Consumer Federation of America
1620 I Street, N.W., Suite 200 * Washington, DC 20006

Americans for Financial Reform
Accountability, Fairness, Security

November 24, 2009

The Honorable Christopher J. Dodd
Chairman
Committee on Banking, Housing
and Urban Development
U.S. Senate
Washington, D.C. 20510

The Honorable Richard C. Shelby
Ranking Member
Committee on Banking, Housing
and Urban Development
U.S. Senate
Washington, D.C. 20510

Re: "Restoring American Financial Stability Act of 2009" Committee Print

Dear Chairman Dodd, Ranking Member Shelby and Members of the Committee:

We are writing on behalf of the Consumer Federation of America and Americans for Financial Reform to express our strong support for the provisions in Title IX, Subtitle C of the "Restoring American Financial Stability Act of 2009." This legislation would take much needed steps to strengthen regulatory oversight, increase accountability, and reform the practices of the credit rating agencies that played such a central role in bringing about the financial crisis. While we are pleased to offer the bill our enthusiastic endorsement, we believe it could be further strengthened, in particular by the adoption of amendments to improve credit rating agency governance practices, to gradually reduce our financial system's over-reliance on ratings, and to adopt universal ratings for corporate and municipal bonds based on the likelihood of default.

Improve Governance Practices at Ratings Agencies

The Securities and Exchange Commission (SEC) study of the major ratings agencies released last year uncovered numerous questionable and shoddy practices. Although many attribute these shortcomings to conflicts of interest in the credit rating agency business model, neither the House nor the Senate bill requires any fundamental changes in that business model. Instead, both the Senate Committee Print and the bill recently adopted by the House Financial Services Committee seek to address this problem in part by enhancing the independence and expanding the responsibility of ratings agency compliance officers. The House bill goes further. In particular, it would require ratings agencies or their parent entities to have a board of directors and would make that board responsible for overseeing key functions on which reliable ratings rely, including internal controls over methodologies and procedures to produce ratings, practices to address conflicts of interest, and the activities of the compliance officer.

We encourage you to adopt this provision from the House bill, but to strengthen it by requiring that a majority of board members be independent and by tightening the definition of independence to ensure that these directors truly reflect the interests of users of ratings, such as pension funds and mutual funds, rather than the interests of the issuer and underwriter community. Giving the users of ratings a direct role in the governance of rating agencies and the oversight of key functions within those agencies could provide an effective mechanism for reform without requiring a change in the rating agency business model. The legislation could be further strengthened by adopting the House provision to ban credit rating agencies from performing certain consulting services for ratings customers.

Reduce Reliance on Ratings

In addition to increasing the reliability of credit ratings, it is important to reduce the financial system's vulnerability when ratings prove unreliable. One way to accomplish this is to make both the ratings themselves and the securities rated more transparent. Both the Senate and House bills would provide greater insight into the assumptions used in developing ratings, the sensitivity of the rating to those assumptions, and the nature and quality of the data relied on. This should better enable the users of ratings to assess the nature of risks being rated and the reliability of the rating.

Another way to reduce our reliance on ratings is to begin to untangle the web of references to credit ratings in our laws and regulations. While eliminating legal references to ratings without first determining whether more reliable measures of creditworthiness are available strikes us as reckless, the Senate bill's approach – requiring yet another study – strikes us as too timid. Instead, we favor an approach similar to that proposed in the House manager's amendment (but subsequently changed in mark-up). Under this approach, regulators would be required to identify areas where the laws and regulations refer to or rely on ratings, determine whether better or additional measures of creditworthiness are available, and either replace or supplement the ratings as appropriate.

We encourage the Committee to consider adopting this approach in its version of the legislation. At the same time, the Committee could clarify that reliance on a credit rating does not provide a legal safe harbor. Rather, investors and financial institutions that rely on ratings in selecting investments must conduct adequate due diligence to determine whether the investment in question is appropriate for the intended use.

Universal Municipal and Corporate Bond Ratings

Most municipal bonds are rated on a different, more conservative rating scale than corporate bonds. This dual system employed by the largest rating agencies ends up costing state and local governments and their taxpayers over a billion dollars a year, a cost these governments can ill afford. Bond issuers, be they corporate bond issuers or municipal bond issuers, should be rated on the same standard—the likelihood of default. To address this problem, we encourage you to add language to the bill to require each NRSRO to: (1) establish, maintain and enforce written policies and procedures designed to assess the risk that investors in securities and money market instruments may not receive payment in accordance with the terms of such securities and instruments, (2) define clearly any credit rating symbols used by the organization, and (3) apply such credit rating symbols in a consistent manner for all types of securities and money market instruments.

Enhanced SEC Oversight Authority

The credit rating reform legislation adopted in 2006 was designed primarily to untangle the process for becoming a nationally recognized statistical rating organization (NRSRO). As such, it included only modest provisions to enhance SEC oversight authority over the ratings agencies. In light of the important gatekeeper role that NRSROs play in our financial system, and their repeated failures to fulfill that role responsibly, we believe much more rigorous regulatory oversight is warranted. The discussion draft provides that enhanced oversight. In particular, we support provisions that:

- charge the SEC with conducting annual inspections to ensure compliance with appropriate procedures to support reliable ratings and to address conflicts of interest;
- make the SEC responsible for setting qualifications standards for rating analysts;
- add failure to supervise to the list of conduct that is subject to SEC sanction; and
- provide the SEC with the ability to impose fines and to temporarily suspend or permanently revoke a ratings agency's registration for a particular class or subclass of securities for violations.

The House bill includes additional provisions to enhance regulatory oversight that we also support. The most important of these would add failure to conduct sufficient post-rating surveillance to the list of violations subject to SEC sanction and remove ratings' protection from SEC antifraud authority. In addition, the House bill authorizes the SEC to take action against individuals associated with the rating agencies as well as the firms themselves. We urge the Committee to adopt these provisions from the House bill to further strengthen the Senate bill's provisions to enhance regulatory oversight. In order to ensure that these oversight activities are adequately funded, we encourage you to consider adding a funding mechanism in the form of a modest fee on each rating issued that would be dedicated to funding the new NRSRO oversight office created under this legislation.

Hold Ratings Agencies Accountable

In examining the credit rating agencies' role in the financial crisis, the key policy question that must be resolved is how to make the credit rating agencies less willing to assign ratings to products they do not understand and cannot accurately measure. The most obvious answer, in our view, is to hold the ratings agencies legally liable in a manner that is consistent with their gatekeeper role in our financial system. We therefore strongly support provisions in the Committee Print that seek to hold NRSROs accountable for their actions by making the act enforceable through private rights of action and by imposing legal liability when ratings agencies fail to conduct an adequate investigation to support an accurate rating. We greatly appreciate the steps that were taken to strengthen these provisions in the Committee Print, including by restoring the findings and the strong case they make for denying credit ratings First Amendment protections.

To further capitalize on these improvements, we urge you to make two additional changes to the legislative language. First, we believe the legislation should make clear that credit rating agencies are legally liable for any violation of the securities laws, not only when they fail to conduct an adequate investigation. Also, because of the unfavorable court decision in the *Tellabs* case, the legislation's language on pleading standards, though much improved, is still likely to exclude many meritorious actions. We therefore urge you to consider changing "strong inference" to "reasonable inference" to reduce to a reasonable level the burden of proof that plaintiffs must meet simply to have their case heard in court.

Credit rating agencies' willingness to slap AAA ratings on investments whose risks they did not understand and could not accurately measure played a key role in turning a U.S. housing crisis into a global financial calamity. This legislation offers a strong and comprehensive set of reforms to address that failure. We are pleased to offer it our strong support.

Respectfully submitted,

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Americans for Financial Reform