Testimony: "Reforming Credit Rating Agencies"
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Introduction

Chairman Kanjorski, Ranking Member Garrett, and members of the Subcommittee: My name is Dan Gallagher, and I am the Co-Acting Director of the Division of Trading and Markets at the Securities and Exchange Commission ("Commission"). Thank you for the opportunity to testify before you today on behalf of the Commission regarding the oversight of credit rating agencies.

The Commission shares the Subcommittee's concerns about the role credit rating agencies played in the dislocation of the credit markets. Poor performance by highly rated securities resulted in substantial investor losses and market turmoil which severely damaged the financial markets. As we work to restore the health of the markets, it is vital that we take further steps to improve the integrity and transparency of the ratings process, promote competition among rating agencies, and give investors the appropriate context for evaluating ratings.

To this end, the Commission has been active in its rulemaking and oversight with respect to credit rating agencies registered as nationally recognized statistical rating organizations ("NRSROs"). Congress provided the Commission authority to register and oversee NRSROs in

the Credit Rating Agency Reform Act of 2006 ("Rating Agency Act"). In keeping with this charge, the Commission has adopted a number of rules to date, and earlier this month embarked on new rulemaking designed to (1) promote greater accountability, (2) foster competition, (3) decrease the level of undue reliance on NRSROs, and (4) empower investors to make more informed decisions. The Commission appreciates the opportunity to discuss these new rules and rule proposals, as well as background on the NRSRO oversight program, findings during staff examinations of NRSROs and other actions the agency has taken since Congress enacted the Rating Agency Act.

Initiation of NRSRO Oversight Program

In September 2006, Congress enacted the Rating Agency Act, which mandated that the Commission establish a registration and oversight program for NRSROs. The Rating Agency Act's over-arching goal, as stated in its legislative history, was to "improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency and competition in the credit rating industry."

In June 2007, the Commission adopted six rules and an application form ("Form NRSRO"). The rules, which are described in more detail in the attached Appendix, require NRSROs to make public disclosures about, among other things, ratings performance statistics, ratings methodologies, conflicts of interest, and analyst experience. The rules also require recordkeeping and annual reporting, as well as procedures to prevent the misuse of material nonpublic information and to manage conflicts of interest. In addition, the rules include prohibitions against certain conflicts and engaging in unfair, coercive or abusive practices.

In September 2007, the first seven credit rating agencies were registered with the Commission as NRSROs. Subsequently, three additional credit rating agencies have registered.

2008 In-Depth Staff Examination of NRSROs

At the end of 2007, the Commission staff began an examination of the three largest NRSROs that were most active in rating structured finance products linked to aggressively underwritten mortgages. These examinations of Fitch Ratings, Moody's Investor Services, and Standard & Poor's Ratings Services reviewed their policies and practices related to rating subprime residential mortgage-backed securities ("RMBS") and collateralized debt obligations ("CDOs") linked to subprime RMBSs.

The period reviewed by the examination generally covered January 2004 through July 2008. The firms under examination had become subject to regulation as NRSROs when they registered with the Commission in September 2007. All three NRSROs agreed to undertake remedial actions as a result of the examinations. The staff published a summary of their findings and observations in July 2008.[1]

Staff Examination Findings and Recommendations

The staff examinations of the three NRSROs revealed a number of troubling results. In particular, the examinations raised serious questions about the NRSROs' management of conflicts of interest, internal audit processes and due diligence activities.

[1] See http://www.sec.gov/news/studies/2008/craexamination070808.pdf.

Management of Conflicts of Interest

Each of the examined NRSROs prepares the majority of its ratings under the "issuer pays" model, in which the arranger or other entity that issues the security also is seeking the rating and pays the NRSRO for the rating. While each NRSRO had policies and procedures restricting analysts from participating in fee discussions with issuers, the policies and procedures at each of the firms still allowed key participants in the ratings process to participate in fee discussions. In fact the examiners found that analysts appeared to be aware, when rating an issuer, of the firm's business interest in securing the rating of the deal; that there did not appear to be any internal effort to shield analysts from emails and other communications that discussed fees and revenues from the issuers; and that in some instances, analysts were involved in fee discussions for a rating. In addition, the NRSROs did not appear to take steps to prevent the possibility that considerations of market share and other business interests could influence ratings or ratings criteria. Accordingly, the staff recommended that each NRSRO consider and implement steps that would insulate or prevent the possibility that considerations of market share and other business interests could influence ratings or ratings criteria.

The examiners also observed that each NRSRO had adopted policies prohibiting employees from owning any security that was subject to a credit rating by a team on which the employee was a member. However, the NRSROs varied in how rigorously they monitored or prevented prohibited transactions, including personal trading by their employees, from occurring. As a result of its findings, the staff recommended that each NRSRO conduct a review of its policies and procedures for managing the securities ownership conflict of interest to determine

whether these policies are reasonably designed to ensure that employees' personal trading is appropriate and complies with the requirements of NRSRO regulations.

Internal Audits

The examiners found that the internal audits of the ratings processes of two NRSROs appeared to be inadequate. At one NRSRO, the internal audits of its RMBS and CDO groups constituted a one-page checklist limited in scope to evaluate the completeness of deal files. That NRSRO provided only four examples where the reviewer forwarded findings to management and no examples of any management response. The examination of another NRSRO's internal audits of its RMBS and CDO groups uncovered numerous shortcomings, including the failure of management to formally review/validate derivative models prior to posting for general use. As a consequence of these findings, the staff recommended that two of the NRSROs review whether their internal audit functions are adequate and whether they provide for proper management follow-up.

Due Diligence Practices

The staff found that the NRSROs did not engage in any due diligence or otherwise seek to verify the accuracy or quality of the loan data underlying the RMBS pools they rated during the review period. The NRSROs each relied on the information provided to them by the sponsor of the RMBS.

NRSROs were not required to verify the information contained in RMBS loan portfolios presented to it for rating. Additionally, NRSROs were not required to insist that the issuer

perform due diligence, nor were they required to obtain reports concerning the level of due diligence performed by issuers. Notwithstanding the lack of regulatory requirement to do so, all the NRSROs implemented, or announced that they would implement, measures designed to improve the integrity and accuracy of the loan data they receive on underlying RMBS pools.

Ongoing NRSRO Examination Program

Since issuing the July 2008 staff examination report, the Commission has been monitoring the examined NRSROs as they continue to address the examination findings. In addition, the Commission is conducting a number of other ongoing NRSRO examinations. To bolster our examination program, the Commission recently allocated resources for a branch of examiners dedicated specifically to NRSRO oversight. Once fully staffed, this branch will focus its expertise on conducting routine, special and cause examinations of the NRSROs to review their activities for compliance with the securities laws and rules.

Commission Rulemaking – Strengthening Oversight of NRSROs

The preliminary staff findings from the examinations of NRSROs informed a round of NRSRO rule amendments, which the Commission adopted in February 2009 and which are described in more detail in the attached Appendix. The Commission also proposed additional measures designed to further address, in part, these issues. Earlier this month, on September 17th, the Commission embarked on further rulemaking designed to (1) promote greater accountability, (2) foster competition, (3) decrease the level of undue reliance on NRSROs, and (4) empower investors to make more informed decisions.

Fostering Competition

Creating a Mechanism to Provide All NRSROs with Access to the Same Information to Rate Structured Finance Products. The Commission adopted amendments to Rule 17g-5 that are designed to create a mechanism for NRSROs not hired to rate structured finance products to nonetheless determine and monitor credit ratings for these instruments. To this end, the new amendments require an NRSRO that is hired by an issuer, sponsor, or underwriter ("arranger") to determine an initial credit rating for a structured finance product to disclose on a password-protected Internet web site that it is in the process of determining such a credit rating and the location where information provided by the arranger to determine and monitor the credit rating can be located. The hired NRSRO must make this information available to any other NRSRO that provides it with a copy of a certain certification. The hired NRSRO also is required to obtain representations from the arranger that, among other things, the arranger will provide the same information to the non-hired NRSROs. The goal of this rule is to make it possible for non-hired NRSROs to provide unsolicited ratings in the structured finance market just like they are able to do in the corporate debt market where there is access to information needed to determine and monitor credit ratings.

Empowering Investors to Make More Informed Decisions

At the September 17th meeting, the Commission also adopted new rules to strengthen its registration and oversight program for NRSROs by providing investors with more information to make informed decisions.

Disclosing History of Ratings Activity. One rule augments the current requirement for an NRSRO to disclose ratings history information for a random sample of 10 percent of its outstanding issuer-paid credit ratings. Under the new requirement, an NRSRO must disclose, on a delayed basis, ratings history information in a downloadable format for *all* credit ratings initially determined on or after June 26, 2007, regardless of whether they were paid for by the issuer. This new disclosure requirement is designed to foster greater transparency of ratings quality and accountability among NRSROs, by making it easier for persons to analyze the actual performance of credit ratings. In addition, the ratings history information will generate "raw data" that market observers can use to statistically analyze performance across NRSROs.

Providing More Information on Conflicts of Interest. The Commission also proposed amendments to the instructions for Exhibit 6 to Form NRSRO to require a credit rating agency applying for NRSRO status to publicly disclose: (1) the percentage of the net revenue attributable to the 20 largest users of credit rating services of the NRSRO; and (2) the percentage of the net revenue of the NRSRO attributable to other services and products of the NRSRO.

Providing Additional Information about the Magnitude of Conflicts. The Commission proposed the creation of a new rule – Rule 17g-7 – that would require an NRSRO to make publicly available on its Internet website a consolidated report that shows three pieces of information with respect to each person that paid the NRSRO to issue or maintain a credit rating. Specifically, the NRSRO would be required to indicate in the report for each such person (1) the percent of the net revenue attributable to the person earned by the NRSRO for providing services and products other than credit rating services; (2) the relative standing of the person (top 10

percent, top 25 percent, top 50 percent, bottom 50 percent, or bottom 25 percent) in terms of the amount of net revenue earned by the NRSRO attributable to that person; and (3) identify all outstanding credit ratings paid for by the person.

The second and third proposals are designed to provide investors with additional information on the source and magnitude of revenues an NRSRO receives from its clients. Creating greater transparency about the revenues generated could provide increased information to assist investors and other users of credit ratings in assessing the potential risks to the NRSRO's objectivity. In particular, an NRSRO's disclosure of information about revenues received from major clients and revenues attributable to ancillary services would allow users of credit ratings to have more information about the dimensions of the conflict arising from NRSROs being paid to determine credit ratings as well as the conflict of offering other services to persons who pay for credit ratings. The former would also provide investors and other users of credit ratings more specific information about the extent to which NRSRO revenues are from a concentrated group of clients.

Highlighting Rating Shopping and Other Key Information. The Commission proposed amendments to its rules regarding how credit ratings are disclosed by issuers in connection with registered offerings. First, the Commission proposed amendments that would require that if a registrant, selling security holder, underwriter or other member of a selling group uses a credit rating in connection with a registered offering, certain detailed disclosures regarding the credit rating must be made in the registration statement for the offering. The proposed amendments

would require disclosure of general information about the credit rating, including all material scope limitations of the credit rating and any related published designation, such as non-credit payment risks, assigned by the rating organization with respect to the security. In addition, in order to highlight potential conflicts of interest, the proposed rule would require disclosure identifying the party who is paying for the credit rating. If any additional non-rating services have been provided by the credit rating agency to the registrant over a specified period of time, disclosure of the services and the aggregate fees paid for those services would be required. The Commission also proposed requiring the disclosure of preliminary ratings, as well as final ratings not used by a registrant, so that investors will be informed when a registrant may have engaged in ratings shopping.

In addition, the Commission proposed amendments to forms under the Securities Exchange Act of 1934 to provide investors with updated information regarding credit ratings by requiring disclosure of changes to previously disclosed credit ratings. Under the proposed amendments, a change to a credit rating, including when a rating has been withdrawn or is no longer being updated, would be required to be disclosed within four business days pursuant to a new item in Form 8-K.

Decreasing Level of Undue Reliance on NRSROs

Removing References to NRSRO Credit Ratings in Rules and Forms. The Commission also eliminated references to NRSRO credit ratings in certain of its rules and forms. Specifically, the Commission adopted amendments that removed references in Rules 5b-3 and 10f-3 under the Investment Company Act and Regulation ATS and related forms under the

Securities Exchange Act. The Commission believes that the references to credit ratings in these rules and forms are no longer warranted as serving their intended purposes. The amendments are designed to address concerns that references to NRSRO ratings in Commission rules may have contributed to an undue reliance on those ratings by market participants. The Commission also reopened the comment period on amendments that would eliminate references to NRSROs in other rules and forms under the Exchange Act, the Investment Company Act, the Investment Advisers Act, and the Securities Act. The Commission is seeking additional comment to determine, among other things, whether the use of NRSRO ratings in these additional rules and forms poses any danger of undue reliance on NRSRO ratings by investors and the viability of alternative external or objective measures of credit risk that could be substituted for ratings by an NRSRO.

Promoting Greater Accountability

Expert Liability. The Commission also issued a concept release seeking comment on whether the Commission should propose rescinding Rule 436(g) of the Securities Act of 1933. Currently, Rule 436(g) exempts NRSROs from "expert" liability under Section 11 of the Securities Act. Rescinding Rule 436(g), coupled with a proposal to require disclosure of credit ratings in a registration statement if a rating is used in connection with a registered offering, would cause NRSROs to be included in the liability scheme for experts set forth in Section 11. If the Commission rescinded Rule 436(g), an issuer that includes a credit rating issued by an NRSRO in a registration statement would be required to file the consent of the rating agency

with its registration statement, and the rating agency would be subject to potential Securities Act liability.

Reporting on Compliance Reviews. The Commission also proposed amending Rule 17g-3 to require an NRSRO to furnish the Commission with an additional annual report containing a description of the steps taken by the firm's designated compliance officer during the most recently ended fiscal year to: (1) administer the policies and procedures that are required to be established pursuant the Exchange Act (e.g., the policies to manage conflicts of interest); and (2) ensure compliance with securities laws and regulations. Specifically, the proposed amendments would require the compliance officer to report: (1) a description of any compliance reviews of operations of the NRSRO; (2) the number of material compliance matters found during the reviews of the operations of the NRSRO and a brief description of each such finding; (3) a description of any remediation measures implemented to address material compliance matters found during the reviews; and (4) a description of the persons within the NRSRO who were advised of the results of the reviews. The goal of this proposal is to strengthen the compliance function at the NRSROs and to alert the Commission to issues that may need to be followed-up through an examination.

International Initiatives

The Commission staff also has undertaken a number of international credit rating agency initiatives in an effort to promote greater international cooperation in this area. I currently chair Standing Committee 6 of the Technical Committee of the International Organization of Securities Commissions ("IOSCO"). This committee, comprised of supervisors from

jurisdictions in Europe, Asia and the Americas, has two primary responsibilities: (1) to consider regulatory and policy initiatives concerning credit rating agencies in order to promote greater cross-border regulatory alignment; and (2) to facilitate dialogue between securities regulators and the credit rating industry. The Commission is also actively providing technical advice to our foreign counterparts, including assisting the Committee of European Securities Regulators ("CESR") with its mandate by the EU Commission regarding regulation of credit rating agencies.

Conclusion

In conclusion, I want to emphasize that the Commission is committed to administering a comprehensive and effective oversight program for NRSROs. I believe this commitment is reflected in the multiple rulemakings and examinations undertaken by the Commission since being granted authority in September 2006. We appreciate Congress' interest in this issue and the Commission is happy to provide any assistance the Subcommittee might need in its consideration of measures to reform the financial markets. I would be happy to answer any questions you might have. Thank you.

Appendix

Prior Commission Rulemaking for NRSROs

The first round of post-Rating Agency Act rulemaking established the Commission's rating agency oversight program. Specifically, in June 2007 the Commission adopted six rules (Rules 17g-1, 17g-2, 17g-3, 17g-4, 17g-5 and 17g-6) and an application and ongoing disclosure form ("Form NRSRO").

Rule 17g-1, among other things, requires an NRSRO to disclose information about the: (1) firm's ratings performance statistics (e.g., default and transition statistics); (2) firm's methodologies for determining credit ratings; (3) firm's policies for preventing the misuse of material non-public information; (4) firm's organizational structure; (5) firm's code of ethics; (6) conflicts of interest inherent in the firm's activities; (7) firm's policies for managing conflicts of interest; (8) general qualifications of the firm's credit analysts; and (9) identification and qualifications of the firm's designated compliance officer.

Rule 17g-2, among other things, requires an NRSRO to make and retain certain financial records; document the identities of the credit analysts who determine a rating action and persons who approve the rating action; document the identities of issuers that have paid for ratings and the ratings determined for them; and document all ratings methodologies. NRSROs also are required to retain records such as compliance and internal audit reports, marketing materials, and communications (e.g., emails) relating to determining ratings actions.

Rule 17g-3, among other things, requires an NRSRO, on a confidential basis, to furnish the SEC with annual reports that include: (1) audited financial statements; (2) an unaudited report of revenues received from the different types of rating services offered by the NRSRO; (3) an unaudited report of the aggregate and median compensation of the NRSRO's credit analysts; and (4) an unaudited report of the 20 largest clients of the NRSRO as determined by revenues received.

Rule 17g-4, among other things, requires an NRSRO to establish, maintain and enforce procedures reasonably designed to prevent the inappropriate dissemination of material, non-public information received during the rating process; the trading of securities while in possession of material, non-public information; and the selective disclosure of a pending ratings decision.

Rule 17g-5, among other things, requires an NRSRO to disclose and manage each conflict of interest resulting from its business activities, including from the issuer-pay and the subscriber-pay models. It also prohibits an NRSRO from having the following conflicts: (1) receiving more than 10% of its annual revenues from a single client; (2) having an analyst rate or approve the rating for a security the analyst owns; (3) rating an affiliate; and (4) having an analyst rate or approve the rating for a security of a company where the analyst is a director or officer of the company.

Rule 17g-6, among other things, prohibits an NRSRO from engaging in certain practices that are unfair, coercive or abusive. Such practices include: (1) conditioning a rating on the rated

person buying another service of the NRSRO; (2) deviating or threatening to deviate from established methodologies for determining credit ratings because an issuer did not agree to pay for the rating; (3) modifying or threatening to modify a rating because the issuer does not agree to continue to pay for the rating; and (4) employing a methodology for rating structured finance products that discounts or "notches," for anticompetitive purposes, the ratings of other NRSROs for assets underlying the structured finance product.

In response to the role played by NRSROs in the credit market turmoil and informed by the Commission staff's first round of NRSRO examinations, the Commission adopted a second round of rules in February 2009. Most of the new requirements specifically target the rating process for structured finance products. The new rules require the following, among other things:

- **Enhanced performance statistics**. The Commission amended Form NRSRO to require an NRSRO to provide greater specificity – to achieve better comparability – as to how performance statistics are generated. In particular, NRSROs are now required to provide default and transition statistics over 1, 3, and 10 year time periods (as opposed to the previously prescribed generic "short, medium, and long" time frames). Further, an NRSRO is required to generate these performance statistics for each class of credit ratings for which the NRSRO is registered.

- **Enhanced disclosure of ratings methodologies**. The Commission amended Form NRSRO to require more detailed disclosures concerning the procedures and methodologies an NRSRO uses to determine credit ratings. Specifically, the NRSRO must disclose (as applicable):

    - whether and, if so, how, information about verification performed on assets underlying or referenced by a structured finance product is relied on in determining the rating;
    - whether and, if so, how, assessments as to the quality of originators of assets underlying or referenced by a structured finance product factor into the determination of credit ratings; and
    - with respect to rating surveillance, how frequently credit ratings are reviewed, whether different models are used for surveillance, and whether changes to initial rating or surveillance models are applied retroactively to existing ratings.

- **Record of model deviation**. The Commission amended Rule 17g-2 to add a new recordkeeping requirement relating to the use of models in rating structured finance products. Specifically, if a quantitative model was a substantial component in the process of determining a credit rating for a structured finance product, the NRSRO is required to make a record of the rationale for any material difference between the credit rating implied by the model and the final credit rating issued.

- **Record of ratings history.** The Commission amended Rule 17g-2 to add a new

recordkeeping requirement to allow examiners to track the history of all current ratings. Specifically, for each outstanding credit rating, an NRSRO is required to make a record showing all rating actions and the date of such actions from the initial credit rating to the current credit rating identified by the name of the rated security or obligor and, if applicable, the CUSIP of the rated security or the Central Index Key ("CIK") number of the rated obligor. In addition, NRSROs with 500 or more issuer-paid credit ratings in a credit rating class must publicly disclose on a six-month delayed basis the ratings histories for a random sample of 10% of the current credit ratings in that class.

- **Written complaints**. The Commission amended Rule 17g-2 to add a new recordkeeping requirement to allow examiners to review how an NRSRO handles complaints about credit analysts from, for example, issuers or underwriters of structured products. Specifically, an NRSRO is required to retain any written communications received from persons not associated with the NRSRO (e.g., individuals that are not employees) that contain complaints about the performance of a credit analyst in initiating, determining, maintaining, monitoring, changing, or withdrawing a credit rating.

- **Rating actions report**. The Commission amended Rule 17g-3 to add a new financial report that must be furnished to the SEC annually. The report is designed to alert the SEC about the number of rating actions (upgrades, downgrades, placements on watch or withdrawals) taken by an NRSRO during the fiscal year in each class of credit rating for which the NRSRO is registered.

- **Prohibited conflict – recommendations**. The Commission amended Rule 17g-5 to add a new conflict prohibition to prohibit an NRSRO from making recommendations to issuers and others about how to obtain desired ratings. Specifically, the rule prohibits an NRSRO from issuing or maintaining a credit rating where the NRSRO or an affiliate made recommendations to an issuer, obligor or arranger about how to structure the rated entity or security.

- **Prohibited conflict – fee discussions**. The Commission amended Rule 17g-5 to add a new conflict prohibition to prevent credit analysts and the persons who establish ratings methodologies from participating in fee discussions with issuers and others who pay for ratings. Specifically, the rule prohibits an NRSRO from issuing or maintaining a credit rating where the fee paid to the NRSRO to determine or maintain the credit rating was negotiated, discussed or arranged by a person within the NRSRO with responsibility for determining or approving the credit rating or for developing or approving procedures or methodologies used for determining credit ratings.

- **Prohibited conflict – gifts.** The Commission amended Rule 17g-5 to add a new conflict prohibition designed to prevent credit analysts from being influenced by gifts from issuers and others who pay for ratings. Specifically, the rule prohibits an NRSRO from determining or maintaining a credit rating where a credit analyst who determined the rating or approved the rating received a gift from the person paying for the rating.