Consumer Federation of America
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October 21, 2009

The Honorable Barney Frank
Chairman
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Paul Kanjorski
Chairman, Capital Markets Subcommittee
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515

Dear Chairman Frank, Ranking Member Bachus, and Members of the Committee:

We are writing on behalf of consumers and investors to express our strong support for credit rating agency reform legislation reportedly scheduled for mark-up in your committee this week. The discussion draft circulated late last week provides the combination of improved regulatory oversight, enhanced transparency, reduced conflicts of interest, increased accountability, and reduced reliance on credit ratings that we believe offers the best chance of simultaneously improving the credit rating agencies' performance and reducing the market's vulnerability to their failures. While we are pleased to offer the bill our enthusiastic endorsement, we believe a few relatively modest changes (described below) could further enhance its effectiveness.

Enhanced SEC Oversight Authority

Designed primarily to untangle the process for becoming a nationally recognized statistical rating organization (NRSRO), the credit rating reform legislation adopted in 2006 included only modest provisions to enhance SEC oversight authority over the ratings agencies. In light of the important gatekeeper role that NRSROs play in our financial system, and their repeated failures to fulfill that role responsibly, we believe much more rigorous regulatory oversight is warranted. The discussion draft provides that enhanced oversight. In particular, we support provisions that: make the SEC responsible for conducting annual inspections to ensure compliance with appropriate procedures to support reliable ratings and to address conflicts of interest, add failure to supervise and failure to conduct sufficient post-rating surveillance to the list of conduct that is subject to SEC sanction, provide the SEC with the ability to impose fines on firms and individuals associated with the firms for violations, and remove ratings' protection from SEC antifraud authority.

In order to ensure that these oversight activities are adequately funded, we encourage you to consider adding a funding mechanism in the form of a modest

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fee on each rating issued that would be dedicated to funding the new NRSRO oversight office created under this legislation. In addition, we would encourage you to add the language, contained in Section 3 (6) of companion Senate legislation (S. 1073), that provides the SEC with broad rulemaking authority in addition to the authority specified in the act.

Improve Governance Practices at Ratings Agencies

The SEC study of the major ratings agencies uncovered numerous questionable and shoddy practices. In addition to its provisions to enhance SEC oversight, the discussion draft seeks to address this problem by including several provisions to improve governance practices at the NRSROs themselves. In particular, we support provisions: to require ratings agencies or their parent entities to have a board; to make that board responsible for overseeing key functions on which reliable ratings rely; to clarify and expand the authority of compliance officers; and to put stronger protections in place to ensure the independence of the compliance officer.

> We believe that this section could and should be strengthened by requiring that a majority of board members be independent and by tightening the definition of independence to ensure that independent directors truly reflect the interests of users of ratings rather than the interests of the issuer and underwriter community.

Enhance Ratings Transparency

One way to enable users of ratings to make more informed decisions about whether and to what extent to rely on ratings is to increase ratings transparency. The legislation includes several important provisions that would support this goal by: providing much better information about the assumptions underlying ratings methodologies and procedures, the quality of data relied on, and the ratings sensitivity to assumptions and likely volatility; ensuring consistent application of ratings based on default risks across types of products rated; making ratings performance disclosures more accessible, comprehensible, and comparable across firms; and providing better disclosure of business relationships that may create conflicts of interest.

Reducing Conflicts of Interest

Without proposing to dictate a particular business model for credit rating agencies, the legislation includes several provisions we support to reduce conflicts of interest that may compromise ratings quality. It requires the SEC to adopt rules on payment mechanisms to encourage incentives for reliable ratings and post-rating surveillance. When a ratings agency employee involved in the determination of ratings goes to work for a rating client, it requires the ratings agency to review relevant ratings issued over the past 12-month period to determine whether any conflicts of interest may have compromised the rating. And it prohibits ratings agencies from providing certain types of non-rating services to rating clients, with a focus on those services that are likely to create most significant conflicts of interest by involving the rating agency in structuring the securities it would then be asked to rate. Finally, it directs the GAO to study alternative means of compensating NRSROs to reduce conflicts of interest and strengthen incentives for accurate ratings.

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Hold Ratings Agencies Accountable

In examining the credit rating agencies' role in the financial crisis, the key policy question that must be resolved is how to make the credit rating agencies less willing to assign ratings to products they do not understand and cannot accurately measure. The most obvious answer, in our view, is to hold the ratings agencies legally liable in a manner that is consistent with their legally sanctioned role in our financial system. We therefore strongly support provisions in the discussion draft that seek to hold NRSROs accountable for their actions by making the act enforceable through private rights of action and by imposing legal liability when ratings agencies violate securities laws.

Our one concern is that the legislation relies on language on pleading standards that an unfavorable court decision has interpreted in a way that is likely to exclude many meritorious actions. We therefore urge you to consider changing "strong inference" to "reasonable inference" to reduce to a reasonable level the burden of proof that plaintiffs must meet simply to have their case heard in court.

Reduce Reliance on Ratings

While we sympathize with the frustration that has led some to conclude that the most appropriate response to repeated ratings failures is to eliminate legal references to ratings, we are concerned that simply removing such references without putting anything in their place could inadvertently increase risks in the system. As noted above, we believe the provisions of this legislation that increase ratings transparency will enable investors and other users of credit ratings to make a more informed judgment about their reliability. In addition, separate measures are needed to ensure that investors receive the information they need to make informed decisions about investment products, particularly the structured products that are often sold in private sales outside the protections of the regulated marketplace or through a shelf-registration system that provides inadequate pre-sale disclosure.

Because we prefer an approach that reduces, but does not eliminate, reliance on credit ratings, we greatly appreciate the changes that have been made to the discussion draft in this area. Requiring the agencies to conduct a careful, case-by-case review of any references to credit ratings in their regulations should produce a more informed and appropriate response than outright repeal across the board.

In order to further strengthen this provision, we urge you to consider revising it to require agencies to look not only at alternatives to ratings, but at whether adding additional measures of credit risks to supplement ratings might offer the best approach. In addition, we believe agencies should be directed to look at whether it has been their practice to treat reliance on ratings as a sort of "safe harbor." We believe reliance on ratings could be effectively reduced by eliminating any such implied or explicit safe harbor and by requiring agencies to take steps to make clear that ratings don't provide a "seal of a approval" and that investors and others

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> are still responsible for conducting adequate due diligence to determine whether the security or instrument in question is appropriate for the intended purpose.

Credit rating agencies' willingness to slap AAA ratings on investments whose risks they did not understand and could not accurately measure played a key role in turning a housing crisis into a global financial crisis. This legislation offers a strong and comprehensive set of reforms to address that failure. We greatly appreciate your leadership in crafting this bill and offer our strong support for its passage without weakening amendments.

Respectfully submitted,

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