpoint, we lose our subscribers but under the issuer-paid model, the record shows that there are no adverse consequences for being wrong. The major rating agencies were assessing the debt of Enron, WorldCom, and Global Crossing at investment grade practically to the point of these companies' filing for bankruptcy, but in the ensuing years their profits reached record levels. The existing system does not work and, with the collapse of the credit market with trillions of dollars of losses, individuals, companies and governmental entities demand that we fix it now and fix it right.

TALF and Other Government Assistance Programs Should Mandate Reforms

Late last year, the Treasury Department, Federal Reserve and other financial regulators began implementing TALF and several other government-assisted programs intended to support the financial markets. Initially, the ratings component of TALF was limited to "major NRSROs" which meant only Moody's, S&P and Fitch. The same limitation was adopted with respect to other programs such as that backstopping the commercial paper market, which has now grown to over $250 billion.

We are pleased that the Federal Reserve is taking the steps necessary to pre-screen all rating companies for eligibility in these programs in which taxpayers' guarantees are being placed behind the collateral assets. We appreciate that these programs had to be developed and launched under stressful and time-sensitive circumstances, but it is likewise important that there be consequences for failing to perform their mission.

TALF and other comparable programs utilize the standard industry practice of requiring two ratings for the securities to be deemed suitable collateral, and there is no valid

public policy reason for not insisting that at least one of these ratings be an independent, subscriber-based rating. A mandate to have TALF and other government-assistance programs include at least one independent rating agency would enhance investor confidence in those programs and set the stage ultimately for the resurrection of reliable ratings in the private sector. The American taxpayer should not have to settle for more of the "ratings shopping" syndrome that I have previously described.

Liability

A number of "reform' initiatives have focused on the judicial aspect of the ratings industry and, in particular, the First Amendment or "freedom of speech" defense which has traditionally been invoked to defeat civil claims for rating failures. Resorting to the courts for effective remedy resolution is not more of what we need in the business community. Credit ratings are opinions regarding the likelihood of payment of a financial obligation in accordance with the stated terms of the debt agreement; we are not and cannot be financial guarantors either directly or indirectly.

By way of example, at Realpoint, we have issued outstanding ratings on approximately $780 billion of CMBS. The idea that our modest company could be confronted with potential liabilities on this scale does not align with our business model. Even if we could afford it, no company would or should commit to that level of errors and omissions insurance. Whether or not the larger companies could manage that risk is for them to determine, but at Realpoint, we would be forced to surrender our SEC designation. The Credit Rating Reform Agency Act of 2006 was designed and has, in fact, fostered growth in

the number of SEC-designated national rating agencies,[4] but the removal of our liability protections would have the opposite effect.

Conclusion

We have attempted to be quite candid in our presentation today. First, the integrity of the ratings process is flawed because the industry fee structure relies too heavily on the issuers and arrangers of debt offerings to control the process through the direction of fees for new issues. Second, this is not a complex problem and, in fact, it is not that different from when we were all in high school and everyone sought out the teachers who were known as "easy-graders." This is what drove the massive level of high-grade defaults during the last two years and it still driving the remainder of the pre-sale process today. Third, current industry practices place too much emphasis on new issue ratings as opposed to ongoing surveillance on what are debt obligations of ten or twenty years or even longer durations.

AAA investors abandoned the market for private asset-backed securities and they are not coming back until the system is changed. In our view, the best solution is the simple one of letting the issuers' pre-sale information be made available to all qualified rating agencies. In the short run, this can best be done through TALF and comparable programs which could be further enhanced by having their securities rated co-equally by subscriber-based rating agencies. The government can set this higher standard now and let it serve as the mark for reforming the rest of the industry over the longer term.

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[4] Among the findings on which the Credit Rating Agency Reform Act of 2006 was based was that: "the two largest credit rating agencies serve the vast majority of the market, and additional competition is in the public interest." Section 2 of the Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291 (2006).

FitchRatings

Prepared Statement of Stephen W. Joynt

President & Chief Executive Officer, Fitch Ratings

before a hearing of the

Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises

Committee on Financial Services

U.S. House of Representatives

on

"Approaches to Improving Credit Rating Agency Regulation"

May 19, 2009

Nearly two years has passed since the onset of the "credit crisis." Clearly in that time what began as stress focused on the global debt capital markets has evolved into a severe global economic slowdown. An array of factors contributed to this – and these have been broadly analyzed and debated by market participants, the media, and within the policy-making and regulatory communities. Key underlying factors include historically low real interest rates, greater global demand for relatively riskier and higher-yielding assets, significantly higher

degrees of systemic leverage, lax underwriting standards in the mortgage origination markets, inadequate discipline in the securitization process, insufficient risk management practices at financial institutions, an outmoded global regulatory framework and credit ratings in RMBS and CDOs that have not performed as originally intended.

During this time, the focus of Fitch Ratings has been on implementing a broad and deep range of initiatives that enhance the reliability and transparency of our rating opinions and related analytics. More specifically, our primary focus is on vigorously reviewing our analytical approaches and changing ratings to reflect the current risk profile of securities we rate. In many cases that continues to generate significant numbers of downgrades in structured securities, but also impacts other sectors, such as banks and insurance. We are releasing our updated ratings and research transparently and publicly, and we are communicating directly with investors the latest information and analysis we have. These are occasionally difficult meetings as investors are sometimes unhappy about their own decision-making – and the part that ratings played in their decisions. But we must reassess the risk today to move forward.

In parallel, we have been introducing a range of new policies and procedures – and updating existing ones – to reflect the evolving regulatory frameworks within which credit rating agencies operate globally.

On each of these dimensions, we have been as transparent as possible and broadly engaged with a wide range of market participants, including policy makers and regulators. We are happy to expand upon any of these topics should Members of this Committee or their staff so desire.

That said the primary focus of today's hearing is "where do we go from here." Clearly, credit rating agencies continue to be topics of interest in the market and in the regulatory communities. The SEC has made a number of rule proposals and considered a number of important questions in its roundtable discussion in April. The EU recently agreed a registration and oversight system and related rules for credit rating agencies. Other nations are considering similar measures.

As this Committee considers these questions, we would like to offer our perspective on a number of important issues. Let me reiterate that Fitch is committed to engaging on all of these matters in a thoughtful, balanced, constructive and non-self serving manner. At the same time, a number of perceptions and proposals continue to circulate that warrant further consideration, clarification, or in some cases "reality checking."

Managing Conflicts of Interest. The majority of Fitch's revenues are fees paid by issuers for assigning and maintaining ratings. This is supplemented by fees paid by a range of market participants for enhanced research subscriptions and complete rating feeds. The primary benefit of this model is that it enables Fitch to be in a position to offer analytical coverage on every asset class in every capital market – and to make our rating opinions freely available to the market in real-time, thus enabling the market to freely and fully assess the quality of our work. Fitch has long acknowledged the potential conflicts of being an issuer-paid rating agency. Fitch believes that the potential conflicts of interest in the "issuer pays" model have been, and continue to be, effectively managed through a broad range of policies, procedures and organizational structures aimed at reinforcing the objectivity, integrity and independence of its credit ratings, combined

with enhanced and ongoing regulatory oversight. A few examples our relevant policies and procedures are below:

- Business development is separated from credit analysis, to keep each group focused on its core task.
- Employees involved in the assignment of the resulting ratings do not handle fees discussions for an issuer or transaction.
- No analyst or group of analysts is directly compensated on the revenues related to their ratings.
- Ratings are determined using a committee structure, not by a single analyst. These committees include a mandatory independent member.
- Cross-group committees and an independent internal review function review all ratings criteria.
- Fitch has introduced the new role of group credit officer in each of its rating groups.
- Fitch has established and enforces a Code of Conduct (consistent with IOSCO's and updated in February 2009) and ancillary policies to specifically address potential conflicts.
- Fitch has relocated all of its non-rating operations into a separate division, Fitch Solutions, which operates behind a firewall.

No payment model would be completely immune to conflicts of interest, whether from investors, issuers, governments or regulators. An "investor pays" model also contains direct conflicts, given that most major investors have a vested financial interest in the level of ratings and many are rated entities. A move to a complete "investor pays" model, by definition making the ratings

a subscription product, could also remove ratings from the public domain. This would conflict with investor and policymakers' call for ratings to be broadly available, thereby allowing the market to openly judge ratings performance.

Disclosure of Ratings Methodologies. The definitions for all of Fitch's ratings and rating scales are regularly reviewed and updated, publicly disclosed and freely available on our website. The most recent ratings definitions update is set forth in a March 2009 report entitled "Definitions of Ratings and Other Scales." In addition, the criteria that details Fitch's analytical approach to rating issues and issuers in every region and asset class are also regularly reviewed and updated, and freely available on our website on a centralized "criteria homepage." In select cases where Fitch is considering what it believes to be a material shift in our thinking regarding our analytical approach to a given sector, we normally release our thinking to the market as an "exposure draft." In such a case, we solicit feedback from market participants and engage in transparent discussions about our approach – such as one-on-one meetings, webcasts and conference calls – and we have done so repeatedly in the last few years. In addition, the processes we follow internally in developing and approving such methodology updates are also fully codified, consistent with SEC and IOSCO rules, and freely available. Finally, we develop and publish an enormous number of rating commentaries (over 15,000 in 2008) and research reports that summarize our opinions on issues, issuers and market sectors as part of our efforts to ensure the market is aware of our perspective. We do not believe for a minute that everyone will agree with all of our opinions, but we are committed to ensuring the market has the opportunity to discuss them.

Issuer Disclosure and Due Diligence in Structured Finance. Some market participants, in reviewing the performance of ratings in structured finance markets, have noted that limits on the amount of information that is disclosed to the market by issuers and underwriters has made the market over-reliant on rating agencies for analysis and evaluation of structured securities. The argument follows that the market would benefit if additional information on structured securities (such as asset specific data on residential and commercial mortgage backed securities) were made broadly and readily available to investors, thereby enabling them to have access to the same information that mandated rating agencies have in developing and maintaining our rating opinions. Fitch fully supports the concept of greater disclosure of such information. However, we also believe that responsibility for disclosing such information should rest fully with the issuers and the underwriters, *not* with rating agencies. Quite simply, it is their information on their deals, so they should disclose it.

Furthermore, Fitch notes that the disclosure of additional information is of questionable value if the accuracy and reliability of the information is suspect. That goes to the issue of due diligence. While rating agencies have taken a number of steps to increase our assessments of the quality of the information we are provided in assigning our ratings, including adopting policies that state that we will not rate issues if we deem the quality of the information to be insufficient, due diligence is a specific and defined legal concept. Due diligence is not currently, nor should be, the responsibility of credit rating agencies. The burden of due diligence belongs on issuers and underwriters. In that regard, we support the concept that issuers and underwriters ought to be required to conduct rigorous due diligence on the underlying assets that comprise asset backed and mortgage backed securities offered or sold in the U.S. Fitch believes Congress should

consider amending the securities law to require such due diligence on underlying assets for all ABS and MBS securities offered or sold in the US, whether or not the securities are registered under Section 5 or sold pursuant to an exemption from such registration. Congress ought not to hold rating agencies responsible for such due diligence or for requiring that others do it. Rather, Congress should mandate that the SEC enact rules to require issuers and underwriters to perform such due diligence – make public the findings – and enforce the rules they enact.

Regulation and Transparency. Stated simply and clearly, Fitch supports fair and balanced oversight and registration of credit rating agencies and believes the market will benefit from globally consistent rules for credit rating agencies that foster transparency, disclosure of ratings and methodologies and management of conflicts of interest.

The dialogue on changes to rating agency regulation follows two primary – and not necessarily consistent – themes. The first is the imposition of additional rules and regulations that are manifested in a range of new or enhanced policies and procedures. This has been the primary thrust of recent SEC rulemaking and of the recently passed EU rules. Fitch is or will be fully compliant with these new rules.

At the same time, a number of commentators have spoken on the topic of the market's perceived over-reliance on credit ratings. To a certain extent, we agree with this premise, in so far as some market participants clearly used ratings for purposes for which they are not intended, such as valuation, or as a substitute for – as opposed to a complement to – their own fundamental credit analysis. Or, perhaps, they came to similar conclusions as rating agencies regarding risk

assessments, and simply prefer to direct attention elsewhere. One proposed remedy for this is to eliminate the use of ratings in regulation or to eliminate the NRSRO concept altogether. While deceivingly simple, we believe this proposal warrants several comments. Ratings have been used constructively in many places in regulation, as they are an important common benchmark. In many cases, if you eliminate the use of "NRSRO" ratings in regulation, company and industry participants will develop their own guidelines and use credit ratings anyways. We believe they will default to the largest "brand name" rating agencies (Moody's and S&P), which is not a positive if one of your objectives is increasing competition and thereby fostering a better work product. Note that the SEC proposed a variation on this theme in 2008 with respect to money market funds and their use of ratings but chose not to move forward. Some have suggested replacing ratings with market prices for debt – either bond spreads or CDS spreads. While these may reflect the market's sense of price at a given point, recall from the events of the last two years that not all securities are liquid, that bid-ask spreads can widen materially in times of stress and that market prices by definition are inherently more volatile than a fundamentally driven credit rating. If one is serious about eliminating ratings in regulation, we suggest you transition to elimination over an intermediate time frame with careful consideration of each regulation, rather than wholesale elimination. A better solution is continued recognition and oversight of NRSROs with the goal of improving the performance and usefulness of ratings. It would also seem counter-intuitive to focus on less regulation in a time of great market stress.

Speaking of competition and regulation, the SEC also has approved a wide range of new NRSROs. Some are established with global reach, resources and coverage, while others are focused geographically or by sector, have modest resources, and/or coverage and ratings history

that are more limited. Given the divergent profiles, it is quite a challenge to consider the issues we are discussing today. For example, we do not believe the definitions and meanings of ratings are all the same among NRSROs, let alone the levels of the ratings themselves. We also believe it is significant that a verifiable record of performance is not publicly available from all NRSROs and that not all ratings are publicly available in real-time. Specifically, the market benefits from the differences of opinion as expressed by the different ratings assigned by credit rating agencies. Usually, the initial rating assigned by Fitch will be proven reliable. As we have seen recently, that is not always the case. The same is of course true of any other agency. However, if some NRSROs need not disclose all of their ratings, that dynamic merely allows them to "cherry-pick" the selected ratings where they believe they were "first" or "better" without the obligation to provide the information that enables the market to fully compare and contrast the opinions and performance of the NRSROs based on *all* of their ratings. If a goal is improvement of the reliability of credit ratings through increased competition and transparency, we believe all oversight requirements should be applied consistently and equally to all NRSROs.

Accountability and Liability. Ultimately, the market imposes accountability for the reliability and performance of our ratings and research. That is, if the market no longer has sufficient confidence in the quality of our work, the value of Fitch's franchise will be diminished and our ability to continue to compete in the market will be impeded. We believe that a reputation is difficult to earn and easy to lose. We at Fitch have worked tirelessly and invested a great deal over many years to build an alternative global rating agency. The market's acceptance of, and trust in, Fitch is something of which we are quite proud. We acknowledge that the events of the

last two years have been troubling to many. That is why we have been so diligent in taking steps to enhance and improve everything that we do as described above and elsewhere.

While we understand and agree with the notion that we should be accountable for what we do, we disagree with the idea that the imposition of greater liability will achieve that. Some of the discussion on liability is based on misperceptions, and those points are noted below. More fundamentally, we struggle with the notion of what it is that we should be held liable for. Specifically, a credit rating is an opinion about future events – the likelihood that an issue or issuer will meet its credit obligations as they come due. Imposing a specific liability standard for failing to accurately predict the future in every case strikes us as an unwise approach.

The first misconception is that rating agencies are free from liability and hide behind the First Amendment to shield them from legitimate securities law liability.

Rating agencies may be held liable for securities fraud just as any person or entity may be (including accountants, lawyers, officers, directors and securities analysts) to the extent that a rating agency intentionally or recklessly makes a material misstatement or omission in connection with the purchase or sale of a security. Of course, a plaintiff must prove securities fraud against a rating agency just as against any other defendant. The reality of U.S. securities law is that any plaintiff may make a claim against a rating agency under the antifraud provisions of the securities law, just as they can against accountants, lawyers, officers, directors and securities analysts, but they must prove their claims to the standard required under the securities law. To date, plaintiffs generally have failed to meet the standard of proof. Just because rating

agencies have not been found to be liable under the existing securities laws does not justify creating a new standard for rating agencies as opposed to applying the same standard to rating agencies that applies to all other parties.

Some also have criticized rating agencies for what they perceive as taking undue advantage of the First Amendment and its protection of free speech. We believe this is an overblown argument that fails to acknowledge key facts about the nature of ratings. We publish all of our ratings, accompanied by detailed published commentary about the companies and securities we rate. Fitch's ratings are available free to anyone who has access to the Internet. The companies and securities we rate are of significant interest to investors of all types and other parties interested in the securities and the capital markets. Hundreds of investors, fiduciaries, government entities and other interested parties subscribe to our published commentary and thousands access our website daily.

As noted earlier, a Fitch rating is our opinion about the future financial capacity of a company or other issuer to pay its debt. It is not a statement of fact or a professional judgment. It is not a recommendation to buy a security, it is not investment advice, it is not an advertisement or an offer to buy or sell a security. A rating is a prediction of a future event (payment) relating to public companies and/or securities held by the investing public. We believe Fitch enjoys the same free-speech rights as any other person or entity to comment on matters of public interest and to "make informed, thoughtful predictions about the future. That is no different from what

newspapers or scholars do."[1] We further believe that the manner in which we are paid and the nature of the securities we rate do not affect the essence of what we do or the free-speech rights we enjoy in connection with our work.

A second misconception centers on where the responsibility for full and complete disclosure about companies and securities, and appropriate due diligence to ensure the accuracy and adequacy thereof, should be placed. As discussed above, these obligations are today, and have been since the enactment of the earliest U.S. securities law, the sole responsibility of issuers, their officers and directors and underwriters. The obligation to enforce these responsibilities falls squarely on the shoulders of the Securities and Exchange Commission and the courts.

In contrast, rating agencies, just as investors do, rely on full and complete disclosure by issuers and that underwriters perform the due diligence required of them to ensure the accuracy and adequacy of the disclosure made by issuers.

It is a mistake to make rating agencies responsible for ensuring adequate disclosure or verifying the accuracy of data and the absence of fraud. Disclosure adequacy, fraud detection and data verification is the province of issuers, accountants and underwriter due diligence and not credit analysts.

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[1] Nathan Koppel, "Credit Raters Plead the First; Will It Fly?" *The Wall Street Journal,* April 21, 2009, C1 (quoting Professor Eugene Volokh).

Rating agencies are currently liable on the same basis as other market participants for securities fraud. They may not disregard red flags. Current law thus gives rating agencies strong reason to use reliable data without the negative consequences of overreaching liability.

Some have proposed that rating agencies should be liable not merely for material misstatement, but for the investigation of rated securities and the verification of information. In one draft bill, rating agencies would be liable for knowingly or recklessly failing to conduct such investigation or verification, which will cause rating agencies to be judged by whether, in hindsight, they could have reasonably done more. Because a plaintiff could base a claim on "you had to have known more could be done," the effect is negligence based private rights of action. Even a requirement to plead with particularity might not be at all protective in this context.

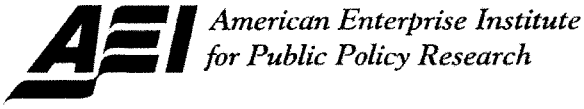
Negligence based liability in the rating context is effectively guarantor liability. By comparison, auditing, while critical, is based on clear, uniform standards and is the backward looking verification of a company's financial results for a prior period. Ratings are forward looking assessments of future performance and far more difficult to judge "accuracy." In addition, there are no "Generally Accepted Ratings Standards." In hindsight, it will always look like a rating agency could have reasonably foreseen future problems with different assumptions and stress testing. Guarantor liability would arise not only for default, but also for loss of value due to rating changes.

Congress should consider the consequences of such a law. If a bill such as the one being discussed is passed, all rating agencies will be motivated to rate a security as low as possible.

There will be no other effective way to adequately mitigate liability. If Congress seeks to improve the "accuracy" of ratings this may not be the way to do it.

Congress also ought to consider the barrier to entry such draconian liability will needlessly impose on smaller rating agencies.

While we believe some proposals are ill advised, Fitch has been and will continue to be constructively engaged with policy makers and regulators as they consider important ideas and questions about the oversight of credit rating agencies. Fitch has taken a number of important analytical and procedural steps already, and we acknowledge there is more to do. We remain committed to enhancing the reliability and transparency of our ratings, and welcome all worthwhile ideas that aim to help us achieve that.



Statement before the House Committee on Financial Services

Subcommittee on Capital Markets, Insurance, and GSEs

On "Approaches to Improving Credit Rating Agency Regulation"

Enhancing the Performance of Credit Rating Agencies Through Competition

Alex J. Pollock

Resident Fellow

American Enterprise Institute

May 19, 2009

The views expressed in this testimony are those of the author alone and do not necessarily represent those of the American Enterprise Institute.

Mr. Chairman, Ranking Member Garrett, and Members of the Subcommittee, thank you for the opportunity to be here today. I am Alex Pollock, a Resident Fellow at the American Enterprise Institute, and these are my personal views. Before joining AEI, I spent 35 years in banking, including twelve years as President and CEO of the Federal Home Loan Bank of Chicago. I have been working on the issues of the credit ratings agency sector since 2004, including previous Congressional testimony during the deliberations which led to the Credit Rating Agency Reform Act of 2006.

A Concentrated Point of Vulnerability to Failure

In the housing and mortgage bubble of the 21st century, the government-sponsored credit rating agencies turned out to be a notable weak spot.

In considering any system, we should look for concentrated points of possible failure. If you create such points, it is likely that sooner or later they will fail.

The old NRSRO system made the dominant rating agencies into just such a concentrated point of possible failure—which then indeed failed, thus making a important contribution to the huge costs of the subsequent bust.

Considering this history, Deven Sharma, the President of S&P, has rightly said that we need to "avoid inadvertently [let alone intentionally!] encouraging investors to depend excessively on ratings, rather than treating them—as they should—as one of many inputs in decision making."

In my view, this is consistent with a strategy of greater competition in credit ratings. As we all know, Congress made it clear in the 2006 Act that greater competition in the credit rating agency sector was one of its key objectives.

Fallible Opinions About the Future

At the beginning of 2005, I published an essay entitled, "End the Government-Sponsored Cartel in Credit Ratings." That title still summarizes my views.

I do think there has been important progress in this direction since the 2006 Act. I used to call Moody's and Standard & Poors "the other government-sponsored duopoly." The first one was of course Fannie Mae and Freddie Mac, which were also a concentrated point of failure and have since then become a government-owned duopoly. With the credit rating agencies, we can do much better, and keep moving toward a more competitive sector, with less government sponsorship.

In his insightful 1940 book on investing, Where Are the Customers' Yachts?, Fred Schwed observed that what everybody in financial markets wants to know is the one thing that nobody can know: the future. So, he said, Wall Street invents ways to give them assurances about the

future, which will make people feel confident enough to buy securities. These assurances are, of course, opinions.

For the fixed income markets, the single most important such opinions are those of the credit rating agencies on the probability that obligors will pay as called for in the debt instruments. Indeed, the rating agencies have often described themselves as being in the business of publishing opinions on credit and the risk of default.

In this I believe they are right. In the course of financial events, some such opinions will inevitably prove to have been mistaken, and some disastrously mistaken. During the twenty-one months since the onset of financial panic in August, 2007, it has become obvious to all, such as mortgage securities buyers who have lost hundreds of billions of dollars, that important credit opinions some of them relied on were wrong, to say the least. There has been heated criticism of the dominant rating agencies, and the stock prices of Moody's and McGraw Hill, S&P's parent company, are down about 60% since two years ago.

We would all like to have infallible knowledge of the future. So can't we somehow "assure" credit ratings which are "accurate" (to borrow terms from a current proposed Senate bill)? Can't we guarantee having models which are right?

No: Nobody—no rating agency, no regulatory agency, no modeler with however many computers—knows how to make universally correct predictions of future credit events.

So when it comes to opinions about the future, my view is: the more, the merrier. Having more credit rating competitors, especially those paid by investors, increases the chances that new insights into credit risks and how to conceptualize, analyze, and measure them will be discovered. It will also reduce the economic rents granted by government sponsorship to the old cartel and paid for by everybody else.

Of course, any sources of opinions which are too often mistaken, late, or uninformative will have little analytical value to investors and other credit market actors. They would not be purchased in a free market. But government sponsorship may nonetheless create for such opinions a large regulatory value, as opposed to a predictive value, for financial firms, while creating large profits for the favored rating agencies which issue them.

The "NRSRO" Cartel System

Since all opinions are liable to error, and since opinions based on models are liable to systemic error of vast proportions, why would the U.S. government want to enshrine certain opinions as having preferred, preferential, even worse, mandatory status? It should not want to, and it should not—but it did. This was the old NRSRO cartel system. (Still worse, of course, would be for the SEC staff to try to tell the rating agencies how to do credit ratings, thus effectively making the SEC into a monopoly rating agency.)

Under the NRSRO system, all regulated investors—banks, insurance companies, pension funds, thrifts, mutual funds, the vast majority of institutional investors—were required to use NRSRO ratings. Not least importantly, these helped determine regulatory capital requirements. Government regulation thus created a mandated demand for these favored ratings. Whether or not they had reliable predictive or informational value, i.e. competitive market value, the market for them was guaranteed.

While mandating demand, the NRSRO system also restricted supply. We can't be surprised that the price went up. Thus the old system powered remarkable profits, return on investment, cash flow, and until 2007 stock prices, of the dominant rating agencies.

In contrast to the progress of the SEC in registering new NRSROs, the Federal Reserve recently went in the wrong direction. The Fed did this by inventing a new category: "major rating agencies," which means exactly the old government-sponsored cartel. As the Attorney General of Connecticut wrote to the Fed: "inexplicably, [this category] rewards the very incompetence...that helped cause our current financial crisis." It certainly would continue the old NRSRO system as a concentrated point of possible failure. The Fed now appears to be in the process of correcting its mistake.

Increasing Competition from the Investor-Paid Model

A particularly desirable form of increased competition, in the opinion of many of us, is from rating agencies paid by investors, which have a superior alignment of incentives compared to the currently dominant model. A frequent objection to competition in credit ratings is that there would be a so-called "race to the bottom." But this does not apply at all to the logic of investor-paid ratings.

The dominant rating agencies have received much severe criticism for the potential conflict of interest represented by being employed by those who obviously wanted the lowest possible subordination for the highest ratings in structured securitizations. My idea is not to restrict their issuer-paid model, but to encourage meaningful competition between the two models. Let investors and other users of ratings decide which they prefer.

It has been suggested that each rating should prominently include a disclosure of whether it was paid for by investors or issuers. This seems reasonable. More effective would be for all regulatory bodies whose regulations support the government-sponsored ratings cartel, not just the SEC, to develop and implement ways to promote the pro-competitive objective of the 2006 Act.

In my view, all regulatory rules concerning credit rating agencies should be consistent with encouraging competition from the investor-paid model—or at the very least, do not discourage it. A requirement, for example, that all ratings be made public makes an investor-paid model impossible in principle and would be an obvious mistake.

Are there ways to create a more robust presence for the investor-paid model? I have previously proposed that a group of major institutional investors should set up their own rating agency,

capitalized and paid for by the investors, working from their point of view, and supplied with top talent and technology. This would certainly be a more direct and successful process than trying to set rating practices by regulation, and it continues to seem to me likely that the market would demonstrate a preference for the ratings of such an agency.

A successful competitor would find ways to distinguish itself by creating more valuable ratings. It might accompany ratings with calculated probabilities of default and loss-given-default; publish the values and ranges of key parameters; have superior monitoring and updating ratings over the life of securitizations; have all re-ratings based on the most current parameter values—for example, of paths of future house price appreciation or depreciation; and make ratings reflect the risk of increased opacity of structures. A dedicated, competent firm working for investors in a truly competitive market would think of many others.

In sum, competition in the rating agency sector has made some progress since the 2006 Act, and greater competition remains in my opinion not only an essential, but also an achievable objective.

Thank you again for the chance to share these views.

Testimony of

Gregory W. Smith
Colorado Public Employees' Retirement Association
before the
Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
of the
Committee on Financial Services

May 19, 2009

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May 19, 2009

Written Statement

Chairman Kanjorski, Ranking Member Garrett and Members of the Subcommittee:

Good afternoon. I am Gregory W. Smith, general counsel of the Colorado Public Employees' Retirement Association (Colorado PERA) and co-chair of the Council of Institutional Investors (Council). As general counsel of Colorado PERA, a pension fund with more than $29 billion in assets, I am responsible for protecting the retirement security of 430,000 plan participants and beneficiaries located around the United States. In that capacity, I have studied the issues surrounding the credit ratings industry and the ways in which rating agencies' actions impact pension funds. And in April, I had the privilege of expressing the concerns of Colorado PERA as a panelist on the Securities and Exchange Commission's (SEC) Roundtable on Oversight of Credit Rating Agencies.

The Council, a nonprofit association of public, union and corporate pension funds with combined assets that exceed $3 trillion, is a leading voice for good corporate governance and shareowner rights. As such, the Council has been actively investigating and evaluating potential reforms for credit rating agency regulation. My role as chair of the Council's Subcommittee on Credit Rating Agencies allowed me to participate fully in this effort.

Council members last year approved a general statement on financial gatekeepers, including rating agencies, that asserts the Council's support for financial gatekeepers that are "transparent in their methodology, avoid or tightly manage conflicts of interest and have robust oversight."[1] Most recently, the Council commissioned a white paper to help its members analyze, from the perspective of investors, the pros and cons of various proposals to further regulate the ratings

[1] Council of Institutional Investors, Council Policies: Transparency, Independence and Oversight of Financial Gatekeepers http://www.cii.org/policies.

industry.[2] Both of these documents are available to members of the public and included as attachments to this testimony.

I greatly appreciate the opportunity to appear before you today to share my views on such an important topic.

In addition to the attachments mentioned above, my testimony includes: 1) a brief overview of how Colorado PERA utilizes credit ratings issued by Nationally Recognized Statistical Rating Organizations (NRSROs); 2) suggestions on how the SEC can provide better oversight and regulation of NRSROs; and 3) views on the need to strengthen NRSROs' liability for their ratings.

How Colorado PERA utilizes credit ratings

Credit ratings are an important, and sometimes required, tool for many market participants, including pension funds like Colorado PERA. Today references to ratings are incorporated in investment guidelines, swap documentation, loan agreements, collateral triggers and other important documents and provisions.

Most institutional investors do not rely exclusively on ratings. Doing so would be a failure to fulfill their fiduciary obligations to do due diligence.

Colorado PERA does not use ratings as a sole source of buy/sell decisions. Rather, ratings are part of the mosaic of information we consider during the investment process. Our first step in contemplating an investment is to define our risk tolerance and then determine what type of allocation is necessary to stay within that field. Ratings are used at that time, serving as a first cut to identify instruments eligible for further consideration and analysis. Without such a tool,

[2] Council of Institutional Investors, Publications: *Rethinking Regulation of Credit Rating Agencies: An Institutional Investor Perspective* http://www.cii.org/resourcesPublications.

we and many other investors would have no initial way to screen literally tens of thousands of new instruments that we consider each year. Ratings aid Colorado PERA in establishing the initial risk parameters for both our internal and outside portfolio managers. Ratings also are an important factor in our decision to participate in short term credit facilities, such as cash accounts and money market funds.

How the SEC can provide better oversight and regulation of rating agencies

As directed by Congress through the passage of the Credit Rating Agency Reform Act of 2006, the SEC established a formal registration system and rules for credit rating agencies seeking certification as NRSROs. While the act substantially increased the SEC's oversight of credit raters, recent investigations of rating agencies' practices demonstrate the need for additional reform.

The SEC's oversight authority must be strengthened to address conflicts of interest and the lack of adequate transparency and accountability of rating agencies. Both the Commission and Congress must work together to establish and affirm the extension of authority in a variety of areas, including:

- Disclosure of Credit Rating Actions. Each NRSRO must be required to publicly disclose complete historical records for all outstanding credit ratings, regardless of whether, or from whom, the NRSRO received compensation. Without complete disclosure, investors and the market at large lack the data necessary to assess and compare ratings and rating agencies.

- Conflicts of Interest. At a minimum, the Commission must have the ability to 1) mandate disclosure of potential conflicts of interest; 2) police conflicts of interest; 3) freely investigate NRSRO business

relationships; and 4) adopt further rules to ensure the independence of NRSROs and to promote high quality ratings. Specifically, similar to the provisions governing auditors, rating agencies should be required to disclose business relationships and should be prohibited from engaging in business activities other than issuing ratings. A mandatory one-year waiting period should be in place for any NRSRO employee seeking a position with a rating client of the agency. In addition, the Commission should strengthen the current responsibilities and requirements pertaining to each NRSRO's compliance officer. More specifically, the compliance officer should be held accountable for providing periodic certification to the Commission regarding the NRSRO's compliance with relevant laws and regulations and adherence to the NRSRO's stated policies and methodologies. These regulations should apply to all NRSROs regardless of their business models.

- Fees. The SEC must have the power to regulate how NRSROs are compensated for ratings. A full range of payment options—including amortizing fees over the life of the instrument, tying total compensation to the accuracy of the rating and instituting a "fee-for-service" system—should be investigated and feedback from all market participants should be considered. In addition to regulating payment methods, the SEC must have the power to require NRSROs to publicly disclose fee schedules and the amount of compensation received for individual ratings. This level of disclosure would enhance investors' understanding of rating agencies' business relationships and possible conflicts of interest, thereby allowing for more robust assessment of the reliability of a particular rating by the investor.

- Methodologies. At a minimum, NRSROs must be required to disclose to investors greater detail about their rating methodologies, including

assumptions, information used to determine a rating and an assessment of the quality of that information. If the NRSRO veers from its stated methodology when rating a security, it must disclose details regarding its decision to do so within the rating. Disclosure of information of this sort would allow investors to evaluate closely the NRSROs' processes and quality of ratings and encourage the rating agencies to strive to issue sound ratings. The SEC should also have substantive oversight of rating agency methodologies, authority that specifically was denied the Commission in the Credit Rating Agency Oversight Act of 2006. With this authority, the Commission would have the option of sanctioning an NRSRO that fails to maintain a suitable level of reliability as compared to other NRSROs and market information.

In addition to strengthening the SEC's regulatory powers, Congress must ensure that the Commission has the resources and expertise necessary to manage the complexities of the ratings industry.

Strengthening NRSRO liability for ratings

Providing the SEC with additional oversight authority and resources will not in itself create an adequate system of checks and balances. Financial gatekeepers are less likely to engage in negligent, reckless or fraudulent behavior if they are subject to a risk of liability for these behaviors. Rating agencies, however, are currently immune from such checks. In order to ensure that NRSROs are held accountable for their actions, Congress must:

- Remove NRSROs' exemption from liability for forward looking statements in Section 21E of the Securities Exchange Act of 1934;

- Remove NRSROs' exemption from misstatements in registration statements in Section 11 of the Securities Act of 1933;
- Remove NRSROs' exemption from liability as experts under Securities Act Rule 436; and
- Adopt legislation indicating that NRSROs are subject to private rights of action under specified statutory criteria, including the failure to conduct a reasonable investigation into the accuracy of the information used to rate a security or to have obtained reasonable verification from other sources independent of the issuer.

Legislation clarifying the accountability of credit rating agencies certified as NRSROs will effectively, and correctly, elevate the standards of quality required of NRSROs to the same level as the market and regulators have set for other vital financial gatekeepers.

Expressions of concern regarding the business viability of NRSROs in the event a private right of action were recognized by legislation are premised on the contention that NRSROs would become guarantors of the performance of the instruments that they rate or would somehow become liable in the event a particular rating is changed and the value of the instrument is negatively impacted. While this premise serves the interest of those desiring to maintain a lack of accountability, the reality is that no market participant is seeking accountability in that form. Rather we are seeking to have these officially sanctioned gatekeepers held to reasonable industry standards for the process and methodology that is employed, including the adequacy of the diligence and the unbiased nature of the conclusions.

The threat presented to NRSROs by a private right of action is in essence no different than that presented to other participants in the marketplace, including institutional fiduciaries like my organization. We, like others, are responsible for the process we adhere to, our honesty and our lack of conflicts or appearances

of conflicts of interest in the discharge of our responsibilities. We protect our organization from liability by creating a robust process and strictly monitoring our adherence thereto and we see no legitimate barriers to such a risk management approach by the NRSROs.

Conclusion

The current global financial crisis has revealed many weaknesses of the credit ratings industry. As financial gatekeepers, NRSROs wield quasi-governmental power. Such clout mandates a high level of transparency, independence and accountability. The rating agencies, however, fall short on all three. Colorado PERA encourages Congress to support the SEC's continuing efforts to establish high standards for NRSROs by considering legislation to assert and strengthen the SEC's authority. We also encourage Congress to evaluate the appropriateness of these critical financial gatekeepers' exemptions from liability.

Thank you, Mr. Chairman, for inviting me to participate in this hearing. I look forward to the opportunity to respond to any questions.

Testimony of

Gregory W. Smith
Colorado Public Employees' Retirement Association
before the
Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
of the
Committee on Financial Services

May 19, 2009

Attachment 1

Council of Institutional Investors
Statement on Financial Gatekeepers

Statement on Financial Gatekeepers

The Council of Institutional Investors supports financial gatekeepers that are transparent in their methodology, avoid or tightly manage conflicts of interest and have robust oversight.

Capital markets have come to rely on "financial gatekeepers," institutions that help provide investors with the timely, accurate information they need to make informed investment decisions. Such gatekeepers include auditors, credit rating agencies and financial analysts.

In recent years, financial scandals on Wall Street and at operating companies from Enron to Tyco have cast a harsh light on flawed structures and practices of gatekeepers. In many instances, gatekeepers' conflicts of interest, poor disclosure and minimal oversight helped mislead many market participants into investment decisions that produced huge losses. The resulting crisis of confidence in the markets spurred intense scrutiny by regulators and lawmakers. The "global settlement" with Wall Street firms and enactment of Sarbanes-Oxley Act reforms bolstered the accountability of analysts and auditors.

But credit rating agencies were largely untouched. The Credit Rating Agency Reform Act of 2006 eased entry for a few new competitors, but the industry remains overwhelmingly dominated by two players. It is likely that additional regulatory oversight will be needed.

So it is not surprising that once again, credit rating agencies are at the center of the current turmoil in global credit markets. Investors relied on the agencies' initially high ratings of subprime mortgage bonds and complex structured products--only to see billions of dollars of value go up in smoke when it became clear that the agencies grossly underestimated the risks. And regulators are investigating whether credit rating agencies improperly inflated their ratings of mortgage backed securities to win more business from the companies that issued the debt.

Such conflicts of interest are inherent in nearly all of the agencies designated by the Securities and Exchange Commission as Nationally Recognized Statistical Rating Organizations because they are paid by the issuers of securities they rate. At the least, these conflicts must be minimized and managed with care.

Credit rating agencies have long maintained that their ratings are opinions only. But in practice, the agencies wield quasi-governmental power. Such clout carries a responsibility to ensure that ratings are arrived at fairly and are accurate.

The Council recognizes the steps that credit rating agencies are taking to enhance the clarity and understanding of their ratings. But investors remain wary about the soundness and independence of the ratings. The Council welcomes further examination of the industry by regulators, lawmakers, academics and others, to determine what changes, including new rules and stronger oversight, are needed.

(adopted May 16, 2008)

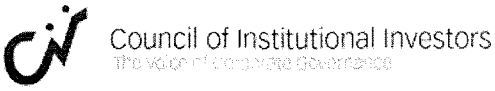
Testimony of

Gregory W. Smith
Colorado Public Employees' Retirement Association
before the
Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
of the
Committee on Financial Services

May 19, 2009

Attachment 2

Council of Institutional Investors White Paper
Rethinking Regulation of Credit Rating Agencies:
An Institutional Investor Perspective



Rethinking Regulation of Credit Rating Agencies: An Institutional Investor Perspective

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* This white paper was commissioned by the Council of Institutional Investors for the purpose of educating its members, policymakers, and the general public about important credit rating agency regulation proposals and their potential impact on investors. The views and opinions expressed in the paper are those of Professor Partnoy and do not necessarily represent views or opinions of Council members, board of directors, or staff. Official policy positions are determined only after extensive research and analysis and approval by a vote of the Council board and membership.

Rethinking Regulation of Credit Rating Agencies: An Institutional Investor Perspective

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Rethinking Regulation of Credit Rating Agencies: An Institutional Investor Perspective

I. Executive Summary

Credit ratings issued by Nationally Recognized Statistical Rating Organizations (NRSROs) are used to fulfill a wide range of regulatory and contractual requirements in the United States and abroad. Over time, NRSRO ratings have become woven into federal and state laws, regulations, and private contracts. Ratings dictate the net capital requirements of banks and broker-dealers, the securities money market funds may hold, and the investment options of pension funds. As legal requirements for ratings have proliferated, the rating agencies have evolved from information providers to purveyors of "regulatory licenses." A regulatory license is a key that unlocks the financial markets. Credit rating agencies profit from providing ratings that unlock access to the markets, regardless of the accuracy of their ratings.

The global credit crisis has called into question this role of rating agencies as financial gatekeepers. The debacle was fueled in part by credit rating agencies "licensing" complex, risky financial instruments with triple-A ratings they did not deserve. Both regulators and institutional investors relied on those ratings, to their peril.

In response, policymakers in the United States and abroad are considering measures to make rating agencies more accountable and rating processes more transparent. Proposals to overhaul credit rating agency regulation run the gamut, from increased disclosure requirements to removing references to credit ratings in rules and regulations.

Given the abysmal performance of rating agencies, widespread reliance on ratings is no longer warranted. However, it is not feasible or practical for regulators and investors simply to stop using ratings. Mandates to use ratings have become part of the fabric of financial markets, and cannot be unwoven instantaneously.

There is an immediate need, however, to revamp the regulatory framework surrounding credit rating agencies. This paper offers an institutional investor perspective of the pros and cons of several proposals for redesigning credit rating agency regulation. It focuses on two areas of primary importance—oversight and accountability—and offers specific recommendations in both areas.

> **Oversight:** Congress should create a new Credit Rating Agency Oversight Board (CRAOB) with the power to regulate rating agency practices, including disclosure, conflicts of interest, and rating methodologies, as well as the ability to coordinate the reduction of reliance on ratings. Alternatively, Congress could enhance the authority of the Securities and Exchange Commission (SEC) to grant it similar power to oversee the rating business.

> **Accountability:** Congress should eliminate the effective exemption of rating agencies from liability and make rating agencies more accountable by treating them the same as banks, accountants, and lawyers.

As financial gatekeepers with little incentive to "get it right," credit rating agencies pose a systemic risk. Creating a rating agency oversight board and strengthening the accountability of rating agencies is thus consistent with the broader push by U.S. policymakers for greater systemic risk oversight. Over the long term, other measures for assessing credit risk may become more acceptable and accessible to regulators and investors. Meanwhile, a more powerful overseer and broader accountability would help reposition credit rating agencies as true information intermediaries.

II. Background

Three players have long dominated the credit rating business: Fitch Ratings, Moody's Investor Service, and Standard & Poor's Ratings Services. Fitch's market share, however, is significantly smaller than its two main rivals. Despite the presence of seven additional NRSROs, this trio is responsible for 98 percent of all outstanding ratings issued by NRSROs. And because only NRSRO ratings can be used to fulfill certain regulatory requirements, these three rating agencies wield immense, quasi-governmental power.

NRSROs have been the subject of intense criticism because of the part they played in the financial crisis. Just months ago, S&P, Moody's, and Fitch gave high investment grade ratings to 11 big financial institutions that later faltered or failed. They rated AIG in the double-A category. They rated Lehman Brothers single-A a month before it collapsed. Until recently, the NRSROs maintained triple-A ratings on thousands of nearly worthless subprime-related instruments.

In June 2008, the SEC reported that its examination of the three dominant agencies had uncovered serious deficiencies in their ratings and rating processes. For example, one analyst expressed concern that her firm's model did not capture "half" of a deal's risk, and that "it could be structured by cows and we would rate it."[1] Legislators have held hearings criticizing the agencies, and regulators have recommended reforms.

Yet these credit rating agencies continue to play a central role as powerful and influential gatekeepers in global financial markets. It is hard to overstate the importance of the role of credit rating agencies and their letter ratings. Thomas Friedman, the *New York Times* columnist, expressed the prominence of credit rating agencies succinctly in 1996, well before the significant increase in the prominence of ratings and ratings-driven deals:

> "There are two superpowers in the world today in my opinion. There's the United States and there's Moody's Bond Rating Service. The United States can destroy you by dropping bombs, and Moody's can destroy you by downgrading your bonds. And believe me, it's not clear sometimes who's more powerful."[2]

Given the central role of ratings, it is worth rethinking a basic paradoxical question: Why are credit ratings and rating agencies so important if they are often so unreliable? This background section addresses this question. Then, the two following

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[1] Summary Report of Issues Identified in the Staff's Examinations of Select Credit Rating Agencies (July 2008), http://www.sec.gov/news/studies/2008/craexamination070808.pdf, at 12.
[2] Interview with Thomas L. Friedman, The NewsHour with Jim Lehrer (PBS television broadcast, Feb. 13, 1996).

sections address the pros and cons of two major areas of reform: oversight and accountability.

A. From Information Intermediaries to Regulatory Licensors

Rating agencies began as information intermediaries, entities that step in to assess product quality when sellers cannot credibly make claims about product quality themselves. Information intermediaries function best when they have reputational capital at stake and will suffer a loss if their assessments are biased, negligent, or false.

In the early debt markets, credit rating agencies helped to bridge information gaps between bond buyers and sellers. In 1909, John Moody published his first *Manual of Railroad Securities*, in which he rated 200 railroads companies and their securities. Moody's insight was that he could profit by selling to the public a synthesis of complex bond data in the form of single letter ratings: Aaa, Aa, A, Baa, Ba, B, Caa, Ca, C, in declining order of credit quality. These letter ratings were not designed to have any specific meaning, as might be the case for modern financial analysis. They were not, for example, designed to mark categories of percentages of expected probability of default or of recovery in the event of default. Instead, they were a rough compilation of disparate information about bonds that investors found difficult or costly to assess on their own.

Over time, however, rating agencies have shifted from selling information to selling "regulatory licenses," keys that unlock the financial markets. This shift began after the 1929 crash, when regulators turned to the rating agencies, primarily Moody's and S&P, for measures of bond quality in banking and insurance guidelines. Federal Reserve examiners proposed a system for weighting the value of a bank's portfolio based on credit ratings. Bank and insurance regulators expressed the "safety" or "desirability" of portfolios in letter ratings, and used such ratings in bank capital requirements and bank and insurance company investment guidelines. States relied on rating agencies to determine which bonds were "legal" for insurance companies to hold. The Comptroller of the Currency made similar determinations for federally chartered banks.

The SEC's introduction of the NRSRO concept in the mid-1970s further encouraged regulators to increase their reliance on ratings.[3] During that same period, the NRSROs stopped selling ratings to investors and began charging the companies that issue the debt they rate. The issuer-pay model introduced significant new conflicts of interest—chiefly, the challenge for credit raters of impartially rating securities of companies that generate their revenues. But the rating agencies believed that they could manage these conflicts internally.

Regulators now mandate that institutions of all types pay heed to NRSRO credit ratings as a necessary step for regulatory compliance. Some rules require that certain investors can only buy bonds with high ratings. Other rules reduce capital requirements

[3] More precisely, the regulatory dependence on credit ratings began in 1973, when the SEC proposed amending broker-dealer "haircut" requirements, which set forth the percentage of a financial asset's market value a broker-dealer was required to deduct for the purpose of calculating its net capital requirement. Rule 15c3-1, promulgated two years later, required a different "haircut" based on the credit ratings assigned by NRSROs. See 17 C.F.R. 240.15c3-1. Since the mid-1970s, statutes and regulations increasingly have come to depend explicitly on NRSRO ratings.

for institutions that purchase highly rated bonds. Without high ratings, bond issuers cannot access certain markets because they do not have a "license" from the NRSROs to comply with NRSRO-dependent regulations.

Regulatory dependence on ratings created higher demand for ratings and increasingly higher profits for NRSROs, even when their ratings proved spectacularly inaccurate. Too often, rating changes lagged the revelation of public information about rated issuers and instruments. Prominent examples included California's Orange County and Enron Corp., both of which received high credit ratings until just before they filed for bankruptcy protection. Even so, the rating agencies have been shielded from liability by their insistence that their ratings were merely opinions protected by First Amendment free speech privileges.

Rating agencies also began rating substantially greater numbers of issuers and increasingly complex instruments. But the resources expended per rating declined. As they expanded ratings to cover large numbers of structured finance products, including tranches of various collateralized debt obligations, some NRSROs neglected to divert resources to update rating models and methodologies or recruit additional staff needed to ensure quality. As a senior analytical manager at one of the big three rating agencies put it in a February 2007 e-mail: "We do not have the resources to support what we are doing now."[4]

B. The Paradox of Credit Ratings

Paradoxically, the leading NRSROs have become more profitable even as the quality of their ratings has declined. Operating margins for some in recent years topped 50 percent; Moody's profit margins were higher than the margins of any other company in the S&P 500 for five consecutive years during the early 2000s. Moody's market capitalization was nearly $20 billion at its peak; S&P was similarly profitable and large. The companies that owned NRSROs drew savvy investors, looking to profit from the reliable returns associated with the sale of regulatory licenses. Warren Buffet is a major investor in Moody's, and as of December 31, 2008, held more than 20 percent of its outstanding common shares.

One explanation of this paradox is that profits from the sale of regulatory licenses do not depend greatly on the informational value of ratings. If regulators and private actors defer to private standard setters, those private standard setters will earn profits from that deference even if their standards are not useful. Over time, both regulators and private actors might decide to shift to alternative sources of information and analysis. However, to the extent they do not shift, the private standard setters will continue to prosper, even if their standards lack informational value.

Another explanation is that rating agencies have been effectively exempt from civil liability. With rare exceptions, rating agencies have not suffered damages from litigation even when they were negligent or reckless in issuing overly optimistic ratings. To some extent, the rating agencies' success in avoiding liability is due to legislative policy, such as the explicit statutory exemption from liability under Section 11 of the Securities Act of 1933

[4] Summary Report of Issues Identified in the Staff's Examinations of Select Credit Rating Agencies (July 2008), http://www.sec.gov/news/studies/2008/craexamination070808.pdf, at 21.

or the limitations on private rights of action in the Credit Rating Agency Reform Act of 2006. But the exemption also is due to a handful of judicial decisions accepting the rating agencies' assertion that ratings are merely "opinions," which, under the First Amendment, should be afforded the same protection as opinions of publishers.

The accountability of NRSROs has deteriorated so much that institutional investors now are vulnerable if they rely on credit ratings in making investment decisions. To the extent rating agencies are not subject to liability, an institutional investor's defense of reliance on ratings is weakened, because constituents can argue that ratings are less reliable when rating agencies are not accountable for fraudulent or reckless ratings.

Overall, this lack of accountability has impeded the ability and willingness of rating agencies to function as information intermediaries because they do not credibly pledge reputational and economic capital in the event they fail to perform their core function. But it also partially explains the paradox: Rating agencies that are insulated from liability have a more profitable, dominant franchise.

The paradox of credit ratings has persisted during the recent financial crisis. Even though ratings have plummeted in informational value, since portions of the U.S. government rescue efforts rely on them, ratings are more important than ever. Specifically, the Federal Reserve's $1 trillion Term Auction Lending Facility (TALF) plan, which lends money to investors to purchase new securities backed by consumer debt, mandates that only securities rated by two or more major NRSROs are eligible for government support.

Moreover, when government officials anticipated the potential negative impact of AIG's announcement of quarterly earnings in March 2009, they implemented a fourth rescue package for the insurer and consulted privately with representatives of the dominant NRSROs, to be sure the plan would be attractive enough to avoid a downgrade of AIG, which would have killed the company. Because of overdependence on NRSROs, both regulators and investors were in a ratings trap.

C. Recent Efforts by Regulators

In response to several market crises over the last decade, regulators have tried to remedy some of the problems in the credit rating industry. The SEC and the International Organization of Securities Commissions (IOSCO), an organization representing dozens of global regulators that focuses on establishing standards of financial regulation, produced reports assessing the role of rating agencies in the markets.

After a series of hearings, Congress adopted the Credit Rating Agency Reform Act of 2006. While this act standardized the process for NRSRO registration and gave the SEC new oversight powers, it prohibited the SEC from regulating "the substance of credit ratings or the procedures and methodologies by which any [NRSRO] determines credit ratings." The act also stated that it "creates no private right of action." The rating agencies supported this act, in part because its scope was so narrowly circumscribed.

More recently, many federal and state legislators and regulators have lambasted the rating agencies for their part in the financial crisis. Even the President's Working Group on Financial Markets, long a champion of deregulation and financial innovation,

sharply criticized the flaws in the rating agencies' assessments of complex products and called them a "principal underlying cause" of the crisis.[5] Lawmakers in the European Union have continued to push for the development of a new European credit rating agency regulatory authority.

In June 2008, the SEC released a report outlining serious deficiencies in the ratings process. It subsequently adopted new rules designed to increase the transparency of NRSRO rating methodologies, strengthen NRSRO disclosures of ratings performance, prohibit certain conflicted NRSRO practices, and enhance NRSRO recordkeeping. These rules reflected much political compromise. For example, regulatory review and scrutiny of NRSRO procedures were limited. Even the NRSROs' obligation to make publicly available their ratings histories was limited to a random sample of 10 percent of issuer-paid ratings for each class of ratings.

In December 2008 the SEC re-proposed rules governing the conduct of NRSROs. Specifically, the SEC proposed barring NRSROs from issuing ratings for structured finance products unless the information related to those securities was published on a password-protected Web site that other NRSROs could access, under certain conditions; other NRSROs would have to agree to provide and maintain ratings on 10 percent of the securities for which they tapped the Web site. The proposals also included a provision requiring complete disclosure of issuer-paid ratings and ratings histories.

The SEC shelved its proposal to eliminate requirements for NRSRO ratings in some of its own regulations. The proposal had received mixed views from investors. Many preferred a more incremental approach. This idea is discussed in more detail later in this paper.

III. Oversight

It is now widely accepted that the architecture of credit rating agency regulation needs reform. SEC Chairman Mary L. Schapiro recently stated: "To this end, allow me to highlight a few of the initiatives that I hope to pursue as priorities: Improving the quality of credit ratings by addressing the inherent conflicts of interest credit rating agencies face as a result of their compensation models and limiting the impact of credit ratings on capital requirements of regulated financial institutions."[6]

These improvements require both a change in regulatory structure and new regulatory powers. Like other areas of financial regulation, the regulation of credit ratings has been piecemeal and is spread throughout numerous state and federal governing bodies, including securities, banking, and insurance. Ideally, improvements in regulatory structure would entail consolidation of credit rating regulation within one umbrella organization with additional responsibilities and new powers.

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[5] The President's Working Group on Financial Markets, Policy Statement on Financial Market Developments, March 2008, at 1.

[6] Address to Practising Law Institute's "SEC Speaks in 2009," Program, February 6, 2009, http://www.sec.gov/news/speech/2009/spch020609mls.htm.

A. Regulatory Structure

One approach would be to create a single independent Credit Rating Agency Oversight Board (CRAOB), with a structure and mission similar to that of the Public Company Accounting Oversight Board (PCAOB). It could be a free-standing entity created by statute to oversee registration, inspections, standards, and enforcement actions related to NRSROs, just as the PCAOB oversees audit firms. The board also could encourage and facilitate the development of alternatives to NRSRO ratings among market participants. Congress should make this mission to facilitate the eventual removal of "regulatory licenses" explicit in authorizing the board.

Two alternative options to a free-standing rating agency oversight board would be to establish an office within the SEC strictly dedicated to the regulation of NRSROs, with enhanced powers, or to house oversight of credit rating agencies within the PCAOB. The functions and duties of a rating agency overseer are somewhat consistent with the mandate of the PCAOB, which was created to protect investors and the public interest by promoting informative, fair, and independent audit reports. Under the PCAOB approach, Congress would simply authorize additional funds for the PCAOB to establish these new functions, and pass legislation creating new PCAOB authority. However, integrating credit rating agency oversight duties into the PCAOB could present organizational and legislative challenges.

Ideally, a consolidated credit rating agency overseer would have two overriding characteristics: independence and specialized expertise. A free-standing board would require independent funding so that it would not depend on Congress or other agencies for frequent funding or decision-making. Initial funding could be in the form of an endowment. Alternatively, funding could be provided through required, periodic NRSRO user fees or transaction fees.

Securing reliable funding would be particularly important in order to offer salaries sufficient to attract high caliber board members. Board members should have specific expertise in assessing credit risk and, more generally, an understanding of financial markets, asset pricing, and alternative information sources and intermediaries. Members of the board should be independent and appointed for limited terms. The appointment process should be designed to limit the potential for influence by the credit rating agencies, and board members should not be permitted to join NRSROs after their service.

Proponents acknowledge that the SEC recently has stepped up its oversight of the rating business. But many believe that the agency is not likely ever to be a bold enough regulator. They say the SEC has been reluctant to use its existing authority or request additional power from Congress and often has been captive to the ratings industry, which has lobbied strenuously against proposals to strengthen accountability and disclosure rules.

In addition, regulatory reliance on NRSROs beyond the SEC's authority limits the commission's ability to implement a coordinated approach to credit rating agency regulation. For example, even the SEC's proposal to eliminate ratings references in some of its own rules would have applied narrowly, and would not have affected regulatory reliance on ratings in banking and insurance regulations.

Critics of a free-standing rating agency oversight board, however, counter that more fragmentation of financial regulation would add more layers to the already complex web of financial market regulation in the United States. They also believe that the SEC already has the staff, expertise, and contacts to regulate rating agencies; they say it simply needs greater authority and resources from Congress.

B. Adding New Oversight Authority

Whatever structure the overseer takes, it will need additional legislative authority to implement its objectives. Although the SEC recently has adopted new rules for credit ratings, the scope of its legislative authority is limited.

Below are several specific areas of oversight authority that could be expanded immediately. One approach would be to enumerate each of these areas in the adopting legislation. Alternatively, Congress might grant the board general oversight authority over NRSRO practices, and let the board adopt rules in each area. Again, the rating agencies might contend that such authority would infringe their free speech privileges; they frequently have made veiled threats to assert such a claim.[7]

Disclosure of Credit Rating Actions. A rating agency overseer should have the statutory authority to require significantly more extensive NRSRO disclosure, including a complete record of rating history, such as initial rating, upgrades, downgrades, placements on watch for upgrade or downgrade, and withdrawals.

Current disclosure proposals are more limited, in part because of questions about the scope of regulatory authority granted by the Credit Rating Agency Reform Act of 2006. For example, the SEC finalized new rules in February 2009 that require NRSROs to make available to the commission individual records for each of their outstanding credit ratings showing all rating actions. In addition, the rules require NRSROs to publicly disclose rating action histories in eXtensible Business Reporting Language (XBRL) format. However, they can delay disclosures for six months and must disclose rating action histories only for a randomly selected 10 percent of issuer-paid ratings. Similarly, in February, the SEC proposed requiring disclosure, on a 12-month delay, of all issuer-paid credit ratings issued on or after June 26, 2007. Under the rules adopted in February and proposals still pending, unsolicited ratings and subscriber-paid ratings are exempt from disclosure.

Congress should authorize the board to require that NRSROs disclose complete records to the public, not merely to the regulator. In addition, disclosure should extend to unsolicited ratings and subscriber-paid ratings. Current rules do not provide investors with the level of information necessary to assess and compare ratings and rating agencies. Securities included in one NRSRO's 10 percent disclosure pool are not necessarily included in other NRSROs' pools, thus making a true comparison between rating

[7] For example, in S&P's comment on the SEC's proposal to eliminate some regulatory reliance on ratings, S&P reminded the SEC of its limited statutory authority and said "the Commission should carefully consider" unintended side effects of its proposal. See S&P Letter, Sep. 5, 2008. Although Moody's historically has favored elimination of regulatory licenses, it backed down somewhat from that position in its recent comment letter on the SEC's proposed rules regarding regulatory reliance. See Moody's Letter, at 5.

agencies impossible. Moreover, excluding unsolicited and subscriber-paid ratings from public analysis eliminates valuable data from market scrutiny.

Critics argue that requiring full disclosure for subscriber-paid ratings would undermine the business model of agencies that issue them. The rationale for bottling up information inside a regulatory authority, however, is not persuasive. Investors need greater transparency to be able to compile and analyze ratings and rating changes. Effective oversight of the credit rating business must include market oversight, which requires that investors have access to complete data regarding credit ratings.

Symbology. Symbology is a contentious topic. Although the oversight board should have the power to assess different categories of ratings and require NRSROs to use alternative symbology (e.g., numbers instead of letters, or letter subscripts) for ratings in different categories, it should take extreme caution before exercising that power.

In June 2008, the SEC proposed amendments to current regulations to require NRSROs to distinguish ratings on structured products by either 1) attaching a report to the rating itself describing the unique rating methodologies used in establishing the rating and how the security's risk characteristics differ from others (i.e., corporate bonds) or 2) using symbols unique to structured products only (i.e., numbers rather than letters). The SEC's intent was to spur investors to perform more rigorous internal risk analysis on structured products, thereby reducing undue reliance on ratings in making investment decisions. Although the commission has not addressed the proposals yet, in March 2009, the European Union moved forward on a proposal to require that rating agencies identify ratings on structured products, as well as unsolicited ratings, by different symbols.

Proponents suggest that alternative symbology could benefit investors in a number of ways. Particular letter ratings mean different things when applied to structured finance issuers vs. corporate issuers vs. municipal issuers. Different symbols for structured products could serve as a flashing light for investors, signaling that the securities' risk characteristics are more volatile than those of other securities. And at a basic level, different symbols for different classes of securities would notify users that the agencies used different methodologies to generate the ratings.

An additional advantage to requiring that NRSROs use letter ratings only for corporate bonds is that most regulations and investment guidelines then would refer only to corporate bonds. Securities rated using a new symbology would fall outside the scope of those rules. Thus, symbology reform could force a wholesale rewrite of the rules governing investments other than corporate bonds. It could remove "regulatory licenses."

Critics assert that if NRSROs were required to use different symbols to rate different categories of securities, the investing public would be more confused than informed. The rating agencies also contend that mandating different nomenclature for different classes of securities would violate their First Amendment protection.

A vital function of the board would be to consider market participants' diverse positions, evaluate the positive and negative consequences relating to credit rating symbols (including which classes of securities could or should be identified by unique symbols), and work with international regulators to mitigate confusion over inconsistencies in symbol regulation.

Methodologies. The board should have the authority to require greater disclosure of NRSRO methodologies. Flawed methodologies were a core reason NRSROs gave overly high ratings to complex structured finance instruments. Allowing investors the opportunity to analyze rating agencies' methodologies would serve as a vital market-based quality check.

Current SEC registration rules require minimal disclosure. Rating agencies' registrations are stale, and their descriptions of methodologies and procedures are opaque. It is not helpful for the rating agencies to release their general statistical methods and models if they do not also specify the assumptions in those models.

The board should focus on disclosures that would enable institutional investors to assess key underlying variables, such as expected probability of default. Letter ratings alone are not helpful. Indeed, the rating agencies admit that letter ratings are ordinal, not cardinal, in that they rank issues in order of relative credit risk, but do not specify any particular expected default. For example, according to S&P: "The definitions of each rating category also make clear that we do not attach any quantified estimate of default probability to any rating category."[8] Yet the rating agencies use default probabilities in their models, and ratings reflect implied default probabilities, which can vary substantially from those implied by market prices.

Rating agencies contend that their methodologies are proprietary and that requiring detailed disclosure of their methodologies would promote free-riding, remove incentives for innovation, and leave the market with a smaller number of similarly derived credit ratings rather than a larger pool of ratings based on different methods of analysis. On balance, however, the likely benefits of enhanced disclosure far outweigh such objections.

Some critics assert that the board also should have substantive oversight of rating agency methodologies, as a quid pro quo for the benefits NRSROs enjoy from regulatory reliance on their ratings. The rating agencies might fiercely resist such authority and argue it would violate their First Amendment rights. Under pressure from the leading NRSROs, Congress explicitly excluded from the SEC's regulatory authority the ability to oversee rating methodologies.

Others believe NRSRO ratings are systemically important enough to the global market to warrant giving the board this authority. With such authority, the board could sanction rating agencies whose ratings consistently failed to meet or exceed an acceptable level of accuracy. The board could bar NRSROs from issuing ratings on new types of securities for which there is little historical data. It also could require NRSROs to use third-party due diligence services to ensure the accuracy of data used to establish ratings on complex securities. Such powers should be exercised cautiously and only after the regulator has investigated the potential costs and benefits.

Conflicts of Interest. New legislative authority also is needed to police NRSRO conflicts of interests and to investigate the extent to which conflicts of interest differ for issuer-pay NRSROs vs. investor-pay NRSROs (also referred to subscriber-pay NRSROs). Section 15E(h)(1) of the Exchange Act requires an NRSRO to establish, maintain, and enforce policies and procedures reasonably designed to address and manage conflicts of

[8] See S&P, Fundamentals of Structured Product Ratings, at 9.

interest. Although Congress directed the commission in 2006 to issue final rules to prohibit or require the management and disclosure of conflicts of interest, the SEC has been reluctant to take full advantage of its power.

Some market participants have urged Congress to prohibit issuer-pay NRSROs altogether. This approach would eliminate the conflicts of interest associated with rating agencies receiving compensation from issuers of the securities they rate. But investor-pay NRSROs are subject to potential pressure from clients to slide ratings one way or another. For example, institutions that can only invest in highly rated instruments might pressure a rater to guarantee a particular security gets an investment-grade rating. Others might press the rating agencies for lower ratings in hopes of receiving higher returns.

An alternative to a blanket prohibition of the issuer-pay business model would be to require disclosure of business relationships and to prohibit NRSROs from engaging in business activities other than issuing ratings. Auditors face similar restrictions. Both the SEC and the rating agencies recognize that conflicts of interest are endemic in the rating process and the SEC has stated that "NRSROs that are compensated by subscribers appear less likely to be susceptible to 'ratings shopping' or reducing quality for initial ratings to induce revenues."[9] The new board should consider whether increased disclosure rules and prohibitions on ancillary business activities should apply equally to all NRSROs.

Fees. Many investors believe the overseer should require rating agencies to disclose their fees. They also call for a reexamination of the compensation structure of NRSROs.

At a minimum, the board should have the power to require NRSROs to publicly disclose fee schedules and individual rating fees for every rated deal. The rating agencies currently disclose only summary information regarding fees, and they do not make data available for fees on individual deals. Fee transparency would increase incentives for ratings accuracy by creating a new method of competition in the ratings business. Ratings "shopping" based on fee levels would not present the same conflicts and challenges as ratings shopping based on rating levels. Moreover, such disclosure could also reveal potential conflicts of interest arising from an issuer's heavy use of one particular agency.

Alternative pay structures, and the power to reform those structures, should also be considered. Some critics have suggested that issuers could pay a small percentage of any fees upfront, with the remaining fee being "earned out" in the following years, until the maturity of the rated instrument. In order to motivate NRSROs to update their outstanding ratings regularly, fees could depend on certain contingencies or milestones, and might even be related to the accuracy of the rating, as assessed by comparison to other measures of credit risk, including market measures. Over time, such performance-based compensation could discipline NRSROs to strive for greater accuracy. Alternatively, rating agencies might be required to hold stakes in certain instruments that they rate highly.

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[9] 2008 SEC NRSRO Report, at 41.

Fee-for-service style payment also should be considered. Incentives are better aligned if both parties are in a pay-as-you-go situation. Under such a regime, if the credit rating agency breached its arrangement with the issuer (for example, by ceasing its ratings or by changing its assumptions in a way that renders the ratings inaccurate), the issuer would no longer be obligated to pay the agency. Staggering pay in this way might avoid some of the perverse incentives in the ratings process.

Access to Inside Information. For years rating agencies have enjoyed an exemption from Regulation Full Disclosure, or Regulation FD, which allows the rating agencies to receive inside information from issuers that is not shared with the market.[10] The agencies contend that the exemption is needed in order to fully evaluate credit risk. NRSROs say the Regulation FD exemption allows them to alert the public to any substantial changes in the status of a security more quickly and clearly through rating upgrades, downgrades, and watches. Moreover, some argue that credit rating agencies should be able to receive material non-public information from arrangers for the purpose of developing unsolicited credit ratings.

But a strong case can be made for removing this exemption. Rating actions, without a substantial increase in transparency, can cause confusion and speculation. And unsolicited credit ratings are rare. Unless that practice becomes common, there is scant justification for giving credit rating agencies access to inside information through a Regulation FD exemption. Moreover, it is far from apparent that credit rating agencies have incorporated inside information in their ratings. Most notoriously, even though Enron made non-public credit rating agency presentations, information about the risks described in those presentations was not reflected in Enron's credit ratings. The same has been true of structured finance ratings. For these reasons, the board should have the power to limit the subsidy given to credit rating agencies to obtain, and act upon, material non-public information.

Regulators also should set governance standards for NRSROs more broadly. It is worth noting that federal overseers have become more involved in governance of other financial institutions as the government's interest in those institutions has increased during the crisis. Rating agencies, too, played a key role in the debacle, and their quasi-governmental powers need stronger checks and balances.

III. Accountability

Although inaccurate and unreasonable credit ratings from NRSROs were a primary cause of the recent crisis, the agencies remain largely unaccountable. As noted above, in order for credit rating agencies to function properly as gatekeepers, they must be able to credibly pledge a loss of reputational capital in the event they fail to perform their functions. Yet the rating agencies vehemently resist any assignment of liability for their ratings, hewing to the dictum that they merely provide "opinions," and that no one should rely on ratings in making investment decisions. But ratings are more than opinions, and rating agencies must become more accountable.

[10] 17 CFR 243.100-243.103.

Critics offer two approaches to improving the accountability of credit rating agencies: litigation and competition. A credible threat of civil liability would force credit rating agencies to be more vigilant in guarding against negligent, reckless, and fraudulent practices. A credible threat that both regulators and market actors will switch to alternatives to credit ratings could force rating agencies to behave more like information intermediaries than providers of regulatory licenses. Both accountability measures are consistent with oversight reforms. A stronger regulator could help to ensure that credit rating agencies are more accountable to private market actors and subject to competition.

A. Eliminating the Rating Agency Exemption from Liability

Historically, the threat of liability has been an effective tool in encouraging gatekeeper accountability. In general, gatekeepers are less likely to engage in negligent, reckless, or fraudulent behavior if they are subject to a risk of liability.

Although most financial market gatekeepers have been subject to serious threats of civil liability, credit rating agencies have not. Some market observers believe that, with appropriate changes in policy, litigation could become a viable tool for ensuring NRSRO accountability.

Rating agencies have been sued relatively infrequently, and rarely have been held liable. As rational economic actors, rating agencies factor in the expected costs of litigation, including the cost of defending lawsuits as well as any damage awards or settlements. Given the litigation track record, the fact that the rating agencies have published unreasonably high ratings should not be surprising.

Litigation against the credit rating agencies often is deterred by statutory provisions and judicial precedent that limit the liability of NRSROs. NRSROs are immune from liability for misstatements in a registration statement under Section 11 of the Securities Act of 1933. Securities Act Rule 436 explicitly provides that NRSRO are exempt from liability as an expert under Section 11.[11]

In addition, courts have not been willing to impose liability on rating agencies for other alleged federal and state violations, and the threat of NRSRO liability is limited given judicial precedent in the area. Rating agencies were sued following a number of defaults, including class action litigation related to the Washington Public Power Supply System default in 1983; claims related to the Executive Life bankruptcy in 1991; a suit by the Jefferson County, Colorado, School District against Moody's in 1995; and claims by Orange County, California, based on professional negligence, against S&P in 1996. However, the only common element in these cases was that the rating agencies won. The suits were dismissed or settled on favorable terms to the rating agencies. For example, Orange County's $2 billion suit against S&P nettled a paltry settlement of $140,000, roughly 0.007 percent of the claimed damages.

A more recent example was the portion of the consolidated Enron litigation involving claims brought by the Connecticut Resources Recovery Authority.[12] Consider the following statement from the Houston federal district court hearing that case:

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[11] See also Item 10(c) of Regulation S-K.

[12] See Newby v. Enron Corporation, 511 F. Supp. 2d 741 (S.D. Tex. Feb. 16, 2005).

> "After reviewing the case law regarding credit rating agencies and a number of reports and law review articles, this Court finds that generally the courts have not held credit rating agencies accountable for alleged professional negligence or fraud and that plaintiffs have not prevailed in litigation against them. Moreover, there is even a statutory exemption under the Securities Act of 1933 for Section 11 claims against credit rating agencies like the three Defendants here that have been designated 'nationally recognized statistical rating agencies' or 'NRSROs.'"[13]

The Enron court, like some other courts, extended a qualified First Amendment protection to credit rating agencies. Ironically, in doing so, the judicial decision cited the Senate Committee on Governmental Affairs report, "Financial Oversight of Enron: The SEC and Private-Sector Watchdogs" and its statement that "It is difficult not to wonder whether lack of accountability—the agencies' practical immunity to lawsuits and nonexistent regulatory oversight—is a major problem."[14]

Recently, however, a few courts have exhibited some skepticism about judicial protection of credit rating agencies from liability. One plaintiff has had success alleging that Moody's made misrepresentations regarding its independence and ratings methodologies.[15] Another court indicated skepticism of the rating agency's First Amendment argument in the context of private placements, because the rating is not published generally to the public.[16]

Such modest pushback against the rating agencies' free speech assertions is strongly rooted in the economics of ratings, and the fact that ratings agencies are compensated for their "opinions" by the same issuers they are opining about. Rating agencies' profit margins have exceeded 50 percent, whereas more traditional publishing companies' profit margins have been less than 10 percent. Given the high profile nature of the problems with rating agencies and the continuing profitability of the ratings business, judges in future cases may be less inclined to view rating agencies' "opinions" as on par with opinions of publishers.

Indeed, given the dearth of rating agency employees compared to rated issues, rating agencies hardly act like publishers. In 2005, before the beginnings of the recent crisis, Moody's provided ratings for roughly 745,000 different securities; even the largest publishing companies publish only a fraction of that number of stories or opinions.

Moreover, in one important context—the compensation of their senior executives—rating agencies behave more like financial service companies than publishers. Compensation of NRSRO senior management is much higher than executive pay at publishing companies.

Moody's peer group for compensation purposes, as disclosed in its most recent Compensation Discussion and Analysis, was dominated by financial services firms, including AllianceBernstein, BlackRock Inc., CME Group Inc., Eaton Vance Corp.,

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[13] Id. at 815-17.
[14] Newby at 817 (citing Report at 116).
[15] See In re Moody's Corporation Securities Litigation, 2009 U.S. Dist. LEXIS 13894 (S.D.N.Y. Feb. 23, 2009).
[16] See In re National Century Financial Enterprises, Inc., Investment Litigation, 580 F. Supp. 2d 630 (S.D. Ohio. Jul. 22, 2008).

Federated Investors Inc., Franklin Resources Inc., Invesco Ltd., Morningstar, NASDAQ OMX Group Inc., NYSE Euronext, Union Bank California, and other financial firms.[17] Only a handful of publishing companies were on the list. If NRSROs are not comparable to publishers for compensation purposes, they should not be comparable to publishers in litigation for First Amendment purposes. Firms like BlackRock and Union Bank of California are not immune from securities fraud claims.

Perhaps most important, judicial immunity for rating agencies creates challenges for institutional investors, particularly those that rely, at least in part, on credit ratings in their investment process. If judges find that NRSROs are not accountable for negligent, reckless, or fraudulent behavior, it is riskier for investors to rely on NRSRO ratings. Indeed, investors who rely exclusively or primarily on NRSRO ratings may have an increased risk of liability regarding claims that they unreasonably relied on ratings from unaccountable NRSROs.

Moreover, there is judicial precedent that investor reliance on NRSRO ratings is not reasonable. For example, in one dispute involving the purchase of A-rated collateralized mortgage obligations which were downgraded to CCC and defaulted soon thereafter, the court said: "While it is unfortunate that [the investor] lost money, and we take him at his word that he would not have bought the bonds without the S&P 'A' rating, any reliance he may have placed on that rating to reassure himself about the underlying soundness of the bonds was not reasonable."[18] Thus, investors who rely on unaccountable NRSRO ratings are exposing themselves to liability.

In order to make NRSROs properly accountable, critics contend, there must be a real threat of liability. Many believe that Congress should amend Section 11 of the Securities Act of 1933 to add NRSROs as potential defendants. Further, they say lawmakers also should adopt legislation indicating that NRSROs are subject to private rights of action under the anti-fraud provisions of the securities laws. That legislation should include a description of the pleading standard for cases against rating agencies, to indicate that it would be sufficient for a plaintiff to plead the required state of mind by stating that the credit rating agency failed to conduct a reasonable investigation of the rated security or to have obtained reasonable verification from other sources independent of the issuer.

One final advantage to imposing accountability on rating agencies through liability is that it would obviate the need for regulators to provide parameters upfront governing when NRSROs have satisfied their responsibilities as part of the oversight process. In other words, ex ante oversight does not need to be as specific or draconian if regulators and investors can rely on ex post adjudication of rating agency negligence, recklessness, and fraud. Through an evolutionary approach, judges and private litigants could develop a common law understanding of appropriate rating agency behavior.

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[17] Moody's Corporation Schedule 14A, March 18, 2009, at 19.
[18] Quinn v. McGraw-Hill, 168 F.3d 331, 336 (7th Cir. 1999).

B. Enhancing Accountability through Competition and Reduced Reliance on Ratings

Finally, critics assert that competition in the credit rating business has not been effective. Some say the problem is due to insufficient industry competition and that the solution is to designate more NRSROS. Others contend that opening the NRSRO designation to more rating agencies fails to change the fundamental feature of the rating business, which is that ratings are driven by regulatory licenses. Instead of a supply-side solution, they argue that the demand side—regulators and market participants—should broaden and deepen their reliance on alternative measures of credit risk.

Credit ratings are an important, and sometimes mandated, tool for many categories of market participants. Today, references to ratings are incorporated in investment guidelines, swap documentation, loan agreements, collateral triggers, and other important documents and provisions.

Most institutional investors do not rely exclusively on ratings. While credit ratings are part of the mosaic of information considered as part of the investment process, they are generally not an appropriate sole source for making decisions.

A variety of alternative measures may be used to evaluate credit risk and supplement or even replace credit ratings. They include the following:

- Investors might use the variables underlying ratings, such as expected probability of default, recovery in the event of default, and default correlation, when relevant. For example, an investor might amend its investment guidelines to state it would only purchase bonds with an expected probability of default of 1 percent or less during maturity. The decision about expected probability of default then could be made based on a wide range of information.

  A "first cut" filter might be based on the market-wide expectation of default, as reflected in a bond's price. Most bond underwriters can provide this information for a range of issues; relatively inexpensive information services, such as Bloomberg and Reuters, also provide such information. Professor Edward Altman also has published extensive data in this area. In addition, credit default swap data is available from services, such as Markit, for numerous fixed income issues. Credit default swaps have been criticized in various ways, but abundant evidence suggests that credit default swap spreads more quickly and accurately reflect underlying credit risks than do NRSRO ratings.

- Investors might use the default probability implied by a bond's price, not only at the time of purchase but over time, as part of their portfolio management process. Many services provide such information. Indeed, NRSROs increasingly incorporate such market measures into their own ratings, though on a lagged basis. Investors concerned about the volatility of market prices could use 30-day or 90-day rolling averages.

Rolling averages of market prices at least potentially reflect a wider range of available information than credit ratings, and may be a more timely and accurate measure of credit risk. Rolling averages also more accurately reflect available information than credit ratings and are not likely to be subject to manipulation or abuse.

Basing investment decisions on a rolling average of market measures may motivate investors to assess early on the risks associated with investments and to limit their exposure in the event of a market downturn. Some institutions might be forced to sell during periods of price declines, but those that do may avoid more sustained declines that occur when stale ratings permit investors to continue to hold and to deny that investments have declined in value. Moreover, to the extent forced sales occur relatively early, these new policies may help deter prolonged crises.

- Investors might revise their guidelines to reflect a blended standard of information sources used to make investment decisions based in part on professional judgment. For example, investors might rely on: 1) private information obtained through due diligence, 2) publicly available "soft" information, and 3) market-based measures and prices. The blended information might include credit ratings.

Liquidity risk is also becoming a more important part of investment decision making. NRSRO ratings do not cover liquidity risk. As a result, the market for information about liquidity risk does not suffer from the same regulatory license distortions as the market for credit risk. Many relatively new information intermediaries, such as Markit, Kamakura Corp., and some investor-pay NRSROs, have developed competing analytic systems for assessing both credit and liquidity risk. As investor guidelines evolve to focus more on assessments of liquidity risk, this focus may apply market pressure to NRSROs, making them more accountable.

Ultimately, institutional investors vary in the amount of time and money they can afford to spend on the analysis of credit and liquidity risks. Accordingly, they have mixed views on whether references to credit ratings should be immediately removed from regulations. Some say ratings are meaningless and useless; they are comfortable with an immediate abolition of regulatory references to credit ratings. They argue that new intermediaries will come forward to fill the gaps left by the dominant NRSROs. Others say credit ratings remain an important tool. They argue that a sweeping removal of regulatory references to credit ratings would leave a gap for certain investment processes, would harm investors by removing a minimal floor for some investment decisions, and would disrupt the credit markets. In order to reduce private reliance on ratings, credible alternatives and substitutes must be developed, particularly for institutions that lack the resources to assess independently the huge number of available fixed income instruments.

Over the longer term, institutional investors at large are likely to grow more comfortable with a regulatory move away from credit ratings. And as institutional investors continue to encourage the formation and development of alternative information markets, market pressures from the demand side should motivate the NRSROs to improve their performance and accountability. Given the lack of accountability of

NRSROs, this approach may be more effective and efficient than an approach that explicitly incorporates NRSRO ratings.

V. Conclusion

Many credit rating agencies have ventured far from their original role as reliable financial gatekeepers. They no longer provide consistently dependable information about credit risk. This has put many institutional investors in a box because they are still required to use ratings, regardless of the accuracy of the ratings. Stung by losses on investments in a string of once highly rated companies, from Enron to Lehman Brothers, investors are seeking ways to strengthen oversight and accountability of rating agencies, as well as new tools to evaluate credit risk.

Alternatives are emerging but may be out of reach for some investors for some time. For that reason, it is the author's view that Congress should step in to ensure that rating agencies are motivated to be more diligent in their assessment of credit risk. Toward that end, lawmakers should create a new Credit Rating Agency Oversight Board with the power to regulate rating agencies. At a minimum, Congress should provide the SEC with the financial and statutory resources to be an effective regulator of the industry. Secondly, it is time to take away the rating agencies' liability shield. Exemption from liability is not justified or tolerable, given the enormous clout that rating agencies now wield.

Ultimately, as institutional investors become more comfortable with alternative sources of credit information, competitive pressure could spur credit rating agencies to improve their performance and accountability. "Regulatory licenses" should disappear. Meanwhile, more vigorous oversight and accountability measures can improve the performance of NRSROs.

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May 15, 2009

Dear Members of the Committee:

I was asked to provide an objective First Amendment analysis of whether and how credit rating agencies can be regulated, and whether and how they can be held liable for allegedly erroneous ratings. I do not represent any rating agencies, or people or organizations interested in suing rating agencies. Though I do some consulting for the Mayer Brown LLP law firm, I am here solely in my capacity as Professor of Law at UCLA School of Law, and not on behalf of anyone else.

Consumers, businesses, and investors routinely rely on a large range of product and business evaluations. These include newspaper or magazine reviews of consumer products and business products, from cheap to very expensive. They include articles on companies' current performance and future prospects. And they include ratings issued by credit rating agencies, whether by themselves or as part of more extended articles providing specific details.

1. Generally speaking, such speech is presumptively fully protected by the First Amendment, whether it comes from the pages of the *Wall Street Journal* or *Forbes* or from Standard & Poor's. First Amendment law generally provides *the media* with no special immunity from laws that don't target the media;[1] it is therefore usually unnecessary to decide whether Standard & Poor's, a business blog, or a think tank constitutes "the press." Rather, First Amendment law protects *speakers* and *speech*. Credit rating agencies are speakers, and their evaluations, opinions, and factual assertions are speech.[2]

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[1] Cohen v. Cowles Media, 501 U.S. 663, 669 (1991). Some state journalist's privilege statutes do distinguish media defendants from non-media defendants, and some even distinguish different kinds of media, for instance offering protection to newspaper reporters but not to magazine reporters or book authors. *See, e.g.*, Ala. Code § 12-21-142; Fla. Stat. tit. VII, § 90-5015. But in this testimony I am speaking of the broad thrust of First Amendment law, which does indeed generally protect speakers equally, without having to define who counts as the "media" and who doesn't. For some cases deciding whether the journalist's privilege applies to various rating agencies, see, *e.g.*, Compuware Corp. v. Moody's Investors Servs., 324 F. Supp. 2d 860, 862 (E.D. Mich. 2004) (yes, as to Moody's); *In re* Scott Paper Co. Securities Litigation, 145 F.R.D. 366, 370 (E.D. Pa. 1992) (yes, as to Standard & Poor's); *In re* Fitch, Inc., 330 F.3d 104, 109 (2d Cir. 2003) (no, as to Fitch); American Savings Bank v. UBS PaineWebber, Inc., 2002 WL 31833223, *3 (S.D.N.Y. 2002) (no, as to Fitch).

[2] *See, e.g.*, Compuware Corp. v. Moody's Investors Servs., Inc., 499 F.3d 520, 529 (6th Cir. 2007); Jefferson County School Dist. No. R-1 v. Moody's Investor's Servs., Inc., 175 F.3d 848, 856 (10th Cir. 1999).

The First Amendment also protects speech about business as much as it protects speech about politics. The Court has indeed at times said that "expression on public issues 'has always rested on the highest rung of the hierarchy of First Amendment values,'"[3] but the public issues on this highest rung have long included "economic, social, and political subjects"[4] and not just the political. That's why labor unions, for instance, are free to express their views about management in their newsletters, leaflets, and advertisements, and in their officials' speeches.[5] It's why the *Wall Street Journal*'s business pages are as protected as its editorials and news pages. And it's why other speakers' statements about a business's prospects are protected as well.

The First Amendment also protects speech that is published by for-profit entities as well as speech published by ideological organizations.[6] Most newspaper, magazine, and book publishers, for instance, are for-profit entities. Neither the subject matter nor the profit motivation of credit rating agencies strips them of First Amendment protection.

2. I began the preceding section, though, with "generally speaking," because there are some important exceptions to the rule. One is that *commercial advertising*—speech aimed at proposing a commercial transaction[7]—is much less constitutionally protected

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[3] NAACP v. Claiborne Hardware Co., 458 U.S. 886 (1982) (quoting Carey v. Brown, 447 U.S. 455, 467 (1980)).

[4] *Carey*, 447 U.S. at 466.

[5] *See* Edward J. DeBartolo Corp. v. Florida Gulf Coast Bldg. and Const. Trades Council, 485 U.S. 568, 576 (1988); Thomas v. Collins, 323 U.S. 516, 537-38 (1945); Bigelow v. Virginia, 421 U.S. 809, 818 (1975) (noting that labor speech such as that in *Thomas* doesn't lose its constitutional protection just because the speaker's motive "may have involved financial gain").

[6] *See, e.g.*, Simon & Schuster, Inc. v. Members of New York State Crime Victims Bd., 502 U.S. 105 (1991); Smith v. California, 361 U.S. 147, 150 (1959); Joseph Burstyn, Inc. v. Wilson, 343 U.S. 495, 501 (1952); Grosjean v. American Press Co., 297 U.S. 233 (1936).

[7] Virginia State Bd. of Pharmacy v. Virginia Citizens Consumer Council, Inc., 425 U.S. 748, 761 (1976). The Court has at times suggested that the commercial speech category may also generally cover speech that is "related solely to the economic interests of the speaker and its audience," Central Hudson Gas & Elec. Corp. v. Public Serv. Comm'n, 447 U.S. 557, 561 (1980), but this can't be right: Consider again the newspaper that discusses business affairs, almost entirely in order to make money by helping its readers do well in business; consider a product review written by its author because he wants to be paid, published by the newspaper because it wants to keep its paying subscribers, and read by readers because they want to know how to best spend their money; consider a union buying TV ads urging people to "Buy American" because that's the best way of maintaining the viewers' (and the union members') standard of living; all are fully protected speech. In fact, every one of the Court's dozens of commercial speech cases has involved speech that advertised a product or service; and more recent precedents, which have generally been shifting in the direction of more protection even for speech that is classified as "commercial speech," have stressed the "proposes a commercial transaction" formulation and largely ignored the "solely economic interests" test. *See, e.g.*, Lorillard Tobacco Co. v. Reilly, 533 U.S. 525, 554 (2001) (referring to the "proposes a commercial transaction" formula without referring to the "solely economic interests" formula) (likewise); U.S. v.

than other kinds of speech (whether about politics, business, science, or what have you). This is why securities regulation, which is directed at speakers who are advertising the sale of securities, is generally constitutional.

This is also why a car ad in a magazine is less protected than the magazines' review of a car. And if an entertainment magazine takes money from Ford in exchange for *positive coverage* (for instance, in exchange for showing celebrities in photos driving Mustangs), such coverage would likely be treated as a form of commercial advertising, even if it's presented to the reader as straight editorial content. Likewise, if an organization—whether a rating agency or a newspaper—takes money in exchange for giving someone a favorable review, that would make the review into commercial advertising.

What if the subject of the speech pays a flat fee for the speaker's evaluation? The Supreme Court has never spoken to this precise situation, but I think this wouldn't make the speech into commercial advertising. Newspapers and magazines routinely receive money from people whose products they review. Car magazines usually carry many car ads, including from companies whose cars the magazine reviews. Newspapers' entertainment sections have movie ads. It's true that the presence of such ads might in theory indirectly pressure the publication to give good reviews, for fear that bad reviews will alienate advertisers. But the possibility of such indirect pressure doesn't make the reviews into less constitutionally protected commercial advertising.

To be sure, a typical advertiser's payment isn't directly linked to whether the product is being reviewed. But the principle is the same: The subject of a review is paying the speaker. The speaker is reviewing the subject's product or company. So long as the payment isn't buying a positive evaluation—so long as the speaker isn't proposing a commercial transaction in which it itself has a financial interest—it seems likely that the evaluation will remain fully constitutionally protected.

3. In libel lawsuits, speech is also less protected when it is seen as involving "no issue of public concern."[8] Opinions and true factual statements are likely still protected even in such a case,[9] but false factual assertions involving "no issue of public concern"

United Foods, Inc., 533 U.S. 405, 409 (2001); Liquormart, Inc. v. Rhode Island, 517 U.S. 484, 504 (1996); City of Cincinnati v. Discovery Network, Inc., 507 U.S. 410, 421 (1993) (stressing that the Court has been shifting away from the "economic interests" formulation and towards the "proposes a commercial transaction" formulation); Rubin v. Coors Brewing Co., 514 U.S. 476, 482 (1995) (same); United States v. Edge Broadcasting Co., 509 U.S. 418 (1993) (same); Edenfield v. Fane, 507 U.S. 761 (1993) (same).

[8] Dun & Bradstreet, Inc. v. Greenmoss Builders, Inc., 472 U.S. 749, 757 (1985) (plurality). I will treat the plurality opinion as the view of the Court, because Chief Justice Burger and Justice White, who concurred in the judgment, took an even more pro-plaintiff view of the matter. There were thus five votes for the proposition that in the circumstances described by the plurality, a lower level of First Amendment protection would be provided.

[9] *See* Connick v. Myers, 461 U.S. 138, 147 (1983).

can lead to liability even without a showing that the speaker knew the statements were false or probably false.

Unfortunately, the Court has never provided a clear definition of which issues are "of public concern" and which are not. It has said, in *Dun & Bradstreet, Inc. v. Greenmoss Builders*, that the question is one of "content, form, and context," and that some credit reporting is "subject to reduced First Amendment protection," while other credit reporting retains full protection.[10] And it has pointed to several factors that cut in favor of a statement's being seen as being of purely private concern: that the speech is "solely in the individual interest of the speaker and its specific business audience," that it is "wholly false and clearly damaging to the victim's business reputation," that it is divulged confidentially to a very few subscribers as opposed to the whole world, and that it "is hardy and unlikely to be deterred by incidental state regulation."[11] Moreover, the speech in *Dun & Bradstreet*—an erroneous statement that a construction contractor had filed for bankruptcy—was said about a very small company in a small town. Such speech was thus of concern to only very few members of the public.

It's not clear how the *Dun & Bradstreet* analysis would apply to most of the speech of the major rating agencies. Such speech is indeed chiefly in the speaker's and audience's business interests, but of course that's equally true of much that's in a newspaper's business pages, and for that matter of much speech by labor unions to their members. That alone can't strip speech of full First Amendment protection.[12] Likewise, the speech is hardy and less likely to be deterred by the threat of liability than, say, a newspaper editorial. But again that could equally be said about a large range of historically hardy speech, from religious advocacy to business-related speech by business magazines that have to engage in such speech to stay in business.

Allegedly unduly positive ratings—the matter that people seem to now be concerned with—aren't "clearly *damaging* to the victim's business reputation," so the traditionally recognized legal interest in protecting reputation isn't in play here. (Historically, tort law has provided much more protection to people whose reputation is injured by erroneous public statements than to consumers or investors who are injured by such statements, at least when the statements didn't constitute advertising for the speaker's own product or service.[13]) Moreover, the statements that credit agencies are faulted for making are generally not "wholly false" statements about specific facts—did Greenmoss Builders file for bankruptcy?—but rather supposedly false implications drawn from a

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[10] *Id.* at 761 n.8.

[11] *Id.* at 762-63.

[12] *See supra* note 5.

[13] *See* Jaillet v. Cashman, 189 N.Y.S. 743, 744 (Sup. Ct. 1921), *aff'd without opinion*, 194 N.Y.S. 947 (App. Div. 1922), *aff'd without opinion*, 139 N.E. 714 (N.Y. 1923), and the many cases that cite it; Judge Robert D. Sack, Sack on Defamation: Libel, Slander, and Related Problems § 13.8 (describing *Jaillet* as a "seminal case"). *See also* Winter v. G.P. Putnam's Sons, 938 F.2d 1033 (9th Cir. 1991).

credit agency's evaluation. So it's not clear if or how this element, obviously developed in the context of libel law, would carry over to liability for speech that's alleged to be misleadingly positive.

It's also not clear to what extent the size and importance of the rated companies would affect the "public concern" analysis. The *Dun & Bradstreet Builders* decision did not specifically discuss this factor in its analysis, but it seems clear that there is a much greater public concern in the economic health of General Motors than in the economic health of Greenmoss Builders. As the Court held in another "public concern" case (involving the speech of government employees), the question is whether the speech can be "fairly considered as relating to any matter of political, social, or other concern to the community";[14] and lower courts have made clear that "the relevant concern need not be of paramount importance or national scope"[15] to qualify. The financial standing, whether good or bad, of a large bond issuer does relate to a matter of concern to the community.

Finally, the wider the intended dissemination of the statement, the more likely the statement is to be treated as being on a "matter of public concern." If a rating is published to the world by the rating agency, or if the rating agency conveys the rating with the expectation that it will be published to the world by others, then the rating of a large company becomes hard to distinguish from an article about the company in a financial newspaper—surely a matter of "public concern."[16] But if the rating is conveyed to only a few people, who are bound by a confidentiality agreement not to distribute it further, then the analogy to *Dun & Bradstreet Builders* becomes stronger (though still not perfect if the subject of the rating is a large and important company).[17]

4. The discussion so far has assumed that the rating agencies are speaking to the public generally, rather than giving individualized advice to a client. Individually targeted professional-client speech is often very heavily regulated.

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[14] Connick v. Myers, 461 U.S. 138, 146-47 (1983).

[15] Levinsky's, Inc. v. Wal-Mart Stores, Inc., 127 F.3d 122, 132 (1st Cir. 1997).

[16] *See, e.g.*, *In* re Enron Corp. Securities, Derivative & "ERISA" Litigation, 511 F. Supp. 2d 742, 820 (S.D. Tex. 2005) (so concluding); Compuware Corp. v. Moody's Investors Servs., 324 F. Supp. 2d 860, 862 (E.D. Mich. 2004) (so concluding); County of Orange v. McGraw Hill Companies, Inc., 245 Bankr. 151, 155 (C.D. Cal. 1999) (so concluding); *In re* Pan Am Corp., 161 Bankr. 577, 584 (S.D.N.Y. 1993) (so concluding, in reversing a contrary Bankruptcy Court conclusion). *But see In re* Nat'l Century Fin. Enters., 580 F. Supp. 2d 630, 640 (S.D. Ohio 2008) (concluding, in my view unsoundly, that the cases finding protection for speech on matters of public concern do not apply when "the ratings . . . were [not] published to the investing public at large" but rather "were issued by a privately-held company, and . . . targeted to a select class of institutional investors with the resources to invest tens of millions of dollars in the notes").

[17] *Cf.* LaSalle Nat'l Bank v. Duff & Phelps Credit Rating Co., 951 F. Supp. 1071, 1095-96 (S.D.N.Y. 1996) (treating a rating agency's speech as less protected because it was "intended for use in the private placement Offering Memoranda, rather than for publication in a general publication").

Lawyers and psychotherapists, for instance, can be barred from giving advice to clients unless they first get a license (which might only be obtainable by those who engage in years of formal study and then pass a grueling and difficult exam). They can also be sued for giving negligent advice, even if there are no false factual statements within the advice. "One who takes the affairs of a client personally in hand and purports to exercise judgment on behalf of the client in the light of the client's individual needs and circumstances is properly viewed as engaging in the practice of a profession," and may thus be regulated notwithstanding the First Amendment.[18] But no government body can demand a license of people who write books, scholarly articles, or newspaper columns about law or psychiatry, even when those works contain advice. Nor can someone sue a newspaper columnist for malpractice based on the supposedly poor advice about law that the column provided.

Likewise, a financial advisor or a rating agency that is giving individualized advice to a particular client could be held legally liable for malpractice based on its unsound advice,[19] or even required to have a license in order to give such advice. But speaker who give broad recommendations to the general public, whether the speakers are newspapers, investment newsletters, or rating agencies, do not fit within this professional-client speech exception to First Amendment protection. "Where the personal nexus between professional and client does not exist, and a speaker does not purport to be exercising judgment on behalf of any particular individual with whose circumstances he is directly acquainted, government regulation . . . becomes regulation of speaking or publishing as such, subject to the First Amendment's command."[20]

5. So if I'm correct about the above, the speech of rating agencies is generally fully protected, at least so long as the agencies aren't paid to write positive reviews (as opposed to reviews generally), and so long as they are communicating to the public as opposed to a few confidential subscribers or a particular entity that hired them to give individualized advice.

In such a situation, the agencies' speech would be entitled to the same level of constitutional protection as that enjoyed by newspapers, magazines, newsletters, Web site operators, and the like. The speakers' opinions would be categorically constitutionally protected. The speakers' factual assertions would also be constitutionally protected, unless a plaintiff can show that the speakers knew that the statements were false or

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[18] Lowe v. SEC, 472 U.S. 181, 232 (1985) (White, J., concurring in the judgment) (drawing this distinction in the context of investment advisors). Justice White's three-judge opinion in *Lowe* is often cited as authoritative on the matter of professional-client speech and the First Amendment; the majority did not disagree with it on this point.

[19] *See, e.g.*, Commercial Financial Servs., Inc. v. Arthur Andersen LLP, 94 P.3d 106, 110 (Okla. Ct. Civ. App. 2004) (so holding as to rating agencies).

[20] *Id.*; *see also id.* at 207-08 (majority opinion) (agreeing that a contrary view would at least raise serious constitutional problems).

likely false.[21] (That's the "actual malice" standard, though "actual malice" is a legal term of art that has nothing to do with actual malice as ordinary English speakers understand the term.[22])

A rating agency's bare prediction about a company's creditworthiness, captured in the rating itself, will likely be seen as pure opinion. As the Sixth Circuit held in this very sort of case, "a viable defamation claim exists only where a reasonable factfinder could conclude that the challenged statement connotes actual, objectively verifiable facts. A Moody's credit rating is a predictive opinion, dependent on a subjective and discretionary weighing of complex factors. We find no basis upon which we could conclude that the credit rating itself communicates any provably false factual connotation. Even if we could draw any fact-based inferences from this rating, such inferences could not be proven false because of the inherently subjective nature of Moody's ratings calculation."[23]

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[21] *See* Compuware Corp. v. Moody's Investors Servs., 222 F.R.D. 124, 127 (E.D. Mich. 2004) (applying this to rating agencies); County of Orange v. McGraw Hill Companies, Inc., 245 Bankr. 151, 155 (C.D. Cal. 1999) (same). Note that, "Although these issues traditionally arise in libel or defamation actions, the actual malice standard applies to other causes of action when the plaintiff seeks compensatory damages arising from allegedly false statements. See Hustler Magazine, 485 U.S. 46, 108 S.Ct. 876 (intentional infliction of emotional distress); Blatty v. New York Times Co., 42 Cal.3d 1033, 232 Cal.Rptr. 542, 728 P.2d 1177 (intentional interference with prospective economic advantage); Bose v. Consumers Union, 466 U.S. 485, 493-514, 104 S.Ct. 1949 (1984) (product disparagement action); Time, Inc. v. Hill, 385 U.S. 374, 387-88, 87 S.Ct. 534 (1967) ([false light] invasion of privacy)." *County of Orange*, 245 Bankr. at 155; *see also* Jefferson County School Dist. R-1 v. Moody's Investor's Servs., Inc., 175 F.3d 848, 856-57 (10th Cir. 1999) (noting the same).

[22] I will assume throughout the rest of my testimony that the standard is that used for statements on matters of public concern about public figures, as opposed to private figures. It seems likely that companies whose financial instruments are rated by rating agencies will indeed be public figures. But even if they are not, the public/private figure distinction was developed in the law of libel, for reasons specific to the law of libel, chiefly that defamed private figures had less power than defamed public figures to respond via the media with their side of the story, and that defamed private figures hadn't waived their immunity from defamation to the same extent as defamed public figures had. Gertz v. Robert Welch, Inc., 418 U.S. 323, 344 (1974). Neither of these rationales counsels in favor of extending the distinction outside the context of a person's suing over an allegedly false statement that is made about him.

[23] Compuware Corp. v. Moody's Investors Servs., Inc., 499 F.3d 520, 529 (6th Cir. 2007); Jefferson County School Dist. No. R-1 v. Moody's Investor's Servs., Inc., 175 F.3d 848, 856 (10th Cir. 1999) ("the School District's failure to identify a specific false statement reasonably implied from Moody's article, combined with the vagueness of the phrases 'negative outlook' and 'ongoing financial pressures' indicates that Moody's article constitutes a protected expression of opinion"); *see also* Aviation Charter, Inc. v. Aviation Research Group/US, 416 F.3d 864, 871 (8th Cir. 2005) (concluding that a rating that is "a subjective interpretation of multiple objective data points leading to a subjective conclusion about aviation safety" "is not 'a provably false statement of fact'" and thus not actionable); Wheeler v. Nebraska State Bar Ass'n, 508 N.W.2d 917, 923-24 (Neb. 1993) (using similar logic to conclude that attorneys' numeric evaluations of judges were opinion and thus not actionable as

A textual report about a business, on the other hand, might include facts that might be proven true. And a court could even conclude that the bare rating "impl[ies] a false assertion of fact."[24] In either case, if the speaker sincerely believes that the implicit or explicit factual assertion is true, or is sincerely unaware of a possible factual inference that listeners may draw from the statement, the speaker is not liable. That's the rule under defamation law, when someone is complaining about the implied factual assertions in a negative opinion. And that would presumably be the rule if someone sues over the implied or explicit factual assertions in a supposedly erroneously positive opinion.[25]

So liability for an unduly favorable textual report is theoretically not foreclosed by the First Amendment (though liability for a bare credit rating might be foreclosed, if courts agree with the Sixth Circuit that such a rating is pure unverifiable opinion). But practically such liability would be hard to establish, because there would have to be evidence that the rating agency knew that particular factual assertions that would likely be implied by the statement are false, or at least "in fact entertained serious doubt as to the truth of [its] publication."[26] Mere "failure to investigate . . . even when a reasonably prudent person would have done so," is not actionable, so long as the agency sincerely believed that the statements were true.[27] "[E]rror of judgment" in interpreting the facts would certainly not suffice.[28] And even a jury's finding of "extreme departure from professional standards" of investigation would not be enough to lead to liability.[29]

And this fits well with the logic of the Court's First Amendment cases, especially when an action is based not on the falsity of the specific statement that the rating agency made, but rather on the falsity of the factual implications that a reasonable per-

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defamation). Rating agencies sometimes describe their work as "objective," but that's objective in the sense of not biased, not objective in the sense of having the rating being "objectively verifiable."

[24] *See* Milkovich v. Lorain Journal Co., 497 U.S. 1, 19 (1990); *cf. In re* Nat'l Century Fin. Enters., 580 F. Supp. 2d 630, 639 (S.D. Ohio 2008) (concluding that a rating could indeed be legally actionable "if the speaker does not believe the opinion and the opinion is not factually well-grounded"); First Financial Savings Bank v. American Bankers Ins. Co., 1989 WL 168105 (E.D.N.C.) (summarily rejecting the First Amendment argument), *vacated in part on other grounds*, 1991 WL 173055 (E.D.N.C. 1991).

[25] *See supra* note 21.

[26] St. Amant v. Thompson, 390 U.S. 727, 731 (1968).

[27] Harte-Hanks Comms., Inc. v. Connaughton, 491 U.S. 657, 688 (1989); *In re* Enron Corp. Securities, Derivative & "ERISA" Litigation, 511 F. Supp. 2d 742, 825-26 (S.D. Tex. 2005) (applying this to rating agencies).

[28] Time, Inc. v. Pape, 401 U.S. 279, 292 (1971).

[29] *Connaughton*, 491 U.S. at 664.

son would draw from the statement. How to interpret the facts that a financial analyst acquires, and how many facts need further investigation, is a subjective matter. How to predict the future based on those facts is even more subjective. Even reasonable predictions will often prove mistaken. It's easy for a lay jury, deciding after a prediction has proven wrong, to conclude—using the fuzzy "reasonable person" standard—that the speaker should have reached a different conclusion. But the Court has concluded that such after-the-fact evaluation of reasonableness doesn't provide speakers with enough constitutional protection.[30]

6. All I've said so far relates to rating agencies' liability for past alleged misevaluations, and to direct regulation of agency evaluations. But going forward, Congress could—if it wishes—require that various commercial transactions (for instance, bond offerings) be accompanied with reports that comply with certain guidelines. It could even insist that any entities supplying such reports agree to have their actions reviewed in court under a negligence standard, or under some other standard.[31]

Such a policy would leave people free to express whatever views they wish about whatever financial products they wish (subject to the First Amendment rules I outlined above). Newspapers would remain free to evaluate companies. So would investment newsletters and rating agencies.

But if a business wants to (for example) sell certain bonds, it would be required to get, and provide to the public, the particular sort of report required by statute. Agencies that want to provide such reports, and have the reports be treated as legally adequate for statutory purposes, would have to agree to follow whatever procedures the statute or regulations prescribes, and (if Congress wishes) would have to agree to waive any immunity from liability that they might otherwise possess. If they don't comply with those procedures, and don't waive liability, but just express their opinion, they would be free to do so. It's just that such procedurally noncompliant statements of opinion will not be legally adequate to allow the bond issue to go forward.

This remedy would have the advantage of not asking courts to reduce the constitutional protection offered to speech about business matters, or to broaden the scope of generally regulable commercial advertising, or to define as a matter of purely "private concern" commentary that is obviously of very great public concern. It would simply

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[30] An accountant's or financial provider's liability to a client for individualized advice may indeed be subject to a reasonableness test, but there the speaker is potentially liable only to one plaintiff; if a rating agency is held liable for unduly positive ratings, it could face lawsuits alleging "unreasonable" behavior by many thousands of investors.

[31] I don't want to suggest that this is necessarily good policy. Among other things, Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 Wash. U. L.Q. 619 (1999), which criticizes the rating agencies, suggests that giving rating agencies gatekeeper is part of the problem, not part of the solution. I speak here only of what would be constitutional.

mandate that certain kinds of legally significant statements, to become legally significant, must comply with certain procedures.

I hope this analysis has been helpful, and I would be glad to answer any further questions that anyone from the subcommittee might have.

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May 18, 2009

The Honorable Paul Kanjorski
Chairman
Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
House Financial Services Committee
2129 Rayburn House Office Building
Washington, DC 20515

Dear Chairman Kanjorski:

The Association for Financial Professionals (AFP) welcomes the opportunity to provide formal comments on the Capital Markets Subcommittee's hearing to examine the need for more effective regulation of the credit rating agencies. We appreciate the chance to provide insights and suggestions from the end-user perspective.

As the global resource and advocate for the finance profession, AFP serves over 16,000 members who manage and safeguard the financial assets of more than 5,000 U.S. organizations. Many of our members are responsible for issuing short- and long-term debt and for managing the corporate cash, 401(k) and pension assets of their organizations. In these fiduciary capacities, our members are significant users of the credit rating agencies. Acting as both investors and issuers of debt, our members represent a balanced view of the credit ratings process, and have a significant stake in the outcome of the reform of rating agency practices and regulation.

AFP believes that the credit rating process and investor confidence in those ratings are vital to efficient global capital markets, and that it is necessary that the ratings produced by the Nationally Recognized Statistical Rating Organizations (NRSROs) be sound and reliable. Unfortunately, we believe that the current credit rating agency processes and business models are neither sound nor reliable. In fact, the system is broken. The time has long passed for incremental reform. A new model is needed to address widely-recognized flaws in the credit ratings business and restore investor confidence in credit ratings. The credit rating system must be fundamentally overhauled.

Since 2002, AFP has been a vocal advocate for the reform of the credit ratings industry. During that time, we conducted several surveys that found that both issuers of corporate/municipal 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 their shareholders and other parties rather than investors, and 3) the SEC or some other regulatory body must increase its oversight of rating agencies and take steps to foster greater competition in the market for credit rating information. In April of 2004, AFP and treasury associations from Europe 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).

While AFP believes that the *Credit Rating Agency Reform Act of 2006* (CRARA) and the SEC rules implementing the Act made significant strides toward removing barriers to competition the SEC had imposed, more work must be done to adequately address deficiencies with the current model in place. Regrettably, passage of the *Credit Rating Agency Reform Act of 2006* has not led to real competition in the credit ratings market, nor has it improved the ability of the three dominant rating agencies (Moody's, S&P and Fitch) to produce timely and accurate ratings. While the three dominant rating agencies continue to be complicit in one market crisis after another, their fee structure has continued to rise. The recent market turmoil and disruptions in the credit markets provide strong empirical evidence that the rules do not go far enough – **significant reform** is necessary in order to fix this inherently broken system.

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Therefore, AFP is proposing the following changes and enhancements to the current model. We realize that additional work will need to be done should either of these ideas materialize into action, but it is our hope that these suggestions can serve as the foundation for meaningful dialogue and deliberative action towards the necessary reform of the CRAs. AFP has proposed two ideas for the rating agencies that are worthy of further consideration: a) create a stand-alone model, where the only activities of the enterprise would be credit ratings; and b) implement rules that direct government support of the other non-major NRSROs.

Our first proposal is to implement a model that is similar in nature to a utility to support ratings organizations whose sole business purpose would be to provide credible and reliable ratings. These new ratings organizations could be financed by a transaction fee, which could be levied upon both, investors and issuers alike. Rating agencies operating under this model would be able to interact with and advise organizations being rated, but could *not* charge fees for providing advice, as Moody's, S&P, and Fitch currently do today.

AFP believes this model is a viable way to compensate a ratings organization that agrees to provide credible and reliable ratings as their sole business purpose. With this stand-alone model, most of the conflicts of interest that the current CRAs have would be removed. The key to making this model work is to have it funded by the transaction fee. Under the current system, it is our view that whether the fees are paid by the issuer/structurer or the investor, there are inherent biases in place. In the issuer-paid model, there will be pressure from issuers for the CRA to give the highest rating and to maintain that rating in order to lower borrowing costs. In an investor or subscription-paid model, there may be pressure for the initial rating to be as low as possible to maximize the yield on purchased debt. Subsequently, investors may push for higher or at the very least stable ratings in order to increase or protect the value of their investments. In either scenario, potential conflicts exist that could obscure the outcome of an unbiased, thorough credit analysis. However, we believe the stand-alone model funded by transaction fees would significantly mitigate conflicts of interest issues that currently exist.

By creating a funding source that is beyond the influence of both issuers and investors, the focus of the CRAs will be on producing the most accurate and timely credit analysis rather than satisfying the desires of any other vested interest. Under this model, the SEC would still have to exercise vigorous oversight of the rating agencies to ensure that they are fulfilling their mission of providing reliable ratings and are held accountable for inaccurate ratings.

The other proposal we believe is worth exploring would be for the U.S. government to require itself, and any federal programs that require credit ratings, as well as any business that has had a capital infusion from the U.S. government, to utilize at least one NRSRO, other than the dominant three, as additional credit analysis providers when issuing debt. This departure from tradition by such a key market participant would encourage the development of a truly competitive environment and give credibility to new rating agencies that have not had an opportunity to establish their bona fides on the open market.

Given the dominant market position that S&P, Moody's and Fitch currently possess, the possibility of one of the alternative NRSROs growing to the point of being an equal competitor seems remote. In fact, the U.S. government's reliance on the dominant three severely erodes or eliminates the benefits of competition envisioned by the CRARA by treating other NRSROs as inferior to the dominant three. The U.S. government must break its own addiction to S&P, Moody's and Fitch due to their history of poor performance – and should not be rewarding them for past failures. The government, including the Treasury Department, must immediately begin to accept alternative NRSROs and direct some ratings business to these NRSROs rather than relying solely on ratings provided by S&P, Moody's and Fitch. We further propose that federal agencies be required to utilize at least one alternative NRSRO for all transactions with underlying assets of $50 million or more.

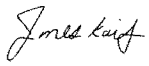
Corporate America currently has the ability to utilize one of the alternative NRSROs. But the reality is that this is unlikely to occur until these entities are viewed by the U.S. government as being on a level playing field with the dominant three. In the current climate of risk aversion, financial executives are unlikely to recommend the use of a rating agency for their debt issuance or investment decisions that Federal agencies treat as inferior to the dominant three.

AFP fully supports increased disclosure requirements, but argues for model-agnostic disclosure – it must be the same across the board for all NRSROs regardless of how they are compensated. Above all, whether we move to a different rating agency model or not, regulators must enforce strong anti-conflict of interest rules. Recent history has shown that NRSRO's cannot or will not police themselves.

The rating agencies are an ingrained component of the investment decision process, but they have clearly failed to provide accurate and timely information to investors over most of this current decade. Market participants have been severely punished during this time, while the dominant three management teams and their shareholders have benefited greatly from 'cranking out' ratings that have turned out to be suspect at best. We must ensure that reform of the credit rating system is of the highest priority to restore confidence in our capital markets.

Thank you for the opportunity to provide AFP's perspective and feedback on oversight of the credit rating agencies from the end-user perspective.

Sincerely,



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