Testimony on "Oversight of the Credit Rating Agencies Post-Dodd-Frank"

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Committee on Financial Services

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Chairman Neugebauer, Ranking Member Capuano, and members of the Subcommittee:

My name is John Ramsay, and I am a Deputy Director in 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 and the regulatory treatment of ratings.

Introduction

The Commission's efforts to increase oversight of rating agencies began before the financial crisis with the adoption of rules under authority granted by the Credit Rating Agency Reform Act of 2006 ("Rating Agency Act"), which mandated that the Commission establish a registration and oversight program for nationally recognized statistical rating organizations ("NRSROs"). The Rating Agency Act expressly prohibits, however, the Commission from regulating the substance of credit ratings or the procedures and methodologies used by NRSROs to determine credit ratings.

In June 2007, the Commission adopted new rules establishing a regulatory program for NRSROs, and later that year, 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. In order to address deficiencies that were identified in those examinations, and to take further action to improve the integrity of the ratings process, the Commission adopted two substantial new sets of rules in 2009. Most recently, in May of this year, the Commission proposed a comprehensive set of additional requirements ("Dodd-Frank rule proposals") under the mandate established by the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") with a comment period that runs through August 8th. The Commission currently also is working to complete studies related to rating agency reform required by the Dodd-Frank Act. Further, the Commission has increased its examination focus on NRSROs and is on track this year to complete an examination of every NRSRO.

In its regulatory initiatives in this area, the Commission has focused special attention on ratings of structured finance products. As is now well-known, faulty ratings of mortgage-related and other structured finance instruments played a significant role in the financial crisis by

facilitating the accumulation of excessive risk in the financial system. The Commission's efforts in this area have been designed to address conflicts of interest, make more transparent the process for rating structured securities and the basis for individual ratings, and promote competition among rating agencies that are involved in this business.

In addition to its efforts to increase oversight of NRSROs, the Commission is also seeking to eliminate references to credit ratings in its rules in order to reduce reliance on credit ratings. Acting in response to the mandate of the Dodd-Frank Act, the Commission has proposed to remove numerous references to credit ratings or NRSROs in its rules and to substitute appropriate standards of creditworthiness.

Improving Oversight of NRSROs

Improving the Integrity of the Rating Process

In accordance with the goals of the Rating Agency Act, the Commission has sought to improve the integrity of the ratings process through its regulation of NRSROs. The Commission's initial rules adopted in June 2007, for example, require NRSROs to have written policies and procedures to prevent the misuse of material nonpublic information and to manage certain conflicts of interest. In addition, the rules prohibit certain other conflicts of interest outright and prohibit NRSROs from engaging in certain unfair, coercive or abusive practices. In 2009, the Commission expanded its conflict of interest rule to prohibit an NRSRO from: (1) structuring the same products that it rates; (2) allowing analysts who participate in determining credit ratings from negotiating the fees that issuers pay to be rated; and (3) allowing analysts to accept gifts in any amount over $25 from entities that receive ratings from the NRSRO.

Conflicts of Interest. The rules proposed in May 2011 under the Dodd-Frank Act include several proposed amendments to strengthen the existing conflict of interest rule to more completely separate the credit analysis function from sales and marketing activities. These amendments would:

- prohibit an NRSRO from issuing or maintaining a credit rating when an employee who participates in sales or marketing activities also participates in determining a credit rating or in developing the procedures or methodologies used to produce the credit rating;

- create a mechanism for a small NRSRO to seek relief from this absolute prohibition if, due to the size of the NRSRO, the separation of sales and marketing activities from the production of credit ratings is not appropriate; and

- set forth findings the Commission would need to make to suspend or revoke the registration of an NRSRO if the Commission found that the NRSRO violated the conflict of interest rule.

The Commission also proposed a new rule that would require an NRSRO to have policies and procedures to address the potential for a credit rating to be influenced by a credit analyst seeking employment with the entity being rated or the issuer, underwriter, or sponsor of the

securities being rated. The Dodd-Frank Act established a self-executing provision requiring an NRSRO to conduct a one-year "look-back" review when a credit analyst leaves the NRSRO to work for an entity rated by the NRSRO or an issuer, underwriter, or sponsor of securities being rated by the NRSRO. The purpose of the look-back review is to determine whether the credit analyst's prospects of future employment influenced a credit rating. If such influence is discovered, the proposed rule would require the NRSRO to have policies and procedures to immediately place the credit rating on credit watch, promptly determine whether the credit rating must be revised so it no longer is influenced by a conflict of interest, and promptly publish a revised credit rating or affirm the credit rating, as appropriate.

Ratings Procedures and Methodologies. The Commission also proposed a new rule in May 2011 that would require an NRSRO to have certain policies and procedures designed to improve the integrity of its credit ratings procedures and methodologies. More specifically, the proposed rule would require an NRSRO to have policies and procedures reasonably designed to ensure, among other things:

- that the methodologies the NRSRO uses to determine credit ratings are approved by its board of directors or a body performing a similar function and that such methodologies are developed and modified in accordance with the policies and procedures of the NRSRO;

- that any material changes to the methodologies are applied consistently, and that they are applied to currently outstanding credit ratings within a reasonable period of time, taking into consideration the number of ratings impacted, the complexity of the methodologies, and the type of entity or security being rated; and

- that the NRSRO promptly publishes notice of material changes to rating methodologies and of any significant errors that are identified in a rating methodology.

Analyst Standards. Finally, the Commission proposed a new rule that would require an NRSRO to have standards of training, experience, and competence for its credit analysts that are reasonably designed to ensure that the NRSRO produces accurate credit ratings. The proposed rule would set forth factors an NRSRO would need to consider in designing such standards and require that the standards provide for the periodic testing of credit analysts and that at least one individual with three years or more experience in performing credit analysis participates in the determination of each credit rating.

Governance and Internal Controls

In addition to targeting improvements to the integrity of the ratings process, the Commission's NRSRO rules also establish recordkeeping and annual reporting requirements designed to improve NRSROs' governance and internal controls as well as to facilitate the Commission's oversight and monitoring of NRSROs. For example, the rules adopted in 2007 require an NRSRO to make and retain certain records relating to its business as a credit rating agency and to furnish to the Commission certain financial reports on an annual basis, including audited financial statements and separate unaudited financial reports. In 2009, the Commission

added requirements that each NRSRO make and retain records of all rating actions and document the rationale for any significant "out-of-model" adjustments used in determining a credit rating whenever a quantitative model is a substantial component of the credit rating process. In addition, the 2009 amendments require NRSROs to retain records of any complaints regarding the performance of a credit analyst in determining, maintaining, monitoring, changing, or withdrawing a credit rating.

The rule proposals under the Dodd-Frank Act would require each NRSRO to file an annual report with the Commission regarding its internal control structure as it concerns policies, procedures, and methodologies for determining credit ratings, including a description of the responsibility of management in establishing and maintaining the internal control structure as well as an assessment of the effectiveness of those internal controls. Each NRSRO would also be required to have policies and procedures in place to ensure that its rating methodologies are approved by its Board of Directors.

Disclosure and Transparency

Performance Disclosures. Historically, the ratings process has suffered from a lack of transparency. Investors have not been given clear or consistent information about the meaning of particular ratings, and investors have had limited ability to compare performance among rating agencies. The Commission has taken significant steps to address these issues by establishing extensive and wide-ranging disclosure requirements for NRSROs. The Commission's June 2007 rules require NRSROs to make public disclosures about, among other things, ratings performance statistics, ratings methodologies, conflicts of interest, and analyst experience. The 2009 NRSRO rule amendments include a significant set of enhancements to these disclosure requirements, including requiring NRSROs:

- To publish performance statistics for 1, 3, and 10 years within each rating category;

- To disclose how frequently credit ratings are reviewed; whether different models are used for surveilling ratings, compared to those used for issuing ratings; and whether changes made to models are applied retroactively to existing ratings; and

- To make publicly available in a machine-readable format ratings action histories for all credit ratings (regardless of the business model under which they are determined) that were initially determined on or after June 26, 2007 (the effective date of the Commission's regulations implementing the Rating Agency Act), with each new ratings action to be disclosed on a delayed basis;

The Dodd-Frank rule proposals would standardize the production and presentation of the transition (i.e., a change from one rating category to another) and default rates that NRSROs are required to disclose, with the goal of making these performance statistics more comparable among NRSROs and easier for users of credit ratings to understand. The proposed amendments would also upgrade the information about credit rating histories that NRSROs are required to disclose in an XBRL format. Specifically, an NRSRO would be required to include in the XBRL file each credit rating that was outstanding as of June 26, 2007 and any subsequent actions taken

with respect to those ratings. In addition, the proposed amendments would increase the number and scope of the data fields that must be disclosed about a rating action.

Usability Improvements. The May 2011 proposals would also require an NRSRO to disclose certain quantitative and qualitative information in a form to accompany the publication of each credit rating. The required information would include, among other things, information about the potential limitations of the rating and information about the methodology used to determine the rating, including the main assumptions underlying the methodology.

The Commission also proposed to require an NRSRO to adopt policies and procedures designed to ensure that ratings can be more readily understood by investors. More specifically, the proposed rules would require an NRSRO to have policies and procedures reasonably designed to: (1) assess the probability that an issuer of a security or money market instrument will default, fail to make timely payments, or otherwise not make payments to investors in accordance with its terms; (2) clearly define each symbol in the rating scale used by the NRSRO; and (3) apply any such symbol in a consistent manner. In addition, in December 2010, the Commission issued a request for comment in connection with a study, mandated by the Dodd-Frank Act, that will address the feasibility and desirability of standardizing credit rating terminology. The comment period for this study ended in February of this year, and Commission staff are currently in the process of reviewing these comments and preparing the required study.

Structured Finance Products

As I noted earlier, the Commission has focused special attention on ratings for structured finance products in recognition of the role that those ratings played in contributing to the financial crisis. In late 2007, the Commission staff conducted in-depth examinations of the three largest NRSROs that were most active in rating structured finance products linked to aggressively underwritten mortgages. These examinations generally covered the period from January 2004 through July 2008, although the Commission did not have regulatory authority over the examined NRSROs until their registration in September 2007. The findings of the examinations have informed the Commission's subsequent rulemaking, which contains a number of provisions designed to apply to structured finance products.

Facilitating Competition. For example, the Commission's 2009 rulemaking sought to increase competition for structured finance ratings by creating a mechanism for NRSROs not hired to rate structured finance products to nonetheless determine and monitor credit ratings for these instruments. This rule requires NRSROs that are hired by issuers, sponsors, or underwriters ("arrangers") to determine an initial credit rating for a structured finance product to disclose to other NRSROs (and only other NRSROs) that they are in the process of determining such a credit rating. The hired NRSRO must then obtain assurances from the arranger that it will provide to other NRSROs the information necessary for them to issue an unsolicited rating for the same transaction. This rule change is one way that the Commission has sought to promote competition and address conflicts of interest in ratings for structured finance products.

The 2009 rule amendments also require disclosure by NRSROs of the way they rely on the due diligence of others to verify the assets underlying a structured product and prohibit NRSROs from structuring the same products that they rate.

Disclosure. In January of this year, the Commission implemented Section 943(1) of the Dodd-Frank Act by adopting a rule requiring NRSROs to include, in any report accompanying a credit rating relating to an asset-backed security, a description of the representations, warranties and enforcement mechanisms available to investors and a description of how they differ from the representations, warranties and enforcement mechanisms in issuances of similar securities. Further, the Commission proposed additional rule amendments with respect to due diligence services for asset-backed securities as part of the Dodd-Frank rule proposals. Specifically, the Commission proposed to require an issuer or underwriter of an asset-backed security to disclose the findings and conclusions of any due diligence report obtained by the issuer or underwriter. This disclosure would need to be made directly by the issuer or underwriter or, alternatively, by an NRSRO, if the issuer or underwriter obtains a representation that the NRSRO will make the disclosure.

To facilitate this disclosure, the Commission proposed to require a provider of third-party due diligence services for an asset-backed security to provide a certification to any NRSRO that is producing a credit rating for the security. The certification would need to include the findings and conclusions of the due diligence firm, and an NRSRO would be required to publish the certification with the disclosure form that accompanies the rating.

Finally, in May of this year, the Commission issued a public request for comment in connection with a study, required by the Dodd-Frank Act, addressing the credit rating process for structured finance products and the conflicts of interest associated with the issuer-pay and the subscriber-pay models, as well as the feasibility of establishing a system in which a public or private utility or a self-regulatory organization assigns NRSROs to determine credit ratings for structured finance products. In order to ensure that as many parties as possible have the opportunity to comment, the Commission has established an extended comment period for the study.

Removing Rule References

Section 939A of the Dodd-Frank Act directs the Commission, along with all other federal agencies, to remove references to credit ratings from its rules and forms and to substitute such alternative standards of creditworthiness as the Commission determines to be appropriate. The Commission began the process of removing references to ratings in its rules and forms in rule amendments approved in 2009. Earlier this year, the Commission proposed to remove references to credit ratings from rules governing the operation of money market funds and the eligibility for companies registering securities for public sale to use "short-form" registration. The Commission also proposed to remove references to credit ratings in the rules applicable to broker-dealer financial responsibility, distributions of securities, and confirmations of transactions. In each case, the Commission's goal is to reduce undue reliance on credit ratings and to encourage independent assessments of creditworthiness. Of particular interest to the Commission is whether the standards it has proposed for creditworthiness are appropriate and

workable and whether they can be implemented without imposing undue costs or reducing investor protection.

Regulation FD

As required by the Dodd-Frank Act, in September 2010, the Commission amended Regulation FD, which addresses the selective disclosure of information by publicly traded companies and other issuers, to remove the specific exemption from the rule for disclosures made to NRSROs and credit rating agencies for the purpose of determining or monitoring credit ratings. Pursuant to Commission rules, NRSROs are already required to have written policies and procedures reasonably designed to prevent the inappropriate dissemination within and outside the NRSRO of material nonpublic information obtained in connection with the performance of credit rating services.

Examinations

Finally, the Dodd-Frank Act requires the Commission to conduct examinations of each NRSRO at least annually and to issue an annual report summarizing the exam findings. Commission staff is currently in the process of completing the first cycle of these exams, which the Commission anticipates will be completed this year. Going forward, these examinations will be critical to enforcing compliance with the substantial new compliance obligations created by the Dodd-Frank Act and the Commission's rules. Fulfilling this objective will, of course, place a burden on the Commission's examination resources.

Conclusion

We look forward to receiving and reviewing comments on our current NRSRO rule proposals and studies required by the Dodd-Frank Act. The Commission will continue its efforts to promote integrity and transparency in the ratings process and competition among credit rating agencies. Thank you again for inviting me to appear before you today. I would be happy to answer any questions you may have.