Testimony of

Gregory W. Smith

General Counsel & COO

Public Employees' Retirement Association of Colorado

before the

Subcommittee on Oversight and Investigations

of the

Committee on Financial Services

on

Oversight of the Credit Rating Agencies Post Dodd-Frank

July 27, 2011

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Full Text of Statement

Mr. Chairman, Ranking Member Capuano, and Members of the Subcommittee:

Good morning. I am Gregory W. Smith, general counsel and COO of the Colorado Public Employees' Retirement Association (Colorado PERA) and board member of the Council of Institutional Investors (Council).

I am pleased to appear before you today on behalf of Colorado PERA to share with you my views on the topic of oversight of credit rating agencies subsequent to the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank).

My testimony begins with a brief overview of Colorado PERA and the Council. The bulk of testimony sets forth Colorado PERA's views on five issues that Subcommittee staff indicated that I might address as part of my testimony at this important hearing: (1) Whether Colorado PERA's utilization of credit ratings has changed since the passage of Dodd-Frank; (2) Whether Dodd-Frank's required removal of references to credit ratings in all federal statutes and regulations will benefit Colorado PERA and other institutional investors; (3) Whether credit rating agencies have self-corrected their practices since the passage of Dodd-Frank; (4) Whether credit rating agencies are held to a sufficient level of liability under Dodd-Frank; and (5) Whether the provisions of Dodd-Frank intended to improve transparency of credit rating agencies are likely to be effective.

Colorado PERA[1]

Colorado PERA provides retirement and other benefits to more than 476,000 plan participants and beneficiaries of more than 400 government agencies and public entities in the state of Colorado. We are the 21st largest public pension plan in the United States (U.S.) with invested assets of more than $40.2 billion. We maintain a diversified portfolio of investments, including approximately 22% in domestic fixed income securities, while adhering to a long-term, strategic asset allocation policy.

The Council[2]

Colorado PERA is an active member of the Council of Institutional Investors. The Council is a not-for-profit association of public, corporate, and labor pension funds with combined assets exceeding $3 trillion. Council members are responsible for investing and safeguarding assets used to fund the pension benefits of millions of participants and beneficiaries throughout the U.S. Similar to Colorado PERA the average Council member has approximately 25% of its portfolio in domestic fixed income securities.[3]

Over the last three years, the Council has taken an active role on policy issues relating to credit rating agencies, including (1) a membership approved statement on credit rating agencies and other financial gatekeepers supporting

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[1] For more information about Colorado Public Employees' Retirement Association (Colorado PERA), see Colorado PERA's website at http://www.copera.org/pera/about/overview.htm.
[2] For more information about the Council of Institutional Investors (Council), see the Council's website at http://www.cii.org/about.
[3] Council of Institutional Investors, 2011 Asset Allocation Survey (forthcoming).

continued reforms "to ensure the pillars of transparency, independence, oversight and accountability are solidly in place;"[4] (2) membership endorsed recommendations of the Investors' Working Group (IWG) on reforming credit rating agencies;[5] and (3) a Council commissioned white paper entitled "Rethinking Regulation of Credit Rating Agencies: An Institutional Investor Perspective."[6] All three items are included as attachments to this testimony.

Whether Colorado PERA's utilization of credit ratings has changed since the passage of Dodd-Frank

It is important to note that neither prior to the financial crisis, nor after the passage of Dodd-Frank, has Colorado PERA ever relied on ratings, including those issued by Nationally Recognized Statistical Rating Organizations (NRSROs), as a sole source of buy/sell decisions. Rather, credit ratings are used as a part of the mosaic of information we consider during the investment process. Many institutional investors approach ratings in the same manner. Relying exclusively on ratings would be a failure to fulfill their fiduciary obligations.

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[4] Council of Institutional Investors, Statement on Financial Gatekeepers 1 (revised Apr. 13, 2010), http://www.cii.org/UserFiles/file/Statement%20on%20Financial%20Gatekeepers.pdf (see Attachment 1).

[5] Investors' Working Group, U.S. Financial Regulatory Reform: The Investors' Perspective 19-21 (July 2009), http://www.cii.org/UserFiles/file/resource%20center/investment%20issues/Investors%27%20Working%20Group%20Report%20(July%202009).pdf (see Attachment 2). Following its issuance, the Investors' Working Group (IWG) Report was reviewed and subsequently endorsed by the Council board and membership. For more information about the IWG, please visit the Council's website at http://www.cii.org/iwgInfo.

[6] Frank Partnoy, *Rethinking Regulation of Credit Rating Agencies: An Institutional Investor Perspective* (Apr. 2009), http://www.cii.org/UserFiles/file/resource%20center/publications/CII%20White%20Paper%20-%20Rethinking%20Regulation%20of%20CRAs%20April%202009.pdf (see Attachment 3).

As for Colorado PERA, traditionally, 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 have proven to be useful as a first cut to identify instruments eligible for further consideration and analysis. Without such a tool, 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 are also used to aid Colorado PERA in establishing the initial risk parameters for both our internal and outside portfolio managers. In addition, they serve as an important factor in our decision to participate in short term credit facilities, such as cash accounts and money market funds.

We fully agree with the conclusions of the Financial Crisis Inquiry Commission and many others that "the failures of credit rating agencies were essential cogs in the wheel of financial destruction."[7] In light of those failures, and the credit rating agency provisions of Dodd-Frank, Colorado PERA has begun to reevaluate our internal use of credit ratings. We are currently in the process of consulting with internal fund managers and outside experts in order to identify appropriate alternative measures of risk. We are hopeful that such measures can also be used to help define in our investment management agreements the level of risk to be taken by individual portfolio managers. The process is a

[7] The Financial Crisis Inquiry Commission, The Financial Crisis Inquiry Report *xxv* (Jan. 2011), http://www.gpoaccess.gov/fcic/fcic.pdf.

challenging one in that to-date no single appropriate substitute for a robust, objective evaluation of credit risk has yet been discovered.

However, we believe that our initiatives and the contributions of other groups wrestling with the same challenge will result in the identification of alternative methodologies to efficiently evaluate the risk properties of investment products. Ideally, the alternative approach would be an accurate reflection of the risk parameters we aim to measure, and be forward-looking, objective, easy to verify, and simple to compute.

In addition to our efforts to identify alternative measures of credit risk, we are also working to establish procedures for evaluating the additional disclosures rating agencies will be required to make under new SEC proposed rules as mandated by Dodd-Frank. Colorado PERA intends to take full advantage of the increased disclosure requirements, discussed further below, in order to better assess the soundness of an individual credit rating, the risks of the rated security itself, and the overall value of a rating agency's work.

Whether Dodd-Frank's required removal of references to credit ratings in all federal statutes and regulations will benefit Colorado PERA and other institutional investors

Colorado PERA has some general concerns about Section 939A of Dodd-Frank that requires each regulatory agency to review any regulations issued that require the use of an assessment of the credit-worthiness of an issuer, security or money market instrument and any references to or requirements

regarding credit ratings. After identifying such regulations, the agencies are to remove any reference to or requirement of reliance on credit ratings and to substitute standards of credit-worthiness as each agency deems appropriate.

Colorado PERA shares legislators' interest in reducing widespread reliance on credit ratings in securities industry regulations. We appreciate the difficult task the U.S. Securities and Exchange Commission (SEC or Commission) and other regulators have been charged. However, we believe the use of a robust indicator of credit quality in industry regulations is systemically important to controlling risk in the financial system.

As described above, Colorado PERA has taken deliberate steps to begin to identify suitable alternative measures of credit risk. We applaud the work regulators, such as the SEC, the Commodity Futures Trading Commission and the Federal Reserve, have done thus far to lessen their reliance on ratings. However, just as it is not feasible or practical for us or other institutional investors to simply stop using credit ratings altogether, it may not be feasible or practical for federal agencies to strike, in one fell swoop, ratings from all of their rules and regulations.

Mandates to use ratings have become part of the fabric of financial regulations, and cannot be unwoven instantaneously. The more practical course for the near term is for the SEC to continue its work to reform the credit rating industry with rules promoting transparency, instilling accountability and reducing

conflicts of interest. In the long-term, regulators and market participants must work in tandem to reduce their reliance on ratings.

We are concerned that hasty efforts to eliminate credit ratings prior to the development of effective substitute tools increases risk to investors, the regulatory environment of insurance companies, banking institutions and others whose capital and reserve requirements are dependent, in part, upon credit ratings, as well as counterparty risk. Therefore, we encourage regulators to take a careful, deliberate approach to eliminating references to ratings over time.

Whether credit rating agencies have self-corrected their practices since the passage of Dodd-Frank

While credit rating agencies clearly have made changes to their practices since the passage of Dodd-Frank, there remains some stubborn facts indicating that industry practices that enabled the financial meltdown are not likely be self-correcting.

First, I would note that the three largest credit rating agencies, that issue about 98% of the total credit ratings in the U.S.,[8] continue to operate under a fundamentally conflicted system that was a significant factor responsible for the

[8] Staff of S. Permanent Subcomm. on Investigations, 112th Cong, Rep. on Wall Street and The Financial Crisis: Anatomy of a Financial Collapse 247 (Apr. 13, 2011), http://hsgac.senate.gov/public/_files/Financial_Crisis/FinancialCrisisReport.pdf.

inaccurate credit ratings leading up to the financial crisis.[9] As the Senate Permanent Subcommittee on Investigations explained:

> The Subcommittee's investigation uncovered a host of factors responsible for the inaccurate credit ratings . . . . One significant cause was the inherent conflict of interest arising from the system used to pay for credit ratings. Credit rating agencies were paid by the Wall Street firms that sought their ratings and profited from the financial products being rated. Under this "issuer pays" model, the rating agencies were dependent upon those Wall Street firms to bring them business, and were vulnerable to threats that the firms would take their business elsewhere if they did not get the ratings they wanted. The ratings agencies weakened their standards as each competed to provide the most favorable rating to win business and greater market share. The result was a race to the bottom.[10]

Second, I would note that that the three largest credit rating agencies continue to be run by the same chief executive officer or president that was in charge of those respective organizations through all or much of the housing boom, the bust and the entire financial crisis.[11] Those individuals managed organizations that despite record revenues had serious operational problems that contributed to their inaccurate ratings.[12] Those problems included: (1) rating models that failed to include relevant mortgage performance data, (2) unclear and

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[9] *Id.* at 7.
[10] *Id.*
[11] Deven Sharma was named President of Standard & Poor's in 2007. Standard & Poor's, About S&P, Americas, http://www.standardandpoors.com/about-sp/management-profiles/en/us (last visited July 22, 2011); Raymond W. McDaniel has served as the Chief Executive Officer of Moody's Corporation since 2005. Forbes.com, http://people.forbes.com/profile/raymond-w-mcdaniel/46481 (last visited July 22, 2011). Stephen W. Joynt has been the Chief Executive Office of Fitch Ratings since 2001. Algorithmics, Executive Management, http://www.algorithmics.com/EN/company/executivemanagement/1-executive.cfm (last visited July 22, 2011).
[12] Staff of S. Permanent Subcomm. on Investigations at 7.

subjective criteria used to produce ratings, and (3) inadequate staffing to perform rating and surveillance services.[13]

Whether credit rating agencies are held to a sufficient level of liability under Dodd-Frank

It is widely recognized that credit rating agencies play a gatekeeper role in the financial markets, exerting influence over the ability of corporations to raise capital and the investment options of many institutional investors.[14] We agree with the findings of the Committee on Banking, Housing, and Urban Affairs that the credit rating agencies' gatekeeper role in the financial markets "justifies the same level of . . . accountability that applies to securities analysts, auditors, and investments banks."[15] The result of those findings, in part, led the U.S. Congress to include two complimentary liability related provisions in Dodd-Frank.[16]

The first provision, Section 933, establishes a private right of action under the federal securities laws for material misstatements made by credit rating agencies in informational reports that they are required to file with the SEC.[17] For example, if a credit rating agency makes a material misstatement in their required conflict of interest disclosures to the SEC, the material misstatement

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[13] *Id.*
[14] *See, e.g.,* Frank Partnoy at 1.
[15] Comm. on Banking, Hous., and Urban Affairs, 111th Cong., Rep. on S.3217, at 94 (Mar. 22, 2010), http://banking.senate.gov/public/_files/RAFSAPostedCommitteeReport.pdf.
[16] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376, at §§ 933, 939G (July 21, 2010), http://www.gpo.gov/fdsys/pkg/PLAW-111publ203/pdf/PLAW-111publ203.pdf.
[17] Council of Institutional Investors, Dodd Frank Issue Brief: Requirements Affecting Credit Rating Agencies 2 (Apr. 2011) (on file with Council).

could be actionable by an investor under the federal securities laws. Thus, Section 933 generally subjects credit rating agencies to the same level of liability as other gatekeepers such as certain registered accounting firms and security analysts that are required to file reports with the SEC.[18]

The second provision, Section 939G, eliminates a special exemption for NRSROs from liability for material misstatements or omissions of fact relating to credit rating opinions included in issuers' registration statements.[19] The SEC originally put the special exemption in place in 1982, in part, to encourage the disclosure of credit ratings in registered offering documents.[20]

Section 939G's elimination of the special exemption for NRSROs places NRSROs in essentially the same position as auditors, investment bankers, non-NRSRO credit rating agencies, and other financial gatekeepers when they include their reports or opinions in registered offering documents.[21] In response to the implementation of Section 939G, the major NRSROs collectively refused to provide consent to issuers to reference their credit rating opinions in registration statements.[22] In addition, the SEC staff suspended indefinitely the requirement that asset-backed securities offerings include credit rating disclosures.[23] As a result, credit ratings are generally no longer included in issuer offering statements. We note that this result has to-date had little

[18] *See* Comm. on Banking, Hous., and Urban Affairs at 99.
[19] *See* Investors' Working Group at 21.
[20] Concept Release on Possible Rescission of Rule 436(g) Under the Securities Act of 1933, Securities Act Release No. 33-9071, at 9 (Oct. 7, 2009), http://www.sec.gov/rules/concept/2009/33-9071.pdf.
[21] Issue Brief at 2.
[22] *Id.*
[23] *Id.*

impact on debt offerings, principally because NRSROs publish their ratings widely and contemporaneously.[24] We also note the result is generally consistent with the intent of the previously referenced requirement in Section 939A of Dodd-Frank to remove references to credit ratings in order to reduce the perceived over-reliance on ratings by both regulators and investors.[25]

In any event, in our view, Section 939G, like Section 933 of Dodd-Frank, simply holds rating agencies to the same level of accountability to investors as other financial gatekeepers that serve similar roles in the financial markets.[26] Thus, Colorado PERA, like many other investors, strongly supports these two provisions of Dodd-Frank.

Whether the provisions of Dodd-Frank intended to improve transparency of credit rating agencies are likely to be effective

As directed by the U.S. Congress through the passage of the Credit Rating Agency Reform Act of 2006 (Act), 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, the rating agencies' role in the recent financial crisis demonstrated the need for additional reform. In response, Congress included a number of provisions in Dodd-Frank designed to strengthen the SEC's oversight authority, address conflicts of interest and increase the transparency and accountability of rating

[24] *Id.*
[25] *Id.* at 3.
[26] *See, e.g.,* Frank Partnoy at 16.

agencies. Implementation of a large majority of those provisions is still in progress. We note that recently the SEC issued a proposed rule to implement many of those requirements.

Colorado PERA believes that the following three provisions intended to improve transparency of credit ratings and the ratings industry are likely to be most effective so long as the SEC is fully able and willing to exercise its oversight authority: (1) increased disclosure about individual ratings and the methodologies used; (2) enhanced and standardized disclosure of information about rating agency performance; and (3) a report on internal controls. The following is a brief discussion of each of those three provisions and why we believe they are likely to be effective for investors.

Individual Ratings and the Methodologies Used

Colorado PERA strongly believes that all financial gatekeepers, including NRSROs, should be transparent in their methodologies and avoid or tightly manage conflicts of interest.[27] Moreover, as recommended by the IWG, we believe more complete, prominent and consistent disclosures of conflicts are needed.[28] For those and other reasons, we strongly support Section 932 of Dodd-Frank, which directs the SEC to adopt rules to require NRSROs to publish a form with each credit rating that includes additional details about the rating and the methodology used to determine it. Under the SEC's current proposed rule, an NRSRO would be required to disclose along with a rating

[27] Council Statement on Financial Gatekeepers at 1.
[28] Investors' Working Group at 21.

(including an expected or preliminary rating, initial rating, upgrade, downgrade, placement on watch, affirmation or withdrawal) the version of the methodology used to determine the rating; main assumptions underlying the methodology; potential limitations of the rating, including the types of risks excluded (such as liquidity); information on the reliability, accuracy and quality of the data used; a statement on the extent to which data essential to the determination of the rating were reliable or limited; the findings of a third-party due diligence service, if used; and information relating to conflicts of interest associated with the rating.

In addition to unchecked conflicts of interest, flawed methodologies and inadequate, inaccurate data were core reasons some NRSROs continued to issue inflated ratings for complex structured finance instruments leading up to and during the financial crisis.[29] Colorado PERA firmly believes that if fully implemented, the proposed rule would provide a disincentive for rating agencies from knowingly issuing ratings based on inaccurate models using insufficient, outdated data.[30] The transparency that would result from the robust disclosure provided by this provision would allow investors the opportunity to analyze the assumptions and methodologies an NRSRO used to develop a particular rating, and evaluate whether the rating may be based on insufficient data or influenced by conflicts of interest. Disclosure of information of this sort would also promote more prudent use of credit ratings by investors.

[29] Staff of S. Permanent Subcomm. on Investigations at 244.
[30] *See, e.g.,* Staff of S. Permanent Subcomm. on Investigations at 289.

Finally, the proposed disclosures would serve as a vital market-based check on NRSROs' processes and quality of ratings.

Information about Rating Agency Performance

Section 932 of Dodd-Frank also requires the SEC to develop rules to require credit rating agencies to disclose publicly information on their initial credit ratings and subsequent changes to such ratings. The SEC's current proposed rule standardizes the way NRSROs calculate and present information about the performance of their initial ratings over time and how often a rated entity or product defaulted. The proposal was designed to result in disclosures that are simply presented, easy to understand, uniform in appearance and comparable across credit rating agencies.

The proposed enhancements to current performance disclosure rules will allow users of credit ratings to easily evaluate the accuracy of ratings over time and compare the performance of different credit rating agencies. Without quality data, investors have been unable to judge the performance of an NRSRO in terms of its ability to accurately assess the creditworthiness of issuers and obligors. The new rule will also assist both credit rating users and NRSROs by drawing attention to those rating agencies that demonstrate they have superior methodologies and competence, thus attracting new clients and enhancing competition within the industry.

Report on Internal Controls

Section 932 of Dodd-Frank builds on the current requirement that credit rating agencies have an effective internal control structure and requires each NRSRO to submit an annual report to the SEC containing, among other things, an assessment of the effectiveness of its internal control structure and its compliance with securities laws and the NRSRO's policies and procedures. The SEC's recent proposed rule addresses this provision and requests comment on whether the internal control report should be disclosed to the public.

We believe that it is necessary for the protection of investors and the U.S. financial system as a whole that NRSROs' compliance reports be publicly disclosed. Investors and other users of credit ratings would greatly benefit from access to this information, in that it would allow users of credit ratings the ability to evaluate the effectiveness of a rating agency's internal control structure and consider what impact, if any, it may have on the quality of the credit ratings issued.

Dodd-Frank also creates a new Office of Credit Ratings within the SEC charged with conducting annual examinations of each NRSRO (we note that due to budgetary uncertainties, the formation of this vital office has been postponed). Through this office, the Commission must make public an annual report summarizing the findings of all NRSRO examinations conducted that year and include the responses of NRSROs to identified regulatory deficiencies and

whether previous SEC recommendations have been addressed. So long as the contents of the report are comprehensive, we expect the publication of this report to serve as a deterrent to credit rating agencies from allowing conflicts to unduly influence their ratings. The annual examination report would also provide investors with valuable information that would help them evaluate the independence and value of a rating agency's ratings.

That completes my testimony. Colorado PERA and the Council look forward to continuing to work closely with this Subcommittee, the SEC and other interested parties to ensure that credit rating agencies post Dodd-Frank will effectively and efficiently serve the needs of investors and all participants in the U.S. financial system.

Thank you, Mr. Chairman and Ranking Member Capuano for inviting me to participate at this important hearing. I look forward to the opportunity to respond to any questions.

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Attachment 1

Council of Institutional Investors, Statement on Financial Gatekeepers

Council of Institutional Investors
The Voice of Corporate Governance

Statement on Financial Gatekeepers

The Council of Institutional Investors believes financial gatekeepers should be transparent in their methodology and avoid or tightly manage conflicts of interest. Robust oversight and genuine accountability to investors are also imperative. Regulators should remain vigilant and work to close gaps in oversight. Continued reforms are needed to ensure that the pillars of transparency, independence, oversight and accountability are solidly in place.

Auditors, financial analysts, credit rating agencies and other financial "gatekeepers" play a vital role in ensuring the integrity and stability of the capital markets. They provide investors with timely, critical information they need, but often cannot verify, to make informed investment decisions. With vast access to management and material non-public information, financial gatekeepers have an inordinate impact on public confidence in the markets. They also exert great influence over the ability of corporations to raise capital and the investment options of many institutional investors.

In recent years, the global financial crisis and 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 cases, poor disclosure, conflicts of interest, minimal oversight and lack of accountability helped mislead many market participants into making investment decisions that ultimately yielded huge losses. The crisis of confidence in the markets that followed spurred regulators and lawmakers to scrutinize and rein in gatekeepers.

The Sarbanes-Oxley Act of 2002 and the "global settlement" with Wall Street firms in 2003 bolstered the transparency, independence, oversight and accountability of accounting firms and equity analysts, respectively. For example, accounting firms now are barred from providing many consulting services to companies whose books they audit. And banks are not allowed to include analysts in investment banking "roadshows" and must make analysts' historical ratings and price target forecasts publicly available.

Credit rating agencies largely escaped meaningful oversight until the passage of the Credit Rating Agency Reform Act of 2006. While the act has improved disclosure and

competition in the rating industry, more transparency, stronger regulation and genuine accountability are still needed. Investigations by Congress and the Securities and Exchange Commission (SEC) have uncovered repeated instances where credit raters inflated ratings on structured financial products to win business from firms that issued the debt. And rating agencies continue to face minimal accountability for the fairness or quality of their ratings. The Council welcomes further examination of financial gatekeepers by regulators, lawmakers, academics and others, to determine what changes, including new rules and stronger oversight, are needed.

(Adopted April 13, 2010)

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Attachment 2

Investors' Working Group, U.S. Financial Regulatory Reform: The Investors' Perspective

U.S. Financial Regulatory Reform:

The Investors' Perspective

A Report by the Investors' Working Group

An Independent Taskforce Sponsored by
CFA Institute Centre for Financial Market Integrity
and
Council of Institutional Investors

July 2009

U.S. Financial Regulatory Reform:

The Investors' Perspective

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July 2009

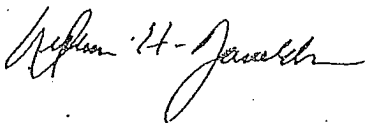
ABOUT THE INVESTORS' WORKING GROUP

During the summer of 2008, the CFA Institute Centre for Financial Market Integrity and Council of Institutional Investors began exploring the idea of commissioning a study on financial regulatory reform. Both organizations were concerned that investor views were missing in the ongoing national debate about overhauling the U.S. system of financial regulation. The U.S. Treasury Department's "Blueprint for a Modernized Financial Regulatory Structure," released in March 2008, largely ignored investor considerations, focusing instead on making U.S. markets more globally "competitive" by reducing costs for public companies and financial institutions.

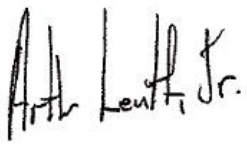
The result was the launch in February 2009 of the Investors' Working Group (IWG). This independent, non-partisan panel was formed to provide an investor perspective on ways to improve the regulation of U.S. financial markets. The IWG worked collaboratively to seek agreement on the recommendations. This report fairly reflects the consensus views of the group on myriad reforms. However, not all IWG members agreed with every recommendation in the report.

Our report could not be more timely. Over the past year, the worst financial crisis since the Great Depression has brought markets to the brink of collapse, toppled iconic financial institutions and forced repeated government bailouts. The debacle has wiped out retirement savings for millions of Americans and crippled the economy. It also has changed fundamentally the terms of the debate about regulation. Calls to unshackle Wall Street and let markets police themselves no longer dominate. Instead, the focus of the discussion now is on making the U.S. system of regulation more comprehensive, effective and responsive to the needs of investors, consumers and the broader financial system.

This report offers an essential roadmap to that destination. It suggests practical, near-term improvements and longer-term, aspirational reforms, some of which may require further study. But all of our recommendations are guided by a profound commitment to restoring confidence in our markets by ensuring that regulation serves the needs of investors. Strong investor safeguards are a prerequisite for market stability and integrity and a vibrant U.S. financial system.



William H. Donaldson, CFA
Co-Chair,
Investors' Working Group



Arthur Levitt, Jr.
Co-Chair,
Investors' Working Group

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*Note: Affiliations are for identification purposes only. IWG members participated as individuals; the report reflects their own views and not those of organizations with which they are affiliated.

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OVERVIEW

The credit crisis has exposed the faulty underpinnings of the U.S. financial services sector. The fundamental flaws are glaring: gaps in oversight that let purveyors of abusive mortgages, complex over-the-counter (OTC) derivatives and convoluted securitized products run amok; woefully underfunded regulatory agencies; and super-sized financial institutions that are both "too big to fail" and too labyrinthine to regulate or manage effectively. Too often, the complexities of the regulatory system and the institutions it is supposed to police benefit institutions, dealers and traders at the expense of investors and consumers.

Designing a more rational financial services sector will take time, thoughtful analysis and political will. The findings of the Financial Crisis Inquiry Commission, which is to report to the U.S. Congress on the origins of the market meltdown and measures to ensure that such catastrophes do not happen again, are critical to that effort. What is at stake—the integrity of the U.S. financial system—is too important to rush the review.

In the near term, there are critical, practical steps that the federal government can take to put the U.S. financial regulatory system on a sounder footing and make it more responsive to the needs of investors. The Obama Administration's regulatory reform plan, announced on June 17, 2009, is a start. The Investors' Working Group (IWG) supports many of these recommendations but advocates a bolder set of near-term measures to strengthen investor and consumer protections and check systemic risks that threaten the health of the financial system.

The IWG believes that the U.S. needs a process for dealing with threats to the broader financial system, but we also believe that bolstering investor and consumer protection is paramount. The lack of sufficient authority, resources and will on the part of regulators helped fuel the financial meltdown at least as much as the absence of systemic-risk oversight.

To address these shortcomings, reform in the near term should focus on:

Strengthening and reinvigorating existing federal agencies responsible for policing financial institutions and markets and protecting investors and consumers. To achieve this goal, the will to regulate must be restored. Light-touch federal regulation has met with disastrous results, as has starving agencies of needed resources. For example, the U.S. Securities and Exchange Commission's (SEC) funding has not kept pace with the explosive growth of the securities markets over the past two decades. Today, the agency monitors 30,000 entities, including more than 11,000 investment advisers, up 32 percent in only the last four years. Even so, in the three years from 2005 to 2007, the SEC's budgets were flat or declining.

Filling the gaps in the regulatory architecture and in authority over certain investment firms, institutions and products. For example, OTC derivatives contracts should be subject to comprehensive regulation; credit rating agencies should be subject to more meaningful oversight and greater accountability for their ratings; investment managers, including managers of hedge funds and private equity, should be required to register with the SEC; originators of asset-backed securities (ABS) should have some "skin in the game"; and regulators should be given resolution authority, analogous to the Federal Deposit Insurance Corporation's (FDIC) authority for failed banks, to wind down or restructure troubled systemically significant non-banks.

Improving corporate governance. The financial crisis represents a massive breakdown in oversight at many levels, including at corporate boards. Investors need better tools to hold directors accountable so they will be motivated to challenge executives who pursue excessively risky strategies. Measures to make it easier for shareowners to nominate and elect directors are a good place to start.

Since the financial crisis erupted, fear that the failure of large financial institutions could have devastating repercussions throughout the U.S. financial system has prompted unprecedented government intervention in the markets and the private sector. Consequently, much of the debate about financial reform has focused on the need to monitor and address future systemic risks. The U.S. regulatory framework was not designed to monitor and respond to risks to the entire financial system posed by large, complex and interconnected institutions, practices and products.

The IWG believes that the appropriate way to address this immediate need is for Congress and the Administration to authorize the creation of an independent Systemic Risk Oversight Board (SROB). Ideally, the SROB would have the authority and highly skilled staff to 1) collect and analyze financial institutions' exposures, practices and products that could threaten the stability of the financial system and 2) recommend steps that existing regulators should take to reduce those risks.

This approach represents a middle ground between the systemic risk regulator advocated by the Administration and the "college of cardinals" model of oversight by the heads of existing federal regulators that some leading lawmakers propose. The IWG views both approaches with skepticism. A council of regulators would have blurred lines of authority—ultimately no one would be in charge or accountable—and could be hamstrung by the usual jurisdictional disputes. The Administration's approach, which envisions the U.S. Federal Reserve Board as systemic risk regulator, has more serious drawbacks. The Fed has other, potentially competing responsibilities—from guiding monetary policy to managing the vast U.S. payments system. Its credibility has been tarnished by the easy credit policies it pursued and the lax regulatory oversight that let institutions ratchet higher their balance sheet leverage and amass huge concentrations of risky, complex securitized products. Other serious concerns stem from the Fed's regulatory failures—its refusal to police mortgage underwriting or to impose suitability standards on mortgage lenders—and the heavy influence that banks have on the Fed's governance.

The Systemic Risk Oversight Board's collection and analysis of data, with an eye on emerging systemic risks, would be informed by the Financial Crisis Inquiry Commission's parallel efforts to understand the root causes of the current crisis. The tandem investigations would help guide policymakers as they consider overall regulation of the financial services sector, including the eventual locus, scope and powers of a systemic risk regulator. Until then, the oversight board would monitor systemic threats and refer appropriate steps to existing regulatory agencies–the Treasury, the Fed and Congress.

While our report focuses on near-term needs, we recognize that there is a larger, long-term agenda. Restructuring the hodge-podge of financial regulators and key financial institutions is clearly an imperative, regardless of how politically arduous the task. Policymakers need to map out a path toward a more rational, less conflicted financial system. Steps they should consider include:

Designating a systemic risk regulator, with appropriate scope and powers. One option would be for the Systemic Risk Oversight Board to evolve into a full-fledged regulator.

Adopting new regulations for financial services that will prevent the sector from becoming dominated by a few giant and unwieldy institutions. New rules are needed to address and balance concerns about concentration and competitiveness.

Strengthening capital adequacy standards for all financial institutions. Too many financial institutions have weak capital underpinnings and excessive leverage.

Imposing careful constraints on proprietary trading at depository institutions and their holding companies. Proprietary trading creates potentially hazardous exposures and conflicts of interest, especially at institutions that operate with explicit or implicit government guarantees. Ultimately, banks should focus on their primary purposes, taking deposits and making loans.

Consolidating federal bank regulators and market regulators. Regulation of banks and other depository institutions may be streamlined through the appropriate consolidation of prudential regulators. Similarly, efficiencies may be obtained through the merger of the SEC and the Commodity Futures Trading Commission (CFTC).

Studying a federal role in the oversight of insurance companies. The current state-based regulation makes for patchwork supervision that has proven inadequate to the task.

The IWG believes that the goal of the longer-term effort should be a simpler yet more comprehensive regulatory net, stronger overseers and manageable, better-governed financial institutions that will not pose "too big to fail" threats. The new financial order that emerges must ensure appropriate safeguards for investors. Investors, in turn, must focus on sustainable, risk-adjusted performance, recognizing that pressing investment advisers and executives of portfolio companies for quick returns can spur out-on-a-limb behavior in pursuit of fast but often ephemeral profits.

The regulatory overhaul should not stop at the water's edge. Financial markets are increasingly global. U.S. financial institutions generate a growing share of their revenues and assets overseas. Washington policymakers must lead a fresh effort to forge international consensus on key elements of the regulation of global markets, players and products. U.S. leaders should also press for greater sharing of information among national regulators and harmonization of rules and practices. In contrast to other recent global initiatives, however, the focus should be on *raising* standards, not weakening them.

This report is intended to ensure that policymakers fully consider and reflect on making regulatory changes that serve investors, consumers and the broader financial system. A balance is needed among many interests. In particular, building a U.S. financial system that correctly balances efficiency, global competitiveness, and investor and consumer protection is enormously challenging. It is also an opportunity, however, to put the U.S. financial system on a firmer, more rational footing and ensure that it serves the needs of investors. Strong investor protections are integral to restoring trust, stability and vibrancy to U.S. financial markets. The IWG believes this plan of action is the best way forward toward that goal.

OUTLINE OF RECOMMENDATIONS

I. INVESTOR AND CONSUMER PROTECTIONS

A. Strengthening Existing Federal Regulators

- Congress and the Administration should nurture and protect regulators' commitment to fully exercising their authority.
- Regulators should have enhanced independence through stable, long-term funding that meets their needs.
- Regulators should acquire deeper knowledge and expertise.

B. Closing the Gaps for Products, Players and Gatekeepers

OTC Derivatives

- Standardized derivatives should trade on regulated exchanges and clear centrally.
- OTC trading in derivatives should be strictly limited and subject to robust federal regulation.
- The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) should improve accounting for derivatives.
- The SEC and the CFTC should have primary regulatory responsibility for derivatives trading.
- The United States should lead a global effort to strengthen and harmonize derivatives regulation.

Securitized Products

- New accounting standards for off-balance-sheet transactions and securitizations should be implemented without delay and efforts to weaken the accounting in those areas should be resisted.
- Sponsors should fully disclose their maximum potential loss arising from their continuing exposure to off-balance-sheet asset-backed securities.
- The SEC should require sponsors of asset-backed securities to improve the timeliness and quality of disclosures to investors in these instruments and other structured products.
- ABS sponsors should be required to retain a meaningful residual interest in their securitized products.

Hedge Funds, Private Equity and Investment Companies, Advisers and Brokers

- All investment managers of funds available to U.S. investors should be required to register with the SEC as investment advisers and be subject to oversight.
- Existing investment management regulations should be reviewed to ensure they are appropriate for the variety of funds and advisers subject to their jurisdiction.
- Investment managers should have to make regular disclosures to regulators on a real-time basis, and to their investors and the market on a delayed basis.

Hedge Funds, Private Equity and Investment Companies, Advisers and Brokers (cont.)

- Investment advisers and brokers who provide investment advice to customers should adhere to fiduciary standards. Their compensation practices should be reformed, and their disclosures should be improved.
- Institutional investors—including pension funds, hedge funds and private equity firms—should make timely, public disclosures about their proxy voting guidelines, proxy votes cast, investment guidelines, and members of their governing bodies and report annually on holdings and performance.

Non-Bank Financial Institutions

- Congress should give regulators resolution authority, analogous to the Federal Deposit Insurance Corporation's authority for failed banks, to wind down or restructure troubled, systemically significant non-banks.

Mortgage Originators

- Congress should create a new agency to regulate consumer financial products, including mortgages.
- Banks and other mortgage originators should comply with minimum underwriting standards, including documentation and verification requirements.
- Mortgage regulators should develop suitability standards and require lenders to comply with them.
- Mortgage originators should be required to retain a meaningful residual interest in all loans and outstanding credit lines.

Nationally Recognized Statistical Rating Organizations (NRSROs)

- Congress and the Administration should consider ways to encourage alternatives to the predominant issuer-pays NRSRO business model.
- Congress and the Administration should bolster the SEC's position as a strong, independent overseer of NRSROs.
- NRSROs should be required to manage and disclose conflicts of interest.
- NRSROs should be held to a higher standard of accountability.
- Reliance on NRSRO ratings should be greatly reduced by statutory and regulatory amendments. Market participants should reduce their dependence on ratings in making investment decisions.

C. Corporate Governance

- In uncontested elections, directors should be elected by a majority of votes cast.
- Shareowners should have the right to place director nominees on the company's proxy.
- Boards of directors should be encouraged to separate the role of chair and CEO or explain why they have adopted another method to assure independent leadership of the board.
- Securities exchanges should adopt listing standards that require compensation advisers to corporate boards to be independent of management.
- Companies should give shareowners an annual, advisory vote on executive compensation.
- Federal clawback provisions on unearned executive pay should be strengthened.

II. Systemic Risk Oversight Board

- Congress should create an independent governmental Systemic Risk Oversight Board.
- The board's budget should ensure its independence from the firms it examines.
- All board members should be full-time and independent of government agencies and financial institutions.
- The board should have a dedicated, highly skilled staff.
- The board should have the authority to gather all information it deems relevant to systemic risk.
- The board should report to regulators any findings that require prompt action to relieve systemic pressures and should make periodic reports to Congress and the public on the status of systemic risks.
- The board should strive to offer regulators unbiased, substantive recommendations on appropriate action.
- Regulators should have latitude to implement the oversight board's recommendations on a "comply or explain" basis.

I. Investor and Consumer Protections

The Investors' Working Group believes that strengthening existing regulatory agencies, closing gaps in the regulatory structure, enhancing consumer and investor protections and improving corporate governance are the most important steps Congress and the Obama Administration can take to restore the integrity of the financial system and the stability of financial markets.

Background

When the financial meltdown began, regulators for the most part had enough information and should have recognized the signs but did not, or could not, stop the downward spiral. One reason is that regulators lacked the requisite will, resources and expertise. Another is that the web of regulatory supervision that covers the U.S. financial services industry is riddled with holes. Some are intentional. For example, the OTC derivatives market has been expressly exempted from virtually all federal oversight. But even in regulated parts of the markets, the oversight fabric is not knit tightly enough.

A. Strengthening Existing Federal Regulators

While the IWG acknowledges that regulatory failures were a major contributing cause of the financial debacle, we believe that the right solution is to reinforce, rather than abandon, the existing regulatory framework.

Above all, regulators must be committed to promoting policies that are good for consumers, investors and the financial markets. Although the will to regulate cannot be legislated, Congress can encourage vigorous regulation through general oversight and its specific role in providing advice and consent regarding nominees to lead financial regulatory agencies. Structural and financial changes can also help strengthen regulatory agencies by making them more independent of the industries they supervise and allowing them to hire staff with deep knowledge of complex products and rapid financial innovation. Consolidating agencies as appropriate can help bolster and streamline financial regulation so long as mergers are crafted with a keen understanding of the differences between existing regulators and the markets and institutions they supervise.

Background

Since 1980, a dramatic shift in the financial regulatory system has occurred. Vigorous governmental oversight was abandoned as regulators placed their faith in the ability of markets to self-police and self-correct. Even as the credit crisis unfolded in early 2008, the prevailing view in the industry and among many agency chiefs and government leaders was that too much regulation, rather than too little, was eroding the competitiveness of U.S. markets.

The IWG believes that this view is misguided. The financial crisis has revealed that insufficient and ineffective oversight, not over-regulation, paved the way to financial turmoil.

Beyond a misplaced faith in markets, regulators lacked the will, knowledge and resources to flexibly respond to rapid financial innovation and market expansion. Poor funding and a lack of independence allowed an anti-regulatory ideology to permeate regulatory agencies. The Congressional appropriations process helped to undermine robust oversight. Fearful of political budgetary retaliation, agencies grew reluctant to exercise their authority fully in certain areas. It is no coincidence that these pockets of poor oversight proved to be sources of great risk.

Specific Recommendations

1. Congress and the Administration should nurture and protect regulators' commitment to fully exercising their authority. Congress and the Administration should amend statutory language establishing various financial regulators to prominently include provisions requiring that the President consider potential appointees' determination to exercise vigorous oversight and their commitment to the regulatory mission. Congress should be vigilant in exercising its general supervisory authority and thoughtfully carry out its obligation to provide advice and consent to ensure that nominees possess the resolve to regulate effectively.

The President, Congress and agency leaders must work to foster a culture of regulatory professionalism that rewards high-quality work and instills a community of purpose. Such a culture is rooted in steadfast devotion to vigorous oversight and enforcement. Regulators should be encouraged to exercise the greatest supervision where the need is greatest, including over the most complex and rapidly expanding institutions, products and markets. Resistance to regulation in these often highly lucrative areas is likely to be intense. Staff should be rewarded for asking tough questions, pursuing difficult cases and thinking outside the bounds of conventional wisdom. A healthy tension and skepticism between regulators and those they oversee should be promoted as a hallmark of exemplary regulation.

2. Regulators should have enhanced independence through stable, long-term funding that meets their needs. All federal financial regulators should have the resources and independence to fulfill their mission effectively without political interference or dependence on the firms they oversee. The IWG encourages Congress and the Administration to consider ways to develop mechanisms for stable, long-term funding. To ensure that funding keeps pace with rapid market changes and financial innovation, Congress, the Administration and regulators should periodically reevaluate the resources each agency needs to fulfill its mission. To the extent possible, agencies should have funding flexibility to respond to these changes on their own.

3. Regulators should acquire deeper knowledge and expertise. The speed with which financial products and services have proliferated and grown more complex has outpaced regulators' ability to monitor the financial waterfront. Staffing levels failed to keep pace with the growing work load, and many agencies lack staff with the necessary expertise to grapple with emerging issues. Political appointees and senior civil service staff should have a wide range of financial backgrounds. Compensation should be sufficient to attract top-notch talent. In addition, continuing education and training should be dramatically expanded and officially mandated to help regulators keep pace with innovation. Although we recognize that the "revolving door" between regulatory agencies and the private sector can lead to abuse, we believe that both the public sector and the private sector can benefit from people with experience in both. In particular, agencies should explore ways of recruiting individuals from the private sector to improve the regulators' ability to understand and keep up with complex financial and market innovations. And those who have served in regulatory agencies can assist market players in understanding the perspective of regulators and the need for regulations.

B. Closing the Gaps for Products, Players and Gatekeepers

The nation's regulatory umbrella should be comprehensive. Specifically, it should be broadened to cover important financial products, players and gatekeepers that lack meaningful oversight. Critical gaps that urgently need attention include OTC derivatives, securitized products, investment managers, mortgage finance companies and credit rating agencies.

OTC Derivatives

All standardized (and standardizable) derivative contracts currently traded over the counter should be required to be traded on regulated exchanges and cleared through regulated clearinghouses. Any continuing OTC derivatives trading should be limited strictly to truly customized contracts between highly sophisticated parties, at least one of which requires a customized contract in order to hedge business risk. What remains of the OTC derivatives market should be subject to a robust federal regulatory regime, including reporting, capital and margin requirements.

Background

OTC derivatives generally are bilateral contracts between sophisticated parties. They include interest rate swaps, foreign exchange contracts, equity swaps, commodity swaps and the now-infamous credit default swaps (CDS), along with other types of swaps, contracts and options. It is widely acknowledged that OTC derivatives contracts, and particularly CDS, played a significant role in the current financial crisis. For December 2008, the Bank for International Settlements reported a notional amount outstanding of $592 trillion and a gross market value outstanding of $34 trillion for global OTC derivatives. This enormous financial market was exempted from virtually all federal oversight and regulation by the Commodity Futures Modernization Act of 2000 (CFMA).

Although OTC derivatives have been justified as vehicles for managing financial risk, they have also spread and multiplied risk throughout the economy in the current crisis, causing great financial harm. Warren Buffett has dubbed them "financial weapons of mass destruction." Problems plaguing the market include lack of transparency and price discovery, excessive leverage, rampant speculation and lack of adequate prudential controls.

Specific Recommendations

1. Standardized derivatives should trade on regulated exchanges and clear centrally. Congress and the Administration should enact legislation overturning the exemptive provisions of the CFMA and requiring standardized (and standardizable) derivatives contracts to be traded on regulated derivatives exchanges and cleared through regulated derivatives clearing operations. Legal requirements based on those established in the Commodity Exchange Act for designated contract markets and derivatives clearing operations should apply to such trading and clearing. These requirements would allow effective government oversight and enforcement efforts, ensure price discovery, openness and transparency, reduce leverage and speculation and limit counterparty risk. Although requiring central clearing alone would mitigate counterparty risk, it would not provide the essential price discovery, transparency and regulatory oversight provided by exchange trading.

2. OTC trading in derivatives should be strictly limited and subject to robust federal regulation. An OTC market is necessarily much less transparent and much more difficult to regulate than an exchange market. If trading OTC derivatives is permitted to continue, such trading should be strictly limited to truly customized contracts between highly sophisticated parties, at least one of which requires such a customized contract in order to hedge business risk. Congress and the Administration should enact legislation limiting the eligibility requirement for OTC derivatives trades to highly sophisticated and knowledgeable parties and requiring that at least one party to each OTC contract should certify and be prepared to demonstrate that it is entering into the contract to hedge an actual business risk. This limitation to trading on the OTC market would permit entities to continue to hedge actual business risks but would reduce the current pervasive speculation in the market.

A federal regulatory regime is needed for any continuing OTC market. OTC derivatives dealers should be required to register, maintain records and report transaction prices and volumes to the federal regulator. They should be subject to adequate capital requirements and business conduct standards, including requirements to disclose contract terms and risks to their customers. All OTC trades should be subject to federally imposed margin requirements, and all large market participants should be subject to capital requirements. In addition, transaction prices and volumes of OTC derivatives should be publicly reported on a timely basis.

All market participants should be subject to federal fraud and manipulation prohibitions, recordkeeping and reporting requirements, and position limits if imposed by the federal regulator. The regulator should have broad powers to oversee the market and all its participants, including powers to require additional reporting and inspection of records and to order positions to be eliminated or reduced. Federal legal prohibitions should be enacted to prohibit the use of OTC derivatives to misrepresent financial condition or to avoid federal laws.

3. The FASB and IASB should improve accounting for derivatives. A thorough and comprehensive review of accounting rules related to derivative instruments is needed. The goals of this review should be to ensure consistent reporting about these instruments and to ensure full disclosure for the benefit of investors, counterparties and regulators. To make informed decisions, investors and those entering into counterparty relationships need information about these positions.

4. The SEC and the CFTC should have primary regulatory responsibility for derivatives trading. Currently, the SEC and the CFTC each have regulatory responsibilities for certain portions of derivatives trading, depending on the nature of the derivatives product and/or the type of exchange on which it is traded. Those agencies have the experience and sophistication to oversee derivatives markets and should act as the primary regulators of both exchange trading and any continuing OTC market. It is important that federal standards for derivatives trading be comprehensive and consistent and that agency jurisdiction over such trading be clearly delineated. For this reason, the SEC and the CFTC must agree on appropriate regulatory standards and on their respective regulatory responsibilities, and the terms of such agreement should be enacted into law.

5. The United States should lead a global effort to strengthen and harmonize derivatives regulation. Because the OTC derivatives market is global, U.S. financial regulators should work with foreign authorities to strengthen and harmonize standards for derivatives regulation internationally and to enhance international cooperation in enforcement and information sharing.

Securitized Products

Investors have had a difficult time understanding securitized instruments because of the lack of information about them and the confusing manner in which this information is reported, both to the shareowners of the issuing company (or sponsor), and to investors in these often complex products. This opacity stems in part from securitized products' absence from sponsors' balance sheets. Moreover, securitized products are sold before investors have access to a comprehensive and accurate prospectus.

The IWG believes that accounting standards setters should improve the quality, appropriateness and transparency of reporting related to off-balance-sheet transactions and securitizations by sponsoring institutions. The SEC should develop new rules for the sale of asset backed securities that give investors in these products a reasonable opportunity to review disclosures before making a decision to invest. Sponsors of ABS and structured products should have to retain a meaningful interest in the underlying assets they securitize. Lastly, while the status of government-sponsored enterprises (GSEs) is currently in limbo, the IWG believes the GSEs or their successor enterprises should be subject to the same securities regulations that apply to all other sponsors when they issue ABS.

Background

Beginning in the 1980s, banks and other lenders began repackaging mortgage loans and other predictable cash flows into asset-backed securities. Some $3 trillion were outstanding by year-end 2008.

Both investors in these securities and the shareowners of their sponsoring organizations lack crucial information needed to judge their true risk. The off-balance-sheet accounting treatment of securitizations masks from shareowners of the sponsoring company the potential costs of deterioration in the quality of the assets underlying the instruments. Consequently, shareowners of a sponsoring company may not appreciate the impact on the company of deterioration in the quality of the underlying loans. In addition, the off-balance-sheet treatment allows the sponsor to reduce the amount of capital supporting the underlying loans by as much as 90 percent. Significant capital shortfalls can thus occur when a sponsor chooses to support these securitizations (whether according to or beyond the terms of the securitization) by bringing them back onto its balance sheet.

Beyond poor accounting and disclosures by the sponsors of securitized products, institutions that invest directly in these securities have been ill-served by existing disclosures. In particular, investors often have to decide whether to invest in an ABS issuance based not upon a detailed prospectus but rather on a basic term sheet with limited information. Although these investors could choose not to invest under such terms, doing so would lock them out of many ABS transactions. Institutions feared that this lockout would be inconsistent with their fiduciary duty to find the best investments for their clients. Investing before reviewing a prospectus, however, limits the ability of investors to perform adequate due diligence.

Accounting and disclosure problems were even more severe at the GSEs. As government-chartered corporations, the GSEs were able to operate as major sponsors of mortgage-backed securities, even though they were not subject to the same regulations as other participants. As recent events have shown, an implicit government guarantee does not protect investors from systemic failure. Consequently, investors need to have relevant information that will help them review, analyze and make reasoned and informed investment decisions about securities and firms that might be affected by the financial performance and condition of GSEs. Although the GSEs' future is uncertain at this time, the IWG believes that they or their successors should have to adhere to the same regulations as other securities issuers.

Notwithstanding the serious lack of crucial information about securitized products, the IWG recognizes that investors need to be more diligent. Some investors effectively outsourced their investment due diligence to third parties, such as credit rating agencies, without fully understanding the nature of the collateral underlying the bonds, the purpose of the rating or the rating agency's conflicts of interest that may have colored its ratings. Investors must pay more attention to these details, which are critical to understanding the risks and opportunities of ABS investments.

Specific Recommendations

1. New accounting standards for off-balance-sheet transactions and securitizations should be implemented without delay and efforts to weaken the accounting in those areas should be resisted. The IWG applauds the recent action by the FASB finalizing accounting standards that limit exemptions for consolidating off-balance-sheet entities and require more information about securitization transactions. Efforts to water down or delay the implementation of those new requirements should be vigorously resisted.

2. Sponsors should fully disclose their maximum potential loss arising from their continuing exposure to off-balance-sheet asset-backed securities. Sponsoring companies with off-balance-sheet exposure to ABS that they sponsored and/or are servicing should be required to provide full disclosure about how these exposures could affect shareowners if the firm returns the related assets and liabilities to their balance sheets. More transparent disclosure would permit investors to better understand the amount and type of loans that sponsors are originating and the amount of leverage they could create. The disclosure would also provide investors with information about ongoing changes in loan quality and underwriting standards and the potential risks those changes may create in the future. In particular, such disclosure also should describe how those actions could affect the sponsoring firm's capital and liquidity positions, earnings and future business prospects if the firm repurchases the loans onto its balance sheet.

3. The SEC should require sponsors of asset-backed securities to improve the timeliness and quality of disclosures to investors in these instruments and other structured products. Current rules allowing sponsors to issue asset-backed securities via shelf registration provide for woefully inadequate disclosures to potential investors in these products. Because each ABS offering involves a new and unique security, the IWG does not believe the SEC should allow such issuances to be eligible for its normal shelf-registration procedures. Instead, the SEC should develop a regulatory regime for such asset-backed securities that would require issuers to make prospectuses available for potential investors in advance of their purchasing decisions. These prospectuses should disclose important information about the securities, including the terms of the offering, information about the sponsor, the issuer and the trust, and details about the collateral supporting the securities. Such new rules would give investors critical information they need to perform due diligence on offerings prior to investing. It would also create better opportunities for due diligence by the underwriters of such securities, thus adding additional levels of oversight of the quality and appropriateness of structured offerings.

4. ABS sponsors should be required to retain a meaningful residual interest in their securitized products. Having "skin in the game" would make sponsors more thoughtful about the quality of the assets they securitize. Sponsors should have to retain a meaningful residual interest in ABS offerings. Hedging these retained exposures should be prohibited.

Hedge Funds, Private Equity and Investment Companies, Advisers and Brokers

All investment managers of funds available to U.S. investors should be required to register with the SEC as investment advisers so that they are subject to federal scrutiny. All registered fund managers should have to make periodic disclosures to regulators about the current positions of their funds, and should make regular, delayed public disclosures of their funds' positions to help their investors and other market participants understand the associated risks. Regulators should conduct a full review of rules governing investment managers and their funds to ensure that they adequately address the different types of investment vehicles and practices subject to those rules. In order to improve the quality of advice provided to retail investors and to protect them from abusive practices, the SEC should be empowered to reform compensation practices that create unacceptable conflicts of interest, improve pre-sale disclosures, and subject all those who provide personalized investment advice, including broker-dealers, to a fiduciary duty.

Regulators should also be empowered to oversee new participants and products as they emerge and have adequate resources for timely and careful examinations.

Background

Many hedge funds, funds of hedge funds and private equity funds operate within the "shadow" financial system of unregulated non-bank financial entities. These funds and their managers have been exempt from regulation because of a combination of factors related to the number and relative sophistication of investors they serve and the size of assets under management.

Unencumbered by leverage limits, compliance examinations or full disclosure requirements, many hedge funds and private equity funds operate under the radar. Their ability to take on enormous leverage, in particular, enables them to hold huge positions that can imperil the broader market. If market trends move against a hedge fund or a private equity fund and it is forced to liquidate at fire-sale prices, prime brokers, banks and other counterparties could be subject to significant losses. Even market participants who have no direct dealings with the fund could be battered by the resulting plunge in asset prices and liquidity squeeze. Registration would afford a degree of transparency and oversight for these systemically important market players. It would at least ensure disclosure of basic information about the managers and funds and make them eligible for examination by the SEC.

Oversight of the intermediaries that investors rely on in making investment decisions has failed to keep pace with dramatic changes in the industry. These changes include the development and rapid growth of the financial planning profession and changes in the full-service brokerage business model to one that is, or is portrayed as being, largely advisory in nature. Nevertheless, a series of decisions by regulators over the years allowed brokerages to call their sales representatives "financial advisers," offer extensive personalized investment advice and market their services based on the advice offered, all without regulating them as advisers.

As a result, investors are forced to choose among financial intermediaries who offer services that appear the same to unsophisticated eyes, but who are subject to very different standards of conduct and legal obligations to the client. Most significantly, investment advisers are required to act in their clients' best interest and disclose all material information, including information about conflicts of interest, whereas brokers are subject to the less rigorous suitability standard and do not have to provide the same extensive disclosures.

Meanwhile, although investors are encouraged to place their trust in "financial advisers," compensation practices in the industry are riddled with conflicts of interest that may encourage sales of products that are not in clients' best interests. The disclosures that investors are supposed to rely on in making investment decisions are often inadequate and overly complex and typically arrive after the sale–long past the point when they could have been useful to investors in analyzing their investment options.

As innovation produces new institutions, products and practices, federal regulators must be able to bring them under their jurisdiction, too. One important lesson of the recent crisis is that as financial products and services proliferate and become more complex, they often fall through the regulatory cracks. Extending the scope of examinations will require additional funding for regulators and ultimately result in more effective regulation.

Specific Recommendations

1. All investment managers of funds available to U.S. investors should be required to register with the SEC as investment advisers and be subject to oversight. All investment advisers and brokers offering investment advice should have to meet uniform registration requirements, regardless of the amount of assets under management, the type of product they offer or the sophistication of investors they serve. Exemptions from registration should not be permitted, although smaller advisory firms should continue to be overseen by state regulators.

2. Existing investment management regulations should be reviewed to ensure they are appropriate for the variety of funds and advisers subject to their jurisdiction. The frequency and extent of regulatory examinations should be determined by the nature and size of the firm. The exam process should be augmented by independent third-party reviews and reporting. Regulators should be empowered to extend their jurisdictional reach to cover emerging participants and products.

3. Investment managers should have to make regular disclosures to regulators on a real-time basis and to their investors and the market on a delayed basis. Because of the potential systemic risks associated with investment managers, and their interconnections with other systemically important financial institutions, the IWG believes that all investment managers should have to disclose their positions to regulators on a confidential but real-time basis. This would allow regulators to recognize large and growing exposures and take steps to limit their impact.

The IWG also believes that hedge funds and other private pools of capital should make regular but delayed public disclosures about their positions. Delayed disclosure would provide investors a window on the fund manager's investment strategies while preventing other investors from "front-running" those game plans. It would also give the market at large an understanding of the degree of risk inherent in the investment strategies. In light of new trading techniques and products available, regulators should reexamine how often investment companies are required to report their holdings to investors and the market.

4. Investment advisers and brokers who provide investment advice to customers should have to adhere to fiduciary standards. Their compensation practices should be reformed and their disclosures improved. All investment professionals, including broker-dealers who provide personalized investment advice, should be subject to a fiduciary duty to act in their clients' best interests and to disclose material information. Compensation practices that encourage investment professionals to make recommendations that are not in their clients' best interests should be reformed. Disclosures should also be improved to ensure that investors receive pre-engagement disclosure to aid them in selecting an investment professional and clear, plain English, pre-sale

disclosure of key information about recommended investments. This would provide an added level of protection to both retail and institutional clients.

5. Institutional investors—including pension funds, hedge funds and private equity firms—should make timely public disclosures about their proxy voting guidelines, proxy votes cast, investment guidelines, and members of their governing bodies and report annually on holdings and performance. Investors who champion best disclosure practices at portfolio companies have a responsibility to play by similar rules. Best disclosure practices for institutional investors would foster transparency and accountability throughout the capital markets, thus enhancing confidence in the markets. They would also strengthen fiduciary ties between fund beneficiaries and trustees and guard against misuse of fund assets and abuses of the power inherent in large pools of capital. Specifically, institutional investors should make timely, public disclosures about their proxy voting guidelines, proxy votes cast, investment guidelines, members of their governing bodies and report annually on holdings and performance.

Non-Bank Financial Institutions

Congress should enact legislation granting appropriate regulators resolution authority for faltering non-bank financial institutions. Such authority should include explicit powers to seize, wind down and restructure troubled institutions deemed "too big to fail." The IWG generally supports the Administration's proposal for this new authority but does not take a position on where it should be vested and how it should be implemented.

Background

In the 1930s, chaotic and costly bank failures motivated Congress and President Roosevelt to empower federal regulators to seize and wind down, in an orderly fashion, illiquid and insolvent banks. The financial crisis of 2008 included, in particular, a run on several large firms operating in the non-bank financial system. No mechanism existed, however, to deal with the failure of large, complex, interconnected non-bank institutions, such as Bear Stearns, Lehman Brothers or American International Group (AIG). As a result, federal bailouts were ad hoc and inconsistent, fueling further market chaos that threatened the entire financial system.

Specific Recommendation

Congress should give regulators resolution authority, analogous to the FDIC's authority for failed banks, to wind down or restructure troubled, systemically significant non-banks. Banks are no longer the primary systemically significant players in our financial system. The disorderly failure of large, interconnected investment banks, insurers and other institutions could also trigger cascading failures throughout the financial system. A carefully designed resolution regime for large non-banks would provide much needed market stability by ensuring that the essential functions of failed institutions continue relatively uninterrupted. Consideration also should be given to expanded use of the Bankruptcy Code. An orderly liquidation or restructuring would also help minimize the cost to taxpayers over the long run.

Mortgage Originators

All banks and other mortgage lenders should be required to meet minimum underwriting standards. They should also adhere to baseline standards for documenting and verifying a borrower's ability to repay and for ensuring that loans and credit lines they issue are appropriate for particular borrowers. A new consumer product oversight agency could help ensure that mortgage lenders adhere to such standards and requirements. Mortgage lenders should be required to retain a meaningful residual interest in all loans and credit lines they originate.

Background

Over the past 20 years, the link between mortgage underwriting and origination and retention of the risk of repayment has become increasingly attenuated. Although mortgage bankers and brokers, as well as some bank loan officers, have always been paid on the basis of the size of the loan and its characteristics, it has become common for brokers and others to be paid more for loans with higher interest rates or other characteristics (such as prepayment penalties) that in fact make it harder for borrowers to repay. The practice encouraged steering borrowers to loans for which they were not qualified and falsifying income and other data so borrowers could get loans they could not afford. Lenders that quickly sold loans to packagers of securitized products had little or no interest in the borrowers' ability to repay. Ultimately, investors who purchased mortgage-backed securities shouldered the credit risk.

The lack of meaningful federal oversight of consumer credit product providers exacerbated the off-loading of risk to investors. Without minimum standards and oversight applied consistently to all mortgage lenders, many of the largest mortgage originators "regulated" themselves—and competition drove down standards. The consequences were disastrous for borrowers, lenders, communities and the economy as a whole.

Specific Recommendations

1. Congress should create a new agency to regulate consumer financial products, including mortgages. The financial crisis has demonstrated that mortgage originators cannot exercise necessary market self-discipline and that current regulatory structures, where they exist, have failed to provide appropriate protection for both consumers and investors. The IWG supports the Administration's call for a new federal agency to regulate consumer financial products and payment systems. The agency should have broad rulemaking, oversight and enforcement authority.

2. Banks and other mortgage originators should comply with minimum underwriting standards, including documentation and verification requirements. Mortgage originators will make more responsible lending decisions if they face minimum underwriting standards that are subject to review by federal and state regulators. These standards should be based on a realistic appraisal of the borrower's ability to repay the debt, taking into account any features that would increase the payments in the future. Such standards should also require mortgage originators to obtain and verify key financial information from all borrowers and to obtain and retain evidence that the borrower has seen and agreed with this information before a loan is closed. Federal and state

regulators should monitor all mortgage originators for compliance with these practices. These changes should reduce the "race to the bottom" that characterized the last decade.

3. Mortgage regulators should develop suitability standards and require lenders to comply with them. This will help ensure that mortgage companies consider carefully whether a particular credit product is appropriate for a particular borrower. Innovative features in mortgage products can help certain borrowers. But these should be tailored to each borrower's needs and ability to repay, and originators should be required to offer consumers the best possible mortgage rates, fees and terms for which they qualify.

4. Mortgage originators should be required to retain a meaningful residual interest in all loans and outstanding credit lines. Having "skin in the game" would make lenders more thoughtful about the credit-worthiness of potential borrowers. Mortgage lenders should be required to retain a meaningful interest in all loans and outstanding credit lines they generate. Federal and state regulators should be empowered to determine the minimum holding period and related terms and conditions. Lenders should be prohibited from hedging these exposures.

Nationally Recognized Statistical Rating Organizations

The failure of Nationally Recognized Statistical Ratings Organizations to alert investors to the risks of many structured products underscores the need for significant change in the regulation of credit rating agencies. Congress should grant the SEC greater authority to scrutinize NRSROs. Congress and the Administration should consider steps to encourage alternatives to the predominant, issuer-pays NRSRO business model. Congress also should eliminate the safe harbor in Section 11 of the Securities Act of 1933 that shields rating agencies from liability for due diligence failures. And to deter investors from relying too heavily on rating agencies, lawmakers and regulators should remove or diminish provisions in laws and regulations that designate minimum NRSRO ratings for specific kinds of investments.

Background

Credit ratings issued by NRSROs are widely embedded in federal and state laws, regulations and private contracts. Ratings determine the net capital requirements of financial institutions globally under the Basel II capital accords. They also dictate the primary types of investment securities that money market funds and pension funds may hold. Partly as a result, many institutional investors have come to rely on credit rating agencies as a basic investment screen, a problem that is exacerbated by the lack of adequate disclosures in the sale of asset-backed securities.

Despite the semi-official status of NRSROs as financial gatekeepers, the rating agencies face minimal federal scrutiny. The Credit Rating Agency Reform Act of 2006 did not much alter that "light-touch" oversight. Although it standardized the process for NRSRO registration and gave the SEC new oversight powers, those powers were limited. It also expressly ruled out any private right of action against an NRSRO.

The central role that rating agencies played in the financial crisis makes such limited oversight untenable. The leading NRSROs— Fitch Ratings, Moody's Investors Service and Standard & Poor's Ratings Services—maintained high investment-grade ratings on many troubled financial institutions until they were on the brink of failure or collapse. And well into the credit crisis, NRSROs maintained triple-A ratings on complex structured financial instruments despite the poor and deteriorating the quality of the sub-prime assets underlying those securities.

The conflicted issuer-pays model of many NRSROs contributed to their poor track record. Most NRSROs are paid by companies and securitizers whose debt they rate. With their profitability dependent on the rapidly growing business of rating structured finance products, rating agencies appear to have been all too willing to assign the high ratings that originators and underwriters demanded. Questions about the quality of their ratings continued to rise in recent years even as they rated more and more complicated instruments.

But credit rating agencies' statutory exemption from liability also keeps NRSROs from having to answer for their shoddy performance and poorly managed conflicts of interest. Credit rating agencies have long maintained that their ratings are merely opinions that should be afforded the same protection as the opinions of newspapers and other publishers. Judicial rulings have tended to support their claim to protected status.

To be sure, some investors relied too heavily on NRSRO ratings, ignoring warning signs such as the rating agencies' notorious failure to downgrade ratings on Enron and other troubled companies until they were on the brink of bankruptcy. And some investors ignored or failed to comprehend the fundamental differences between ratings on structured securities and ratings on traditional debt instruments.

Statutory and regulatory reliance on ratings encourages investors to put more faith in the rating agencies than they should. If the rating agencies cannot dramatically improve their rating performance, they should be weaned from such official seals of approval. At the very least, legal references to ratings should make clear that reliance on them does not satisfy the requirement that investors perform appropriate due diligence to determine the appropriateness of the investments. In other words, ratings should be seen not as a seal of approval for certain investments but as defining the investments that should not be considered for a particular purpose.

The IWG recognizes that it is not practical to abolish the concept of NRSROs and erase references to NRSRO ratings in laws and regulations, at least not with one stroke. Mandates to use ratings are embedded in many financial rules. The more practical course for the near term is to reform credit rating agency regulation and to work toward reducing or removing references to credit ratings in laws and regulations.

Specific Recommendations

1. Congress and the Administration should consider ways to encourage alternatives to the predominant issuer-pays NRSRO business model. In addition, the fees earned by the NRSROs should vest over a period of time equal to the average duration of the bonds. Fees should vest based on the performance of the original ratings and changes to those ratings over time relative to the credit performance of the bonds. Credit rating agencies that continue to operate under the issuer-pays model should be subject to the strictest regulation.

2. Congress and the Administration should bolster the SEC's position as a strong, independent overseer of NRSROs. The SEC's authority to regulate rating agency practices, disclosures and conflicts of interest should be expanded and strengthened. The SEC should also be empowered to coordinate the reduction of reliance on ratings.

3. NRSROs should be required to manage and disclose conflicts of interest. As an immediate step, NRSROs should be required to create an executive-level compliance officer position. More complete, prominent and consistent disclosures of conflicts of interest are also needed. And credit raters should disclose the name of any client that generates more than 10 percent of the firm's revenues.

4. NRSROs should be held to a higher standard of accountability. Congress should eliminate the effective exemption from liability provided to credit rating agencies under Section 11 of the Securities Act of 1933 for ratings paid for by the issuer or offering participants. This change would make rating agencies more diligent about the ratings process and, ultimately, more accountable for sloppy performance.

NRSROs should not rate products for which they lack sufficient information and expertise to assess. Credit rating agencies should only rate instruments for which they have adequate information and should be legally vulnerable if they do otherwise. This would effectively limit their ability to offer ratings for certain products. For example, rating agencies should be restricted from rating any product that has a structure dependent on market pricing. They should not be permitted to rate any product where they cannot disclose the specifics of the underlying assets. Credit rating agencies should be restricted from taking the metrics and methodology for one class of investment to rate another class without compelling evidence of comparability.

5. Reliance on NRSRO ratings should be greatly reduced by statutory and regulatory amendments. Market participants should reduce their dependence on ratings in making investment decisions. Many statutes and rules that require certain investors to hold only securities with specific ratings encouraged some investors to rely too heavily on credit ratings. Eliminating these safe harbors over time, or clarifying that reliance on the rating does not satisfy due diligence obligations, would force investors to seek additional and alternative assessments of credit risk.

C. Corporate Governance

Investors need better tools to hold managers and directors accountable for their actions. Improved corporate governance requirements would also help restore trust in the integrity of U.S. financial markets. In particular, shareowners' ability to hold an advisory vote on the compensation of senior executives, as well as their ability to nominate and elect directors, must be enhanced. Board independence should also be strengthened.

Background

The global financial crisis represents a massive failure of oversight. Vigorous regulation alone cannot address all of the abuses that paved the way to financial disaster. Shareowner-driven market discipline is also critical. Too many CEOs pursued excessively risky strategies or investments that bankrupted their companies or weakened them financially for years to come. Boards were often complacent, failing to challenge or rein in reckless senior executives who threw caution to the wind. And too many boards approved executive compensation plans that rewarded excessive risk-taking.

But shareowners currently have few ways to hold directors' feet to the fire. The primary role of shareowners is to elect and remove directors, but major roadblocks bar the way. Federal proxy rules prohibit shareowners from placing the names of their own director candidates on proxy cards. Shareowners who want to run their own candidates for board seats must mount costly full-blown election contests. Another wrinkle in the proxy voting system is that relatively few U.S. companies have adopted majority voting for directors. Most elect directors using the plurality standard, by which shareowners may vote for, but not against, a nominee. If they oppose a particular nominee, they may only withhold their votes. As a consequence, a nominee only needs one "for" vote to be elected and unseating a director is virtually impossible.

Poorly structured pay plans that rewarded short-term but unsustainable performance encouraged CEOs to pursue risky strategies that hobbled one financial institution after another and tarnished the credibility of U.S. financial markets. To remedy this situation, stronger governance checks on runaway pay are needed.

Specific Recommendations

1. In uncontested elections, directors should be elected by a majority of votes cast. At many U.S. public companies, directors in uncontested elections are elected by a plurality of votes cast. An uncontested election occurs when the number of director candidates equals the number of available board seats. Plurality voting in uncontested situations results in "rubber stamp" elections. Majority voting in uncontested elections ensures that shareowners' votes count and makes directors more accountable to shareowners. Plurality voting for *contested* elections should be allowed because investors have a more meaningful choice in those elections.

2. Shareowners should have the right to place director nominees on the company's proxy. In the United States, unlike most of Europe, the only way that shareowners can run their own candidates is by waging a full-blown election contest, printing and mailing their own proxy cards to shareowners. For most investors, that is onerous and prohibitively expensive. A measured right of access would invigorate board elections and make boards more responsive to shareowners, more thoughtful about whom they nominate to serve as directors and more vigilant in their oversight of companies. Federal securities laws should be amended to affirm the SEC's authority to promulgate rules allowing shareowners to place their nominees for directors on the company's proxy card.

3. Boards of directors should determine whether the chair and CEO roles should be separated or whether some other method, such as lead director, should be used to provide independent board oversight or leadership when required. Boards of directors should be encouraged to separate the roles of chair and CEO or explain why they have adopted another method to assure independent leadership of the board.

4. Exchanges should adopt listing standards that require compensation advisers to corporate boards to be independent of management. Compensation consultants play a key role in the pay-setting process. But conflicts of interest may lead them to offer biased advice. Most firms that provide compensation consulting services to boards also provide other kinds of services to management, such as benefits administration, human resources consulting and actuarial services. These other services can be far more lucrative than advising compensation committees. Conflicts of interest contribute to a ratcheting-up effect for executive pay. They should be minimized and disclosed.

5. Companies should give shareowners an annual advisory vote on executive compensation. Nonbinding shareowner votes on pay would make board compensation committees more careful about doling out rich rewards to underperforming CEOs, and thus would avoid the embarrassment of shareowner rejection at the ballot box. So-called "say on pay" votes would open up dialogue between boards and shareowners about pay concerns.

6. Federal clawback provisions on unearned executive pay should be strengthened. Clawback policies discourage executives from taking questionable actions that temporarily lift share prices but ultimately result in financial restatements. Senior executives should be required to return unearned bonus and incentive payments that were awarded as a result of fraudulent activity, incorrectly stated financial results or some other cause. The Sarbanes-Oxley Act of 2002 required boards to go after unearned CEO income, but the Act's language is too narrow. It applies only in cases where misconduct is proven—which occurs rarely because most cases result in settlements where charges are neither admitted nor denied—and only covers CEO and CFO compensation. Many courts, moreover, have refused to allow this provision to be enforced via private rights of action.

II. SYSTEMIC RISK OVERSIGHT BOARD

The Investors' Working Group believes there is an immediate need to monitor and respond to risks to the entire financial system posed by large, complex, interconnected institutions, practices and products and supports the creation of an independent Systemic Risk Oversight Board to supplement, not supplant, the functions of existing federal financial regulators. The mission of the board should include collecting and analyzing the risk exposure of bank and non-bank financial institutions, as well as those institutions' practices and products that could threaten the stability of the financial system and the broader U.S. economy; reporting on those risks and any other systemic vulnerabilities; and recommending steps regulators should take to reduce those risks.

The Systemic Risk Oversight Board would fill an immediate void on systemic issues, and its future would be shaped by the findings of the Financial Crisis Inquiry Commission.

Background

The current U.S. system of financial regulation was not designed to monitor and respond to risks to the entire financial system posed by the interconnectedness of complex institutions, practices and products. To properly address the range of significant threats to the broader financial system, we need better and more coordinated information about a wide range of exposures. Mechanisms to identify and assess information on rapidly expanding markets and products also are critical.

Many factors contributed to the financial crisis, including excessive leverage, lax mortgage underwriting standards and a weak understanding of the risk profiles of complex securitized products. Just as devastating, however, was the absence of any oversight mechanism to track and sound early warnings about the extent to which financial institutions had taken on excessive leverage or held dangerously large concentrations of specific securities.

Individual exposures and the interconnections between institutions with significant exposures were misunderstood or not recognized and, in many cases, hidden from view. AIG was widely recognized as the king of credit-default swaps. But few appreciated that AIG's activities in the CDS market could not just produce catastrophic losses for the company; they imperiled dozens of AIG's counterparties too. The failure to count and connect the dots applied to highly regulated entities as well as those, such as hedge funds and private equity firms, which were lightly or not at all supervised. Even now, regulators world-wide are still sorting out the number and interrelations of many structured financial instruments.

One clear lesson of the financial crisis is the need for an ongoing effort to aggregate and analyze relevant risk exposure information across firms, securities instruments and markets. This oversight must keep up with financial innovation and be able to coordinate with regulators outside the United States. And it must suggest corrective steps before particular risks grow big or concentrated enough to threaten entire markets or economic sectors.

By taking a panoramic view, a Systemic Risk Oversight Board would be quicker to recognize emerging threats than would regulators that tend to focus more narrowly on the safety and soundness of individual institutions or on conduct that harms consumers and investors. In particular, the board would be able to identify practices designed to escape regulatory attention and other efforts by firms or individuals to exploit the cracks between various agencies' jurisdictions.

Much of the discussion surrounding systemic risk oversight has focused on two alternative approaches. One is to set up a strong systemic regulator in the more traditional sense: an agency with statutory authority that permits it to analyze and take direct action to contain or defuse emerging systemic risks before they wreak havoc. The other approach envisions a hybrid advisory council that would be a research- and information-sharing body with formal regulatory powers to address systemic imbalances. This "college of cardinals," as Senator Mark Warner (D-VA) has dubbed it, would have regulatory and enforcement authority and perhaps consist of the heads of key financial regulators.

The IWG believes both of these approaches have major drawbacks. First, the Administration and others in favor of a macro regulator with expansive, plenary authority over systemic risk regulation envision the Federal Reserve playing that role. But that would vest far too much authority in an agency whose credibility has been damaged by its own part in the financial cataclysm. The Fed's easy credit policies, pursued with the aim of stimulating the economy, enabled financial firms to lever up to sky-high levels and amass large concentrations of risky complex securitized products. The potential for conflict between monetary policy, the Fed's primary responsibility, and systemic oversight also argues against making the Fed the systemic risk regulator.

The Federal Reserve's existing duties are daunting enough. Besides crafting monetary policy, the Fed also supervises bank holding companies and the U.S. activities of foreign-owned banks and manages the vast U.S. payments system. Regulating systemic risk would heap too much responsibility on the Fed's already-full plate. Finally, the Federal Reserve's tendency to favor secrecy over public disclosure could undermine transparency and crucial consumer and investor protections.

The IWG also is concerned about systemic oversight via a coordinating council of existing financial regulators. Such a council would add a layer of regulatory bureaucracy without closing the gaps that regulators currently have in skills, experience and authority needed to track systemic risk comprehensively.

The IWG believes that a Systemic Risk Oversight Board would strike an appropriate balance between the two models. We advocate immediate creation of an independent board vested with broad powers to examine information from both bank and non-bank financial institutions and their regulators. The board would also have the authority to make recommendations to the appropriate regulators about how to address potential systemic threats. Regulators would either have to comply or justify an alternative course of action. In this way, existing regulators would still have the primary role in addressing systemic risk but could not ignore the board's findings or advice.

The long-term approach to systemic risk issues and the role of the Systemic Risk Oversight Board should hinge on the results of the Financial Crisis Inquiry Commission. One option would be for the Systemic Risk Oversight Board to evolve into a full-fledged regulator, if that is what policymakers determine is best.

Specific Recommendations

1. Congress should create an independent governmental Systemic Risk Oversight Board. To function efficiently, the board should consist of a chair and no more than four other members. All should be presidential appointees confirmed by the U.S. Senate. The board would be accountable primarily to Congress.

2. The board's budget should ensure its independence from the firms it examines. Funding should be adequate and sustainable to attract and retain highly competent board members and staff. Appropriate funding options include an industry assessment fee similar to that of the Public Company Accounting Oversight Board (PCAOB).

3. All board members should be full-time and independent of government agencies and financial institutions. Members should possess broad financial market knowledge and expertise. Collectively, the members should have backgrounds in investment practice, risk management and modeling, market operations, financial engineering and structured products, investment analysis, counterparty matters and forensic accounting.

4. The board should have a dedicated, highly skilled staff. Staffers should have a range of key skills and experiences and work exclusively for the board. They should be experts who understand the components and complexities of systemic risk and how to fully examine critical interconnections between firms and markets. To attract and retain top-notch individuals, staff and board member salaries should be commensurate with those of the PCAOB.

5. The board should have the authority to gather all information it deems relevant to systemic risk. The IWG believes that federal regulators do not currently have the full scope and depth of information they need to understand systemic risks in the U.S. financial system, much less the behavior of those risks in the context of global markets. For the Systemic Risk Oversight Board to have that capability, it should develop a timely way to identify a broad range of threats emanating from institutions, markets, practices, financial instruments and emerging products. Therefore, the board should have the legal authority to gather all the financial information it deems necessary to assess systemic vulnerabilities.

Defining such threats is not a static process. Systemic risks do not lurk only in systemically significant institutions. Highly concentrated market segments or critical financial instruments can threaten the health of the financial system. Risk may be baked into regulation in ways that are not well understood. For example, the financial crisis has revealed the danger to the markets of rules that make credit rating agencies gatekeepers for issuing debt without ensuring that they are independent and accountable for the accuracy of their ratings.

The board would need to develop appropriate procedures for determining which entities to examine and what information to review. It would need a degree of flexibility so that its focus and examinations could adjust to shifts in market conditions. The board and staff should be able to use their professional judgment to determine the scope of analysis for financial institutions, products or practices. The board should also have the authority to hire consultants and other experts as needed.

6. The board should report to regulators any findings that require prompt action to relieve systemic pressures and should make periodic reports to Congress and the public on the status of systemic risks. If appropriate, the board would also report its findings to specific companies and other institutions. The board should take steps to mitigate any severe market reactions or disruptions that could occur as a result of its reports. How the board reports its activities and findings should take into consideration the confidential nature of much of the information it will gather and the potential for market mayhem if information is not dealt with properly.

The board should also provide comprehensive, periodic reports on the state of systemic risks to all relevant regulators and Congress or committees designated by Congress as well as the public. As appropriate, the board should consult with systemic risk overseers outside the United States. The board should consult with regulators and Congress about the nature of any information it releases publicly.

7. The board should strive to offer regulators unbiased, substantive recommendations on appropriate action. As an independent monitor, the board should identify firms and markets that are at risk before significant damage is done. This might entail identifying exposures, modeling potential solutions and communicating those recommendations fully and clearly to regulators. Regulators should determine whether and how to implement the board's recommendations. Where appropriate, the board should coordinate its recommendations with those of overseas systemic risk overseers.

8. Regulators should have latitude to implement the oversight board's recommendations on a "comply or explain" basis. Regulators are generally better positioned to understand the operational and practical implications of a proposed regulatory action, and a regulator may believe that it would be appropriate to refine or modify a recommendation of the board. For this reason, the IWG does not believe that the Systemic Risk Oversight Board should have regulatory authority or other powers to force a regulator to implement a recommendation.

Instead, the recommendations would shift the onus of systemic risk mitigation onto regulators, by requiring them either to 1) adopt and implement the recommendation(s) as suggested, 2) refine and modify the recommendations as they deem necessary, or 3) reject them and take no further action or follow another course. In the case of options 2 or 3 above, the regulator would provide the board a detailed explanation of its response. This should include a discussion of any alternative approach to address the systemic risk the board identified. The regulator should also address any concerns or issues that could emerge if its alternative approach is not consistent with the coordinated response of other regulators. If the board is not satisfied with the regulator's response, it should communicate its concerns to the President and appropriate Congressional authorities.

ABOUT THE SPONSORING ORGANIZATIONS

About the CFA Institute Centre for Financial Market Integrity

The CFA Institute Centre for Financial Market Integrity develops timely, practical solutions to global capital market issues, while advancing investors' interests by promoting the highest standards of ethics and professionalism within the investment community worldwide. It builds upon the 40-year history of standards and advocacy work of CFA Institute, especially its Code of Ethics and Standards of Professional Conduct for the investment profession, which were first established in the 1960s. In 2007, the CFA Institute Centre published *Self-Regulation in Today's Securities Markets: Outdated System or Work in Progress?*, a report that explored the failure of the current system of self-regulation to keep pace with the dramatic evolution of the global economy.

About the Council of Institutional Investors

The Council of Institutional Investors is a nonprofit association of public, union and corporate pension funds with combined assets exceeding $3 trillion. Member funds are major long-term shareowners with a duty to protect the retirement assets of millions of American workers. The Council strives to educate its members, policymakers and the public about good corporate governance, shareowner rights and related investment issues, and to advocate on our members' behalf. Corporate governance involves the structure of relationships between shareowners, directors and managers of a company. Good corporate governance is a system of checks and balances that fosters transparency, responsibility, accountability and market integrity.

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Testimony of
Gregory W. Smith
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Public Employees' Retirement Association of Colorado
before the
Subcommittee on Oversight and Investigations
of the
Committee on Financial Services
on
Oversight of the Credit Rating Agencies Post Dodd-Frank
July 27, 2011

Attachment 3

Frank Partnoy, Rethinking Regulation of Credit Rating Agencies: An Institutional Investor Perspective

Council of Institutional Investors
The Voice of Corporate Governance

Rethinking Regulation of Credit Rating Agencies:

An Institutional Investor Perspective

Prepared by Frank Partnoy
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April 2009

This white paper was commissioned by the Council of Institutional Investors to educate its members, policymakers and the general public about proposals to regulate credit rating agencies 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.

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Council of Institutional Investors
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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.

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 sections address the pros and cons of two major areas of reform: oversight and accountability.

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 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, 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]

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 Dec. 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 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.

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.

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.

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.

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 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 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.

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.

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.

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.

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:

> "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, CME Group, Eaton Vance, Federated Investors, Franklin Resources, Invesco, Morningstar, NASDAQ OMX Group, 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.

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, 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.

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.

Endnotes

[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).

[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.

[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.

[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.

[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.

[8] See S&P, Fundamentals of Structured Product Ratings, at 9.

[9] 2008 SEC NRSRO Report, at 41.

[10] 17 CFR 243.100-243.103.

[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).

[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).

[17] Moody's Corporation Schedule 14A, March 18, 2009, at 19.

[18] Quinn v. McGraw-Hill, 168 F.3d 331, 336 (7th Cir. 1999).

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Committee on Financial Services

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