Testimony Concerning
Proposals to Enhance the Regulation of Credit Rating Agencies

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Overview

Rapid Ratings International, Inc. ("Rapid Ratings") would like to thank the U.S. Senate Committee on Banking, Housing, and Urban Affairs for inviting us to provide testimony to the critical subject of Rating Agency regulation.

This is an essential topic for the global financial markets, US citizens and residents who have been directly and indirectly affected by the actions of the large, incumbent rating agencies, and those newer ratings firms, like ours, that have built a viable alternative to the status quo.

Rapid Ratings is a subscriber-paid firm. We utilize a proprietary, software-based system to rate the financial health of thousands of public and private companies and financial institutions quarterly. We use only financial statements, no market inputs, no analysts, and have no contact in the rating process with issuers, bankers or advisors. Our ratings far outperformed the traditional issuer-paid rating agencies in innumerable cases such as Enron, GM, Delphi, Parmalat, LyondellBasell, Pilgrim's Pride, Linens 'N Things and almost the entire US Homebuilding industry.

Currently, we are not a Nationally Recognized Statistical Rating Organization ("NRSRO"). We have not applied for the NRSRO status and do not have immediate plans to do so. At present, there are too many mixed messages coming from the SEC, Treasury and Congress for me to recommend to our shareholder that the designation is in their best interests. The Treasury proposal's requirement that all ratings firms would be required to register is another curve ball in an already changing playing field.

That said, we believe that reform in our industry is necessary and must happen with a sense of urgency. However, we caution that speed for speed's sake may have significant, and counter-productive, unintended consequences.

US legislation and regulations have both global and national effects, hard lessons reinforced over the last two years. Despite years of legislative action on corporate governance, Sarbanes Oxley (2002) and the Credit Rating Agency Reform Act (2006), through a combination of conflict of interest, self-interest and, unfortunately, entrenched regulatory protection, issuer-paid rating agencies (principally S&P, Moody's and Fitch (the "Big Three")) facilitated a toxic asset flood that deluged the global markets, contributing to the worst economic crisis in 80 years.

The SEC has been wrestling with new rules and rule amendments and has made some headway in areas of curbing conflicts of interest. Though not attacking and seeking to end the clearly conflicted issuer-pay revenue model, the Commission is taking some positive initiatives to curb the more egregious behavior evidenced by these conflicts. The new Department of Treasury proposal, however, takes multiple steps in the wrong direction and threatens to further solidify the entrenched position held by the Big Three, erecting further hurdles to competition in this industry. The Treasury proposals are misdirected in 5 areas:

1. **One-size does not fit all:** Proposals designed to fix major deficiencies in the issuer-paid business model should not be loaded indiscriminately on to subscriber-paid agencies, thus increasing their costs, increasing barriers to entry and reducing competition.

2. **Disclosure Rules Affecting Intellectual Property:** The new rules must avoid requiring the forced disclosure of proprietary intellectual property. Appropriate safeguards must be introduced to protect intellectual property.

3. **Accuracy:** It is unreasonable to believe the SEC can effectively be the arbiter on accuracy in the ratings industry. The market will decide very effectively which ratings are more accurate through usage of competing credit rating agencies ("CRAs"), as long as there are not barriers to entry protecting S&P, Moody's and Fitch and disadvantaging new entrants or small rating agencies.

4. **Forcing NRSRO registration** on all companies issuing ratings will force compliance costs on new CRAs thus erecting further barriers, potentially force small CRAs out of business and deter potential new capital sources entering this industry, all thereby undermining the growth of innovative and more accurate ratings technology. The vast number of firms captured by this sweeping net would not only confuse users of ratings, potentially hundreds of new agencies would be designated that would not have qualified as NRSROs under the Credit Rating Agency Reform Act of 2006. All of these would fuel the use of the largest brand names, and solidify regulatory protection of S&P, Moody's and Fitch.

5. **Rating Disclosure:** Requiring subscriber-based rating agencies to disclose their history of ratings can undermine the subscriber-based business model which is predicated on selling current and past ratings to investors. The Treasury proposal covers all types of rating agencies and for 100% of their ratings. This erects a major barrier to competition by subscriber-based CRAs against the issuer-paid CRAs by stripping them of their

revenues. This proposal may violate anti-trust laws because the proposal undermines competition.[1]

The Big Three have lobbied heavily to promote the notion that all business models carry conflicts of interest and therefore that theirs is no worse than any other. Can conflicts occur in other business models? Sure. Have conflicts in other business models contributed to a catastrophic financial disaster that taxpayers will be paying for dearly for years to come? No. This red herring cannot drive new legislation. The problem is not the potential behavior of the subscriber-paid rating agencies; rather it is the misbehaviors of the issuer-paid rating agencies that have already occurred.

Effective legislation and regulatory framework must focus on reforming the issuer-paid model's most negative features, providing oversight of the NRSROs that prevent the self interested behavior that contributed to the current financial crises and creating an even playing field for competition. The latter has two major components: fostering (or at least not inhibiting) new players, methodologies and innovation; and, equivalent disclosure of data used by other NRSROs for rating the highly complex instruments The Big Three have demonstrated are in dire need of alternative sources of opinion.

Innovation and responsible alternatives to a status quo are both highly American traits. For true reform to have a fighting chance, these themes must be protected by the legislative framework for the ratings industry and we must be critically aware of how the unintended consequences of poorly implemented regulations can leave us with a broken system that has proven it is not deserving of protection.

Much of the current legislative effort, including the SEC's newest Rule Amendments, re-proposed rule amendments, Treasury's proposal and initiatives which we understand are underway on the Hill, are all concentrating on largely the same group of issues:

- Ratings shopping
- The consultative relationships between the issuer-paid rating agencies and issuers and their bankers
- Access to the information used in due diligence of structured products
- Disclosure of ratings history and actions

[1] Spectrum Sports, Inc. v. McQuillan: "The purpose of the [Sherman] Act is not to protect businesses from the working of the market; it is to protect the public from the failure of the market. The law directs itself not against conduct which is competitive, even severely so, but against conduct which unfairly tends to destroy competition itself."

- Ratings symbology for structured product ratings
- New payment structures for ratings
- What entities should register as NRSROs
- The existence of ratings in regulations

Largely neglected in the proposals, rules and acts are the following:

- Should the issuer-paid revenue model be abolished?
- The consequences of rules targeting essentially three issuer-paid firms on the subscriber-paid businesses that are growing to provide competition and alternatives to investors
- Accuracy of ratings

Answers and Comments

In the following pages I hope to provide comments on the strengths and weaknesses of the various proposals, detailed comments about the Treasury proposal specifically and broad thoughts on the state of rating agency regulation.

Some of the Committee's specific questions I have repeated and answered below and others are addressed directly and indirectly in the collection of comments given in the following pages. I would be pleased to address any item here in greater detail in a subsequent submission at the Committee's request.

1. ***Q: What is your assessment of the effectiveness, including the strengths and weaknesses, of the Federal regulation of credit rating agencies (including the performance of regulators)?***

   A: Federal regulation has not been successful in protecting institutional and individual investors from capital loss associated with rating agency behavior. The Big Three issuer-paid agencies through a combination of conflict of interest, self-interest and entrenched regulatory protection, facilitated a toxic asset flood that deluged the global markets, contributing to the worst economic crisis in 80 years. All of this occurred despite years of theoretically increased Federal regulation on corporate governance, Sarbanes Oxley (2002) and the Credit Rating Agency Reform Act (2006).

   The payment, communication, consulting, collaboration and ratings shopping that have long underpinned the special relationship between issuers and the Big Three issuer-paid agencies are inarguably conflicts of interest. This does not mean that every rating is tainted or designed in some way to mislead the public. But these elements of the issuer-paid model have been allowed to remain in the past and are only now being addressed in the recent SEC rule changes, re-proposed rules and the recent Treasury proposal. *The core problem, the issuer-paid revenue model, continues to be fundamentally unchallenged. Instead, the collection of regulatory efforts is attempting to curb the most egregious behavior of the issuer-paid agencies -- in other words, the symptoms, not the cause.*

Despite the absence of a fundamental change to the industry, many of the recent real and proposed changes can achieve some positive results and are strengths of the recent regulatory actions. There are fundamental weaknesses as well. Many of these are addressed in the material below.

2. ***Q: What are your views on the strengths and weaknesses of the legislative reforms affecting credit rating agency regulation proposed by the Department of the Treasury, in Subtitle C of Title IX of Treasury's recent proposal?***

A: The Treasury's proposals are a mix of positive steps and disturbing developments. As a whole, the intent seems to be to increase supervision, disclosure and oversight of the agencies and to curb conflicted, poor behavior. That is hard to disagree with. The proposal though, if enacted as written, would have the counterintuitive result of further solidifying the Big Three's oligopoly and creating another set of regulatory hurdles to increased competition and innovation in the industry. Also, the proposals omit comment on a highly topical subject – legal liability of rating agencies, other than fines if there is failure to comply with the rules.

Clearly, any regulatory regime has compliance costs. Those compliance costs can be barriers to entry and serious barriers to entry for smaller new entrants. What is most troubling to us is imposing compliance procedures and costs on a subscriber-paid rating agency which were designed to address serious flaws in the issuer-paid rating agencies. That approach, which is currently being contemplated, will thwart competition and innovation in the ratings industry.

These and other critical issues in the proposal warrant a topic by topic review (descriptions in italics are taken from Treasury's July 21, 2009 press release titled "Administration's Regulatory Reform Agenda Moves Forward: Credit Rating Agency Reform Legislation Sent to Capitol Hill"):

a. **Conflicts of Interest**

   i. ***Bar Firms From Consulting With Any Company That They Also Rate****: Credit ratings agencies will face similar restrictions to other professional service providers, like accountants, and will be prohibited from providing consulting services to companies that contract for ratings.*

Comment: This is, of course, a logical suggestion, and the SEC has already been making efforts in this area. In the absence of fundamental change to the issuer-paid business model itself, this is one of the larger steps that regulators can make to address poor behavior. Locking in relationships with additional service is an anti-competitive practice that is one of many that need to be stopped. Anti-trust action will eventually be required if the current rules are ineffective.

ii. ***Strengthen Disclosure And Management Of Conflicts Of Interest**: The legislation will prohibit or require the management and disclosure of conflicts arising from the way a rating agency is paid, its business relationships, affiliations or other conflicts.*

Comment: There are perfectly reasonable proposals in the plan including disclosure of fees an agency has billed an issuer in the past and disclosure of affiliations between a person associated with an agency and a person associated with an issuer. But, these are relatively light and knowing whether an issuer and an agency have a long standing relationship or not is not terribly relevant. What merits attention are explicit and implicit quid pro quos.

There is however curious language in page 5 of the proposed Act text: Section (4) Commission Rules "The rules issued by the Commission under paragraph (3) shall include – (A) the establishment of a system of payment for each nationally recognized statistical rating organization that requires that payments are structured to ensure that the nationally recognized statistical rating organization conducts accurate and reliable surveillance of ratings over time, as applicable, and that incentives for accurate ratings are in place;"

It is difficult to understand why an NRSRO would need a new incentive for accuracy unless the business model is compromised by conflicts and the threat of serious large scale competition is minimal. The wording of the Act may inadvertently reflect the complacency towards accuracy that sadly exists in the market. An agency shouldn't be compensated for ratings yet require new incentives to produce accurate ratings. The default standard should be to achieve accuracy and the issuer-paid rating agencies are not even close to being market leaders in producing accurate ratings.

"Accuracy" of course is difficult to define and is addressed further below.

iii. ***Disclose Fees Paid By An Issuer Along With Each Rating Report**: Each rating report will disclose the fees paid by the issuer for a particular* *rating, as well as the total amount of fees paid by the issuer to the rating agency in the previous two years.*

Comment: Issuers typically fall into two categories: an individual industrial or financial institution (issuing plain vanilla debt or structured products) or a special purpose issuance vehicle (typically issuing structured products). Historically, vanilla bond (or, non structured product) issuers have chosen to be rated by both S&P and Moody's. Fitch has less market share in the vanilla bond market and therefore is considered a second tier below S&P and Moody's. Conventional bond market wisdom says that both ratings are needed for maximum potential liquidity in a bond, and therefore the best possible pricing at issue. Institutional investors often wonder about an issuer that only chooses to get one of the two ratings. In these circumstances, investors are often concerned that perhaps an issuer received a poor rating indication from the missing agency, and thus the issuer opted to go to market without that rating.

Structured products more commonly would only carry one of the three ratings, where Fitch has a better reputation and is therefore a viable alternative to S&P and Moody's.

Given the limited number of rating agency choices historically, the length of relationship with an issuer and fees paid for ratings are not terribly meaningful statistics. While fee disclosure may be eye-opening to some industry watchers, it won't deter the large agencies from keeping their fee structure or revenue model.

iv. ***Look-Back Requirement To Address The Conflicts From A "Revolving Door":*** *If a rating agency employee is hired by an issuer and if the employee had worked on ratings for that issuer in the preceding year, the rating agency will be required to conduct a review of ratings for that issuer to determine if any conflicts of interest influenced the rating and adjust the rating as appropriate.*

Comment: This is an interesting provision and is the first time we have seen regulation covering the migration of personnel from the ratings agencies to issuers and, more importantly, to the banks providing rating agency advisory services to issuers.

v. ***Designate A Compliance Officer****: Each rating agency will be required to designate a compliance officer – reporting directly to the board or the senior officer of the firm – with direct responsibility over compliance with internal controls and processes. The compliance officer will not be* *allowed to engage in any rating activities, marketing, sales, or setting of compensation; and will be required to submit a report annually to the SEC.*

Comment: The Big Three will see this simply as a cost of doing business. Given their respective sizes as companies, this additional cost is *de minimus* and, might eventually be passed through to the issuers in the form of rate increases.

b. **Transparency & Disclosure**

i. ***Require Disclosure of Preliminary Ratings to Reduce "Ratings Shopping":*** *Currently, an issuer may attempt to "shop" among rating agencies by soliciting 'preliminary ratings' from multiple agencies and then only paying for and disclosing the highest rating it received for its product. We would shed light on this practice by requiring an issuer to disclose all of the preliminary ratings it had received from different credit rating agencies so that investors will see how much "shopping" happened and whether there were discrepancies with the final rating.*

Comment: This proposal is not relevant to subscriber-paid CRAs like Rapid Ratings. Addressing ratings shopping is a positive development for certain. However, ratings shopping is only one manifestation of the collaborative process of working through structures between agency(ies) and issuer. While the issuers may not be soliciting multiple opinions from agencies on the nuances of their structure, they can certainly glean insight from the dialogue with a single agency that assists in structuring a transaction "correctly" to achieve a certain ratings threshold.

ii. ***Require Different Symbols To Be Used To Distinguish The Risks Of Structured Products****: One of the challenges in the current crisis was that investors did not fully realize that the risks posed by structured products such as asset-backed securities are fundamentally different from those posed by corporate bonds, even with similar credit ratings. Our proposal requires rating agencies to use different symbols for structured finance products as an indication of these disparate risks.*

Comment: This is a counterproductive initiative. The problem is not that investors did not know they were buying structured products (in theory corrected by having a new ratings symbol that alerts them); they either knew and were happy to get the higher yield on a highly rated product and/or did not understand the risk of what they were buying (often because they were too complicated) but were allowed to buy the security BECAUSE it was rated. The problem, in the current regulatory effort, is about the "accuracy" of the ratings, not their symbology. No institutional investor bought a structured bond thinking it was a plain vanilla instrument. What the market needs is to have risks of securities rated on a common basis, to provide an adequate apples-to-apples perspective on investment risks. We do not need yet another confusing ratings scale or it will be arbitraged by players (agencies or otherwise) who wish to obscure the relativity of instruments. This proposal is a classic case of window dressing and it is an unnecessary distraction.

iii. ***Require Qualitative And Quantitative Disclosure Of The Risks Measured In A Rating****: Agencies will be required to provide a much fuller picture of the risks in any rated security through the addition of qualitative and quantitative disclosure of the risks and performance variance inherent in any given security. Ratings cannot be a substitute for investor due diligence. Therefore, to facilitate investor analysis, we will require that each rating also include a clear report containing assessments of data reliability, the probability of default, the estimated severity of loss in the event of default, and the sensitivity of a rating to changes in assumptions. This report will present information in a way that makes it simple to compare this data across different securities and institutions. This additional information will increase market discipline by providing clearer estimates of the risks posed by different investments.*

Comment: The devil is in the details on this set of initiatives and requirements. If the NRSRO would be required to establish process and procedures (and then to follow them strictly, disclosing variances and compliance) that seems like a logical development. If, however, the language will be interpreted to mean disclosure of proprietary intellectual property, this seems to tread on very dangerous ground.

c. **Strengthen SEC Authority and Supervision**

i. ***Establish a Dedicated Office for Supervision of Rating Agencies****: Our legislative proposal establishes a dedicated office within the SEC to strengthen supervision of rating agencies and to carry out the enhanced regulations required.*

Comment: The SEC was essentially moving in this direction prior to the Treasury proposal. The questions will surround the SEC's budget and staffing ability for carrying out these new oversight functions. For instance, as one practical problem, hiring officials who have rating agency experience would seem logical. Will the look-back provision need to cover ex rating agency professionals working at the SEC as well as issuers and their underwriters?

More importantly, and more troubling, is the treatment of ratings accuracy. On page 10 of the proposal, "(p) Nationally Recognized Statistical Organization Regulation," it reads "The Commission shall establish an office that administers the rules of the Commission…and to ensure that credit ratings issued by such registrant are accurate…" How is the SEC going to opine on ratings accuracy? The staffing requirements for the SEC to begin rating all issuers to determine the accuracy of agency ratings is massive and a poor use of the commission's time. If the SEC had the desire or the capacity to become the arbiter of what ratings are good and what ratings are not, we certainly would not be in the current financial crises we find ourselves. It is unreasonable to believe the SEC can take on this role. This is a role for the market. Rating users will weed out the inaccurate ratings and embrace the accurate ratings as long as there are no artificial, including regulatory, impediments to their selection of rating agencies.

ii. ***Mandatory Registration**: Unlike the current voluntary system of registration, our proposal would make registration mandatory for all credit rating agencies. This will bring all ratings firms into a strengthened system of regulation.*

Comment: This is truly one of the most surprising, and frankly short-sighted, proposals that have emerged from any front in this current wave of legislative initiatives. It is also counter to one of the significant elements (though not one without its critics) of the Credit Rating Agency Relief Act of 2006, the requirement that new applicants be in business for three years prior to applying.

There are a number of significant problems with this initiative:

- Currently, rating firms have the option to apply for NRSRO status or not. As with Rapid Ratings, some choose not to apply for any one of a number of reasons. Requiring registration, while the hard and soft costs and risks of being an NRSRO are currently unquantifiable as the landscape is changing, is a major hurdle to newer players and is likely a complete disincentive to the de novo firm, as qualified and competent as they may be.

- If the current Treasury proposal language is enacted and interpreted literally, it could be forcing the disclosure of proprietary intellectual property; a precedent we cannot imagine was intended. On Page 2 of the Act:

REVIEW OF INTERNAL PROCESSES FOR DETERMINING CREDIT RATINGS.—

(A) IN GENERAL.—Credit ratings by, and the policies, procedures, and methodologies employed by, each nationally recognized statistical rating organization shall be reviewed by the Commission to ensure that—

(i) The nationally recognized statistical rating organization has established and documented a system of internal controls, due diligence, and implementation of methodologies for determining credit ratings…

(ii) The nationally recognized statistical rating organization adheres to such system; and

(iii) The public disclosures of the nationally recognized statistical rating organization required under this section about its ratings, methodologies, and procedures are consistent with such system.

Subtitle C of Title IX: "Investor Protection Act of 2009".

Rapid Ratings utilizes a proprietary intellectual property that we do not disclose. We give valuable insights into the methodology but we do not provide certain elements of our process to the public. We recognize that some potential subscribers could choose not to do business with us for this reason, but we have not encountered one yet. If we are required to provide that methodology into the public domain, we lose a competitive advantage. Nevertheless, this disclosure is a business decision to protect an asset of the company and is not something we or others like us should have to disclose by fiat. The protection of property rights is an essential component of any strategy for introducing effective competition.

For new players considering entering the ratings business, in concept a good development if they bring something additive to the industry, this disclosure might be a prohibitive hurdle. Deterring new players is of course another way of protecting the current ones.

If joining the ranks of the NRSROs is something a company like Rapid Ratings may elect to do, as under the CRARA of 2006, a high "cost" of being an NRSRO is something we can calculate and decide on based on a risk-reward scenario. If we are required to register AND forced to disclose our intellectual property, that is a very serious problem.

This concept, we understand, was contemplated for the CRARA of 2006 and ultimately dropped.

Where would one draw the line on defining rating agencies? If we follow the Securities Exchange Act of 1934 Section 3(a)(61) definition:

(61) CREDIT RATING AGENCY.--The term "credit rating agency" means any person--

(A) Engaged in the business of issuing credit ratings on the Internet or through another readily accessible means, for free or for a reasonable fee, but does not include a commercial credit reporting company;

(B) Employing either a quantitative or qualitative model, or both, to determine credit ratings; and

(C) Receiving fees from either issuers, investors, or other market participants, or a combination thereof

Section 3(a)(61) Securities Exchange Act of 1934.

Certainly the definition could be interpreted as incorporating every independent research business, Sell-Side research division, select institutional investors, brokers, etc. One purpose of the various qualifications required in the CRARA of 2006 was to ensure that NRSROs were “nationally recognized,” or had at least a modicum of credentials for the job. Under the Treasury’s proposed rule, the market would be flooded with NRSROs, devaluing the designation by definition. Further, Institutional investors will not have the patience to sort through the products and ratings of potentially hundreds of new players. The certain outcome of this would be institutional investors’ flocking to the names they know best already: S&P, Moody’s and Fitch.

Another result of this initiative is that only new players with massive balance sheets will be interested in entering the ratings business. Innovation typically comes from smaller players. If the Treasury’s proposed scenario is realized, the small players will avoid entering and the market will lose something it desperately needs – innovation. And with innovation comes increased accuracy.

Inadvertently, this mandatory registration will further solidify the S&P, Moody’s and Fitch oligopoly.

iii. ***SEC Examination of Internal Controls and Processes****: The SEC will require each rating agency to document its policies and procedures for the determination of ratings. The SEC will examine the internal controls, due diligence, and implementation of rating methodologies for all credit rating agencies to ensure compliance with their policies and public disclosures.*

Comment: These levels of oversight, if the SEC has proper staffing and funding to carry them out, can help to provide a confidence level in the regulatory regime covering the agencies. Holding the NRSROs accountable for their stated controls and processes will be a challenging job but essential for improvement in the industry. That being said, these are still relatively small costs for the Big Three to maintain compliance. This is neither a punishment nor and discouraging development for the large agencies. It will, however, be factored into every NRSROs legal risk management plans. Failure to comply with controls and processes can expose an agency to potential suits by all too willing potential claimants.

d. **Reduce Reliance on Credit Rating Agencies**

i. ***PWG Review of Regulatory Use of Ratings****: Treasury will work with the SEC and the President's Working Group on Financial Markets to determine where references to ratings can be removed from regulations.*

Comment: The use of the NRSRO designation in federal regulations and various statues only further embeds rating agencies into the fabric of the financial and legal markets. Loan documentation, some bond indentures and even some corporate internal risk management procedures are keyed off of NRSROs (read Moody's and S&P).

To reduce over-reliance, one must first address reliance. Congress, Treasury and the SEC can jointly support a reduction (if not total elimination) of NRSRO reference in regulations. Even if it is phased in slowly, the market will respond to the gesture and "lead by example" sentiment.

ii. ***SEC Recently Requested Public Comment on Whether to Remove References to Ratings in Money Market Mutual Fund Regulation****: As part of a comprehensive set of money market fund reform proposals, the SEC requested public comment on whether to eliminate references to ratings in the regulation governing money market mutual funds, as a way to reduce reliance on ratings. Treasury will work with the SEC to examine opportunities to reduce reliance and increase the resilience of the money market mutual fund industry.*

Comment: The money market funds were some of the most vocal speaking out against the removal, when the rule amendments were originally proposed by the SEC last June. This will be a major battle. The embedding of NRSRO terminology over the decades in hundreds of state and federal regulations affecting the investment behavior of banks, insurance companies, pension funds and mutual funds (i.e. the bulk of the investor side of the market) has created a significant level of dependence on an external referee (i.e. S&P and Moody's) to call line fouls and fair balls so that portfolio managers have a credible scapegoat if something goes wrong. The inclusion of the designation in regulations has given the

Big Three a de facto legal and statutory power over many institutional investors and other financial institutions.

iii. ***Require GAO Study On Reducing Reliance***: *In addition to regulatory efforts to reduce reliance on credit ratings, this legislation would require the GAO to study and issue a report on the reliance on ratings in federal and state regulations.*

Comment: The GAO is being given a deadline of 30 months to complete this review. We would strongly suggest a shorter time frame.

e. **Strongly Support SEC Actions on Credit Rating Agencies**

i. ***Enable Additional Ratings On Structured Products***: *Because structured products are often complex and require detailed information to assess, it can be difficult for a rating agency to provide "unsolicited ratings" – ratings on products it was not paid to rate. These ratings, while in existence previously, were ineffective because investors understood that these unsolicited ratings did not benefit from the same information as the fully contracted ratings. The SEC has proposed a rule that would require issuers to provide the same data they provide to one credit rating agency as the basis of a rating to all other credit rating agencies. This will allow other credit rating agencies to provide additional, independent analysis to the market.*

Comment: This is critically important and likely the area where one of the most productive changes can be brought to the ratings industry. The Big Three have lobbied and worked hard to keep ring fenced the structured product ratings business now for years and the information upon which these structures are based. The CRARA's (2006) application by asset class provision was a boon to the incumbent agencies as it essentially allowed them to maintain a private playground in structured products, with now quite obvious and public results.

The SEC's efforts to create equivalent disclosure of the data underlying structured products ratings is a major step in the right direction for allowing competitive ratings of product and analysis into the market. The complexity of instruments is now notorious and the need for new players to join the Big Three in rating them based on the same due diligence data supplied by those who paid for the ratings originally is critical. These comments apply to providing maintenance ratings on existing securities as well as on new securities – as there are plenty of illiquid structured securities on books around the world and currently only a trickle of new issuance (some of which is really a repackaging of tranches of existing securities).

All involved in weighing in on legislative change must focus on this topic closely. It is not as sexy as many other big headline initiatives, and it is extraordinarily complex, but critical. We also strongly urge legislators and regulators to consider the need to fully address the need for equivalent disclosure of assets underlying collateralized loan obligations (CLOs), not currently in the SEC's domain. While Rapid Ratings does not currently rate these structured products, we know the access to this data, which is entirely controlled now by banks and any of the Big Three hired to rate these instruments, is absolutely essential for anyone to rate these securities on an unsolicited basis.

ii. ***Require Disclosure of Full Ratings History****: The SEC has proposed to require NRSROs to disclose, on a delayed basis, ratings history information for 100% of all issuer-paid credit ratings.*

Comment: As of December, the SEC's new rule amendments require issuer-paid businesses to provide 10% of their ratings for free. In December, the Commission also put out for comment again the question of whether or not this disclosure should apply to subscriber-paid rating agencies too and whether or not this disclosure requirement should actually be for 100%.

The Treasury proposal covers all types of rating agencies and for 100% of their ratings. Rapid Ratings' position is that disclosure of ratings actions and history for subscriber-paid firms should be purely voluntary and not mandated by Federal legislation. In short, we get paid for our ratings from subscribers (largely investors) and that is our primary source of revenue. Competing against well-funded, established players is difficult enough without having our source of revenue taken away because we are forced to give away our ratings history for each company. Prior to the Treasury proposal, and in an environment where the NRSRO application is voluntary, disclosing ratings was a choice any firm like ours could evaluate and assess. We have been strong critics of this possible initiative in the SEC's deliberations. Now, with Treasury's wishing to force registration, the combination of these two elements is truly troubling. This is one key area where we have concerns about the thoroughness of their analysis.

Even with an embargo of, say one year, we would still be giving away for free valuable data. For example, of the companies that have defaulted in

2008-2009 (1st half), Rapid Ratings was downgrading those companies approximately 10% per year for the past three years. Thus, two years of declines of these names would be available as early warning signs for users free of charge. That would devastate and cannibalize our earnings potential. We would be forced to give away our competitive advantage in the market.

This is yet another disincentive for new players to compete in the industry and is a boon for the issuer-paid businesses.

In an ironic, well-kept secret, the issuer-paid agencies actually have very thriving subscriber-paid revenue streams. While it is still a much smaller part of their businesses, the Big Three get great mileage out of stating they provide their ratings for free when in fact they do so only in pretty superficial ways today. The SEC, Treasury and the Committee should not be deceived by this. The "free" ratings have time limits and anyone or any firm wanting notifications of updates/changes or more than just a few ratings has/have to pay (a lot) for a subscription. In other words, the Big Three are getting it both ways - from the issuers and the users - money market funds, mutual funds, asset managers, - anyone who invests in bonds and needs to keep track of the ratings on their holdings are compelled to buy a subscription service. Very few users take advantage of the "free" rating.

Perhaps the Committee might want to query the Big Three as to what amount or percentage of their revenues come from ratings subscription based services vs. issuer-paid services.

iii. ***Strengthen Regulation and Oversight of Credit Rating Agencies****: In response to the credit market turmoil, in February the SEC adopted several measures to increase the transparency of the rating agencies' methodologies, strengthen disclosure of ratings performance, prohibit certain practices that create conflicts of interest, and enhance recordkeeping and reporting obligations to assist the SEC in performing its regulatory and oversight functions. The SEC has allocated resources to establish a branch of examiners dedicated specifically to conducting examination oversight of rating agencies.*

Comment: As discussed above in "Establish A Dedicated Office For Supervision Of Rating Agencies," We do not believe the SEC wants to determine what is a good rating and what is not. The market should decide this issue.

3. ***Q: What are your legislative recommendations to enhance the regulation of the credit rating agency industry?***

   A: Our recommendations are largely interspersed through the answers above. As a broad requirement though, the legislative environment must address the fundamental problems of information availability, containing conflicted behavior and accountability by NRSROs while creating a playing field that allows for competition instead of quashing it. Legislation also needs to emphasize ratings accuracy – not by charging the SEC with being able to determine what is accurate and what is not, but by allowing for accuracy to come through innovation, competition and ubiquitous access to information. Our key concerns are:

   - **One-size does not fit all:** Proposals designed to fix major deficiencies in the issuer-paid business model should not be loaded on to subscriber-paid agencies, thus increasing their costs, increasing barriers to entry and reducing competition.
   - **Disclosure Rules Affecting Intellectual Property:** The new rules must avoid requiring the forced disclosure of proprietary intellectual property. Appropriate safeguards must be introduced to protect intellectual property.
   - **Accuracy:** It is unreasonable to believe the SEC can effectively be the arbiter on accuracy in the ratings industry. The market will decide very effectively which ratings are more accurate through usage of competing CRAs, as long as there are not barriers to entry protecting S&P, Moody's and Fitch and disadvantaging new entrants or small rating agencies.
   - **Forcing NRSRO registration** on all companies issuing ratings will force compliance costs on new CRAs thus erecting further barriers, potentially force small CRAs out of business and prevent potential new capital sources entering this industry, all thereby undermining the growth of innovative and more accurate ratings technology. The vast number of firms captured by this sweeping net would not only confuse users of ratings, potentially hundreds of new agencies would be designated that would not have qualified as NRSROs under the Credit Rating Agency Reform Act of 2006. All of these would fuel the use of the largest brand names, and solidify regulatory protection of S&P, Moody's and Fitch.
   - **Rating Disclosure:** Requiring subscriber-based rating agencies to disclose their history of ratings can undermine the subscriber-based business model which is dependent on selling current and past ratings to investors for survival. The Treasury proposal covers all types of rating agencies and for 100% of their ratings. This erects a major barrier to competition by subscriber-based CRAs

against the issuer-paid CRAs by stripping them of their revenues. This proposal may violate anti-trust laws because the proposal undermines competition.[2]

4. ***Q: Do you have recommendations to improve the performance of the Securities and Exchange Commission in its oversight of ratings agencies or of ratings agency analysts in their formulation of ratings?***

   A: We would be happy to provide additional information on this topic in a subsequent submission

5. ***Q: Do you feel that credit rating agencies should be required to consider in the rating process any relevant and credible information that comes to their attention from sources other than an issuer?***

   A: We believe that, if a rating agency's business model is to provide qualitative assessments of an entity or pool of assets collateralizing a structured product, it should take into account all data it can reasonably attain and qualify as being reliable. Relying only on the information provided by an issuer takes the issuer-paid conflict to an entirely new level.

6. ***Q: Do you have views on the appropriate scope of legal liability to which credit rating agencies should be subject?***

   A: We understand the Big Three's use of the First Amendment as a first level of protection against suits. Their thinking is that the frivolous suits are best caught in this net and it saves them the trouble and expense of having to fight everyone on an individual basis. Given litigious tendencies, there is merit for all ratings firms to have this level of protection.

   Ultimately, we believe that NRSROs should be held accountable for compliance with their internal procedures, as monitored by the SEC, and SEC regulations for disclosure, compliance, etc. We do believe strongly that ratings are opinions and not recommendations and should not be construed as investment advice.

   We are conscious of an irony as well. Subscription-paid ratings firms enter into subscription contracts with subscribers. These agreements state clearly that ratings are opinions and not recommendations and our users indemnify us in this regard. This

[2] Spectrum Sports, Inc. v. McQuillan: "The purpose of the [Sherman] Act is not to protect businesses from the working of the market; it is to protect the public from the failure of the market. The law directs itself not against conduct which is competitive, even severely so, but against conduct which unfairly tends to destroy competition itself."

protection of both the firm and the subscriber can be achieved because we have the commercial relationship directly with the user of the ratings. With issuer-paid agencies and with subscriber-paid firms, IF public disclosure of ratings actions is indeed mandated, anyone (understanding the distinction between opinion and investment advice or not) can have access to these ratings and use them properly or not. The public disclosure of ratings ironically creates more chance for misunderstanding of the nature of ratings and their misuse as opinions and increases the liability for the rating agency.

7. ***Q: Under what circumstances do you feel that the SEC should revoke the registration of a Nationally Recognized Statistical Rating Organization?***

   A: For the SEC's oversight to have any teeth there must be penalties for non compliance by NRSROs of whatever rules are ultimately in place. We understand there are voices for NRSROs to meet minimum accuracy standards in order to maintain their status. This has a certain appeal but begs the questions of who or what is the benchmark for accuracy against which all others will be measured.

8. ***Q: To what degree, if any, should ratings be embedded in regulatory requirements?***

   A: One of the major reasons the Big Three oligopoly has remained so solid for years is that there is such an extensive web of laws and statues that embed the NRSRO designation. While wholesale removal of these references may not be feasible across all regulations, a phased removal from at least the SEC regulations would send a reasonable signal to the market that the SEC is serious about reducing reliance (and, more to the point, over-reliance) on these ratings.

9. ***Q: What should be done to foster competition and heightened quality in credit ratings?***

   A: covered extensively elsewhere in this document.

Additional Topics of Importance to this Debate

The following are some additional thoughts on two significant topics related to this broad discussion.

1. **Conflicts of Interest – are all models conflicted?**
   Central to the issuer-paid rating agencies' argument for defending their conflicted business model is that the subscriber-paid rating agency business model is also conflicted, suggesting that a modified version of the status quo is the only real alternative. Business as usual and ratings rules entropy are their target goals, and they are succeeding. S&P, Moody's and Fitch, are paid by companies (vanilla bonds, commercial paper, etc) and conduit vehicles (structured products) to provide ratings on securities. The communication, consulting, collaboration and ratings shopping that have long underpinned this relationship between issuer and agency is inarguably a conflict of interest. This does not mean that every rating is tainted or designed in some way to mislead the public. As demonstrated last year by an SEC investigation and in the House Oversight Committee hearings, this conflict is too often a practical hindrance to truthful and objective execution of their obvious fiduciary duty. The infamous S&P email correspondence that said that a security "could be structured by cows and we would rate it" to maintain market share and the CEO of Moody's statement that sometimes they "drank the Kool-Aid" of issuers and bankers representing them, are evidence enough of this claim.

   S&P, Moody's and other defenders of the conflicted issuer-paid model have continually proffered the argument that the primary alternative, subscriber-paid agencies are also conflicted. The argument is that one of these firms will be unduly influenced by a phantom, substantial investor client that has investment positions the agency will wish to support and release ratings that grind the subscriber's ax, lest the agency risk losing that subscriber's business. In comments to the SEC Roundtable to Examine Oversight of Credit Rating Agencies in April, of which Rapid Ratings was an invited participant, S&P and Moody's heads commented, respectively, "every business model has positive and negative aspects" and "conflicts are inherent and must be properly managed for any model." Regarding the new Treasury initiatives, Michael Barr, Assistant Treasury Secretary for financial institutions, was reported on July 22nd as justifying the decision not to heed calls for a fundamental overhaul because "there were conflicts inherent in alternative models too." Assuming the report is accurate, the scales of justice in this case are not balanced if this is the logical foundation for new legislation.

   People interested in rating agency reform need to see very clearly into the irony of this situation – the issuer-paid agencies are drawing an analogy between their daily business model and the potential for a subscriber-paid agency to falsify a rating to benefit a paying customer, an act of fraud and fiduciary malfeasance. There is no evidence or claim we know of that any subscriber-paid agency has ever actually overridden their ratings to benefit a subscriber. In Rapid Ratings' case it would be impossible because all of our ratings are generated by computer algorithms based on empirical and published financial statements (not assumptions and projections) and no analyst opinions are involved. Could other subscriber-paid rating agencies be conflicted? There is a remote chance, but it is highly unlikely; even the mere suspicion that this occurred would be the agency's death knell. The issuer-paid agencies have little substance with which to defend their own model (which, importantly, they switched to from the subscription model in the 1970s because, amongst other reasons, it is more profitable) and therefore are attempting to rely on the shaky argument that their competition is also conflicted. So it is clear that their strategy is that the best defense is an offense. If government wishes to perpetuate the issuer-paid business model, so be it. But, let's not miss the irony of the issuer-paid agencies' shifting public attention away from their committed sins to the uncommitted sins of very small competitors paid by investors who are seeking protection from fiduciary irresponsibility.

2. **Competition**

"Competition" in the ratings business is a word that tends to be under-appreciated and underserved yet is perhaps the biggest recipient of lip-service anyway. The SEC has stated a desire to have 30 NRSROs in coming years and the Treasury proposal (generously interpreted) seeks to force competition by requiring registration of all possible parties. The Big Three even say they welcome competition. Some academic research of late has said that more competition has actually been bad for the ratings business. In the 2005-2006 debate over rating agency reform, in the House one opponent to the bill said that more NRSRO competition would create a financial disaster like the S&L crises years ago.

Competition for competition's sake is not the answer. Competition that effects change though innovation, greater ratings accuracy and the establishment of viable alternatives to the status quo is the answer. The recent Treasury proposal takes a bludgeon to the issue of competition and, if passed through Congress, would serve as a massive disincentive to small and large competitor alike. Imagine the NRSRO landscape without new innovators, without new capital being applied to "fix" that which has been highlighted as being wrong, without creating any checks and balances on the Big Three's ratings accuracy.

Rapid Ratings is only one competitor in the ratings business. We have brought innovation to the space and automation that makes us the most scalable player in the industry. Our ratings accuracy typically surpasses the Big Three and often leads credit default swaps and share price movements of companies. Soon we will be rating more industrial companies than any of the Big Three, and we do all of this without getting paid by issuers but by using a proprietary econometric system to evaluate financial health, not default risk.

3. **Value of Innovation**

Innovations and competition in the ratings business can yield better results than the ratings available from the traditional issuer-paid CRAs. Rapid Ratings has an excellent track record in labeling companies as higher risk months and years before they default, typically one to three years ahead of traditional agencies, and generally ahead of market signals such as share prices and credit default swap spreads by months and sometimes years. The Big Three agencies provide highly lagged indicators of risk that follow and rarely lead market signals. Rapid Ratings generally outperforms market signals. Models that incorporate market signals, by definition, have a difficult time outperforming those market signals. It is not difficult for most models to outperform S&P, Moody's and Fitch.

   a. in high profile anecdotal corporate collapses such as Enron, GM, Delphi, Parmalat, LyondellBasell, Pilgrim's Pride, Levitt Corp and WCI
   b. in US bank collapses such as Wachovia Corp., Wilshire Financial Services Group, Indymac Bancorp Inc, Imperial Credit Industries, Cityscape Financial, Bear Stearns, and Downey Financial Corp., and
   c. in the deterioration of entire sectors as in the US homebuilding industry, where Rapid Ratings warned of decline in early 2006 (and subsequently downgraded companies including, notably, Lennar, Centex, Beazer, Pulte, KB, Ryland, Hovnanian, DR Horton, MDC, Meritage, Standard-Pacific, and Toll Bros).

But it is not just the accuracy of the measurement and categorization of risk which differentiates the value of Rapid Ratings' Financial Health Ratings (FHRs™), a material innovation in the ratings industry. Rapid Ratings also generally provides an early warning of slippage from one risk category and rating level to another long before collapse or default, or an early warning of recovery, helping clients to be pro-active in dealing with counterparties, borrowers and investments.

Conclusion

Additional thoughts on many of the topics above as well as specific analysis of the SEC's recent initiatives can be found in our submission to the "SEC Roundtable to Examine Oversight of Credit Rating Agencies" April 15, 2009. Our submission is linked here: http://www.sec.gov/comments/4-579/4579-20.pdf

Thank you again for inviting me to present my views. Rapid Ratings looks forward to working with the Committee and the SEC in any way possible to assist in the reforms to come. I am happy to follow up with additional material and to answer any questions that come from your review of this submission.