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**UNITED STATES SENATE**
**COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS**

**Assessing the Current Oversight and Operation of Credit-Rating Agencies**

**March 7, 2006**

## INTRODUCTION

Good morning. I'm Jeff Diermeier, and I am the President and Chief Executive Officer of CFA Institute. I would like to thank Senator Shelby, Senator Sarbanes, and other members of this committee for the opportunity to speak to you this morning on this important topic.

First, some background about CFA Institute. CFA Institute is a non-profit professional membership organization with a mission of leading the investment profession globally by setting the highest standards of ethics, education, and professional excellence. CFA Institute is most widely recognized as the organization that administers the CFA examination and awards the CFA designation, a designation that I share with nearly 68,000 investment professionals worldwide. We also fund and support the CFA Centre for Financial Market Integrity, which promotes high standards of ethics, integrity, and professional excellence within the investment community.

A common denominator for anyone involved with our organization is adherence to a Code of Ethics that I am comfortable calling the highest ethical standard that exists for investment professionals. Though adherence to the code is a requirement of being a member of CFA Institute, of holding the CFA designation, or of participating in the CFA

Program, it is nonetheless a voluntary standard. That is, I am talking about a self-regulatory system.

For the record, CFA Institute is a staunch proponent of self-regulation. This approach is embodied not just in our Code of Ethics, but also in a number of additional guidelines and standards we have established in areas such as issuer-paid research and objectivity of analyst research. As I will discuss later, these standards might provide some good models for this committee as it determines how to address the issues before you today.

In most cases, I believe that self-regulation is a preferred alternative to government-imposed regulation, which adds complexities and increases the costs of capital, which are ultimately shouldered by investors large and small. This, of course, is a view shared by regulators and standard-setters themselves, which is why we frequently have worked closely with these groups, including the Securities and Exchange Commission, to develop such standards.

However, a necessary prerequisite to self-regulation is that it must be embraced by the market participants whose activities it attempts to standardize. Such appears not to be the case with credit-rating agencies that have been reluctant to embrace any type of regulation over the services they provide to the investment community. This despite the fact that, from our viewpoint, their business model appears to have significant conflicts. In a business that relies upon public trust for its existence, credit-rating agencies should be held to the highest standards of transparency, disclosure, and professional conduct. Instead, there are no standards. There is no oversight. And, as a result, investors are left in the dark, with no assurance that their interests are being served.

We are glad to see that the committee has listed as a priority for this second Session of Congress the need to address conflict-of-interest and competition concerns that have been raised about credit-rating agencies, as Senator Shelby announced on January 31.

**CURRENT SITUATION**

The lessons learned from the crisis of confidence of the recent past should be clearly etched in our memory and should be part of the compass guiding policies to protect investors' interests and promote efficient, fair capital markets. It was a crisis that reached into all segments of our industry and led to substantial reform throughout our financial system. Despite credit-rating agencies' enormous impact on the issuance of debt securities, influence on market prices, and, consequently, on issuers' cost of capital and ability to access capital, they have not embraced, nor are they covered by, the new regulatory controls.

- Were credit-rating agencies operating within an environment of openness and transparency of business practices, free from substantial conflicts of interest, your committee might have been advised to leave them alone. Such is not the case.
- Their problems notwithstanding, if credit-rating agencies were willing to engage with regulators to address the variety of serious issues facing their business, it would have been reasonable for your committee to let those discussions run their course. Such is not the case.
- Or if credit-rating agencies were eager to avoid regulation, but began serious dialogue about a self-regulatory system, there would be no need for this committee to focus its attention on these issues. But such is not the case.

Instead, credit-rating agencies, a small group of firms with enormous impact on our capital markets, repeatedly have disputed the need for reform. Without clear disclosure of how they manage conflicts that appear to be inherent, we cannot know whether these conflicts put rating agencies' business practices at odds with the interests of the investing public.

What we hear from rating agencies when prompted with the idea of reform does not help matters. They state that theirs is not a product intended for use by investors and that their work should be protected under the first amendment as "journalistic product." These viewpoints, I understand, perform well in the court of law, but they aren't in alignment with the reality that investors do indeed rely on their services as an important tool in verifying the legitimacy of debt securities**.**

Rating agencies seem to want it both ways: They embrace the regulatory protection of NRSRO status and the regulatory requirement that debt issuers seek their services, but they reject any semblance of regulatory checks-and-balances on their business. They wish to continue to operate with no rules for disclosing the processes they use to assign ratings, which are, by all accounts, critical to a healthy capital-market system.

Others here today, I'm sure, will delve more deeply into the conflicts and anti-competitive environment that surround credit-rating agencies. So I will summarize what I see as the significant issues that must be addressed to provide some context for the proposals I will encourage the committee to consider.

- Chief among the issues are conflicts of interest that appear to exist, notably that rating agencies rely so disproportionately on revenues provided from the issuers they rate. These conflicts are exacerbated by rating agencies pitching ancillary services to issuers, such as pre-rating assessments and corporate consulting. In these relationships, the rated company holds the cards, meaning it has the power to end a contract if and when the rating agency offers anything other than a glowing review. Rating agencies are under constant pressure to issue favorable reviews in order to retain a particular book of business. Further, agencies are under no obligation whatsoever to publish their findings. Negative reviews, therefore, may never make their way to the investing public.

- Under ordinary circumstances, competitive market forces might be capable of solving the problem: Those with reputations of full disclosure and investor focus could be expected to rise to the top. But, ironically, the one bit of authority the SEC does have is to require issuers of publicly traded debt securities to receive credit ratings from "Nationally Recognized Statistical Rating Organizations," or "NRSROs." This has the unintended consequence of reducing competition since the threshold for a new entrant in the marketplace to achieve "nationally recognized" status is practically insurmountable. As a result, only five agencies hold this coveted status. In other words, even though rating agencies are not beholden to regulators, they nonetheless are beneficiaries of the rules that are in place for issuers. As the SEC itself noted in a rule proposal to change the definition of "NRSRO," greater competition could provide issuers with more choices, "which would lower their costs for this service. The greater competition in the market for credit ratings and analysis could provide more credible and reliable ratings. Greater competition also could stimulate innovation in technology and methods of analysis for issuing credit ratings, which could further lower barriers to entry."

- The SEC has attempted to work with rating agencies to expand the definition of "NRSRO" and to promote better standards and practices, but the rating agencies have stood together in rejecting the proposals.
- In Senate testimony a year ago, Annette Nazareth, then the SEC's director of market regulation pointed to self-regulation as a potential solution. She said that a "strong and effective industry-led regime could prove to be a constructive and reasonable approach to address a number of concerns involving the credit-rating industry." But credit-rating agencies have rejected all such approaches, whether expansion of regulatory reach, imposed self-regulation, or voluntary self-regulation. They assert protection by the fourth amendment right against searches and seizures and, as previously mentioned, by the first amendment right to free speech, arguing that credit ratings are essentially a "journalistic" product.

It is our belief that the standoff between rating agencies and the SEC is likely to remain unless Congress decides either to expand the SEC's oversight powers and/or to mandate rating agencies to submit to either involuntary regulation or voluntary self-regulation. We commend the committee for your leadership in addressing this issue.

**PROPOSALS**

Regardless of its form, if credit-rating agencies provide a service that relies on public trust—which we believe they do—it should be obvious, even to the strongest free-market supporters, that standardization must take place. Let me be clear that I am not talking about disclosure of methodologies used in rating companies or securities, but rather the development and enforcement of standards of disclosure and transparency, along with the development of accompanying codes of professional conduct that befit an industry that serves, and relies upon, the investing public.

Given the impasse that appears to exist between the SEC and rating agencies, we have a number of suggestions that we believe your committee should consider as it determines how to address the current situation for the benefit of all investors.

- **First, the NRSRO definition is antiquated and must be revised.** The initial hurdle to become "nationally recognized" is high and has had the unintended consequence of reducing the ability of new entrants into the marketplace, placing an emphasis on "recognition" versus an emphasis on competence. No set of legislative or regulatory actions will be able to fully address the problems in this sector until competitive forces are allowed to flow. The mere fact that rating agencies are able to stand together in such uniform fashion to oppose even *self*-regulation should be a demonstration to the committee that competition has been artificially stifled, ironically by an SEC-imposed rule intended to protect investors.
- **Second, regulatory oversight for credit-rating agencies should be assigned to the SEC and rating agencies should be subject to periodic SEC review.** Without adequate authority assigned to the SEC, any changes that rating agencies make—either voluntarily or by regulation—cannot be quantified or verified.
- **Third, I believe the situation we're talking about here with credit-rating agencies is materially similar to a situation we've dealt with in the area of issuer-paid research**. In this case, small companies that are not covered by Wall Street analysts pay firms to provide equity research. You don't have to dig deeply to see the conflicts here. To address these conflicts, CFA Institute and the

National Investor Relations Institute partnered to develop best-practice guidelines for managing the relationship between corporations and financial analysts. I believe these guidelines, entitled “Best Practice Guidelines Governing Analyst/Corporate Issuer Relations,” could serve as a model if and when standards for better managing the relationship between corporations and credit-rating agencies are developed. I have included a copy of the guidelines with my written statement and I call your attention specifically to page five of the document, which identifies specific disclosures, checks, and balances related to issuer-paid research.

Another relevant situation of the recent past is the well-documented conflict that historically has existed between the investment-banking and research departments at brokerage firms. This, of course, had a multitude of consequences, most notably that analysts received pressure from both inside and outside their firms to issue favorable recommendations on the stock of current and potential investment-banking clients. In this case, CFA Institute developed Research Objectivity Standards to address the conflicts in the research process, which are not limited to equity research, but extend to fixed-income research and, as I’ve mentioned, credit ratings. The same disclosures and restrictions should be required of credit-rating agencies.

- **Fourth, an industry-wide standard of professional conduct should be developed that clearly defines standards of independence, appropriate relations between agencies and issuers, and duties to the investing public**. Analysts and supervisors should be required to attest annually of their adherence to the standard. In many cases, simply identifying the areas of conflict, and processes to eliminate or manage those conflicts, would be a big step forward, but annual attestation of adherence moves us to a higher standard.

- This code of conduct should required rating agencies to explain in their reports what analyses were performed in arriving at a particular rating and what factors were considered in preparing a credit rating. The current lack of transparency that is endemic among rating agencies must be addressed. No NRSRO standards currently exist for defining what minimal analyses should be performed in support of a credit rating. Until such standards are in place, investors can have little faith that any sort of consistency exists in ratings of a firm or across firms in rating securities of similar characteristics and attributes.
- The code of conduct also should require NRSROs to adhere to standards that govern the analyses performed. One of the simplest approaches would be to require that policies and procedures be established and verified to ensure compliance. These could include requiring documentation in support of the analyses as well as periodic supervisory review of the documentation and ratings. Management must have a specific accountability for these policies and procedures if meaningful change is to take place.
- Last, the code of conduct should establish minimum competency requirements within rating agencies for those who analyze securities and assign their ratings. Given the importance of the ratings in setting market prices and determining issuers’ cost of capital, access to capital, and their

effects on investors' wealth, verification of basic industry knowledge for those involved should not be a lot to ask.

**CONCLUSION**

As I stated earlier, CFA Institute is a proponent, whenever possible, for self-regulation over government-mandated regulation. Nonetheless, we recognize that self-regulation has its limitations and there comes a time when full-fledged regulation is the only course of action. Of all the directions this committee has at its disposal, we believe the one direction it absolutely should avoid is the status quo.

The Code of Ethics I mentioned earlier to which all of our 80,000 members must abide requires them, above all else, to place the interests of investors first. And we believe that if this committee, the SEC, and rating agencies are to follow that same principle, you ultimately will find the right solution. CFA Institute is committed to providing our perspective and any type of assistance to the effort.