



November 28, 2011

Department of the Treasury
Bureau of the Public Debt
Government Securities Regulations Staff
799 9th Street, NW
Washington, DC 20239-0001

Re: Government Securities Act Regulations; Replacement of References to Credit Ratings and Technical Amendments; Docket No. BPD GSRS 11-01; RIN 1535-AA02.

Dear Treasury Staff:

Better Markets, Inc.¹ appreciates the opportunity to comment on the above-captioned proposed rule (“Proposed Rule”) of the Department of the Treasury (“Treasury”). The Proposed Rule would remove certain references to credit ratings in the liquid capital rules applicable to government securities brokers and dealers, and would replace those references with an alternative standard of credit-worthiness. Treasury has issued the Proposed Rule in accordance with the requirements of Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”).

INTRODUCTION

In use for nearly a century, credit ratings have become an extremely important fixture in the capital markets. However, credit ratings have also played an important role in some spectacular financial disasters, including the Enron implosion in 2001, the catastrophic collapse of the mortgage-backed securities markets in 2008, and the financial crisis that began in 2007 and continues to this day.

Fresh evidence of their destructive power lies in the Eurozone, where the current financial peril is in part the product of the deeply flawed ratings system employed by rating agencies. For example, the credit rating agencies consistently rated Greek and other weak sovereign debt as A+ for years. Yet recent revelations about Greece’s actual economic circumstances prove that the rating agencies’ prior A+ ratings could not have been close to accurate and therefore were not a proper evaluation of Greece’s financial condition. In another case of flawed analysis, the fact that only one of the three major rating agencies downgraded long-term U.S. debt this summer—while the other two agencies did not—speaks volumes about the fundamentally arbitrary and unreliable nature of credit ratings.

¹ Better Markets, Inc. is a nonprofit organization that promotes the public interest in the capital and commodity markets, including in particular the rulemaking process associated with the Dodd-Frank Act.

These problems stem from a number of structural flaws in the credit rating industry. Most importantly, the credit rating agencies have long been fraught with conflicts of interest and anti-competitive behaviors. The present issuer-pay model is the most problematic characteristic. A compensation system by which issuers pay for ratings of their own debt securities creates an inherent conflict of interest that perpetually threatens the accuracy and objectivity of credit ratings. Moreover, a compensation system that allows underwriters of debt securities to select rating agencies of the debt that they underwrite via supposed competition between ratings agencies sets up another significant conflict. Rating agencies give better ratings to win more business from the respective underwriter. Finally, poor methodologies, conflicting ratings frameworks, a legally protected status, and reliance by ratings agencies on incomplete data have compounded these problems.

THE DODD-FRANK ACT

The Dodd-Frank Act represents a Congressional attempt to institute regulatory measures that will finally and effectively address the problems posed by credit ratings. The statute includes three fundamentally important reforms.

First, it builds on the regulatory requirements that were implemented in the Credit Rating Agency Reform Act of 2006. The Dodd-Frank Act adds new provisions relating to the registration process for Nationally Recognized Statistical Rating Organizations (“NRSROs”), corporate governance, compliance examinations, conflicts of interest, and public disclosure of ratings and methodologies.

Second, the Dodd-Frank Act substantially increases the accountability of NRSROs by increasing their exposure not only to enforcement remedies such as monetary fines, but also to liability in private actions.

Finally, in Section 939A, the Dodd-Frank Act seeks to reduce reliance upon credit ratings by requiring federal agencies to review their regulations; to remove any references to, or reliance on, credit ratings in those regulations; and to substitute appropriate standards of credit-worthiness in place of credit ratings. The relevant section of the statute provides as follows:

- (a) AGENCY REVIEW.—Not later than 1 year after the date of the enactment of this subtitle, each Federal agency shall, to the extent applicable, review—
 - (1) any regulation issued by such agency that requires the use of an assessment of the credit-worthiness of a security or money market instrument; and
 - (2) any references to or requirements in such regulations regarding credit ratings.

- (b) MODIFICATIONS REQUIRED.—Each such agency shall modify any such regulations identified by the review conducted under subsection (a) **to remove any reference to or requirement of reliance on credit ratings and to substitute in such regulations such standard of**

credit-worthiness as each respective agency shall determine as appropriate for such regulations. In making such determination, such agencies shall seek to establish, to the extent feasible, uniform standards of credit-worthiness for use by each such agency, taking into account the entities regulated by each such agency and the purposes for which such entities would rely on such standards of credit-worthiness.²

SUMMARY OF COMMENTS

The core challenge facing Treasury as it implements the Dodd-Frank Act mandate in Section 939A is to establish alternative "standards of credit-worthiness" that are appropriate substitutes for credit ratings. Eliminating regulatory reliance upon credit ratings without providing adequate alternatives will only undermine effective regulation of our capital markets and could put investors at greater risk, not less.

To protect investors, the standards must be **specific, strong, and uniform**, and to prevent evasion by market participants they must also be **clear, concrete, and mandatory**.

The Proposed Rule is a commendable effort to implement Section 939A of the Dodd-Frank Act and to ensure that the liquid capital rule for government securities brokers and dealers includes appropriate standards of credit-worthiness that can replace references to credit ratings. However, the Proposed Rule must be strengthened in the following ways to comply with the requirements of the Dodd-Frank Act and to achieve its objectives. The Proposed Rule must:

- Incorporate a mandatory list of factors that government securities brokers and dealers must apply in their credit analysis of commercial paper;
- Expand the list of factors to be considered;
- Eliminate all residual reliance on credit ratings; and
- Require government securities brokers and dealers to document not only their policies and procedures on credit risk assessment, but also each credit-worthiness determination they make under those policies and procedures.

With these changes, the Proposed Rule will implement the statutory requirement to end reliance on credit ratings under the liquid capital rule while providing alternative standards of credit-worthiness that will help maintain the financial stability of government securities brokers and dealers.

Equally important, without these changes, the Proposed Rule will dilute the intended effect of Section 939A and might well establish a precedent on which other financial entities will rely when 939A is applied to them in the rulemaking process. That is to say, if this rule is weak, other financial entities will undoubtedly argue that all similar rules implementing Section 939A must be equally weak. Thus, the Proposed Rule has

² Section 939A of the Dodd-Frank Act (emphasis added).

implications that go far beyond the world of government securities brokers and dealers holding commercial paper.

THE PROPOSED RULE

The liquid capital rule prescribes minimum regulatory capital requirements applicable to registered government securities brokers and dealers.³ The rule serves important purposes by helping to maintain the safety and soundness of individual firms, and by helping to limit the systemic risk associated with the failure of any significant market participant.

The rule defines a class of securities, known as “Treasury market risk instruments,” that are entitled to a reduced “haircut” in calculating net capital requirements, because those securities are deemed less susceptible to changes in value arising from market fluctuations. In its current form, the rule incorporates credit ratings to identify the types of commercial paper that qualify as “Treasury market risk instruments.”

Specifically, the rule defines “Treasury market risk instruments” to include “commercial paper of no more than one year to maturity rated in one of the three highest categories by at least two nationally recognized statistical rating organizations.”⁴ The Proposed Rule would remove this reference to credit ratings and would replace it with an alternative standard of credit-worthiness.

Under the Proposed Rule, the alternative standard would cover commercial paper that “has only a **minimal amount of credit risk** as reasonably determined by the government securities broker or dealer pursuant to written policies and procedures the government securities broker or dealer establishes, maintains, and enforces to assess creditworthiness.”⁵ The Release lists a number of factors that the government securities broker or dealer “could consider” when assessing the credit and liquidity risk of commercial paper, but those factors are not included in the Proposed Rule.⁶

Finally, the Proposed Rule would require government securities brokers and dealers to preserve, for a period of not less than three years, the written policies and procedures that it establishes, maintains, and enforces for assessing credit risk for commercial paper.⁷ This record retention requirement would be imposed through incorporation by reference to a similar requirement that the SEC has proposed for brokers and dealers making credit-worthiness determinations under the net capital rule.⁸

³ 17 C.F.R. § 402.2.

⁴ 17 C.F.R. § 402.2(e)(v).

⁵ Release at 59593 (emphasis added).

⁶ *Id.* at 59593-94.

⁷ *Id.* at 59594.

⁸ *Id.*

COMMENTS

The Proposed Rule must establish mandatory factors that government securities brokers and dealers are required to apply in the credit analysis of commercial paper.

The Proposed Rule must be strengthened in several respects. First and foremost, the rule must be more prescriptive and **require** government securities brokers and dealers to consider the list of factors enumerated in the Release. Furthermore, those factors must be set forth in the text of the rule itself.

This approach is crucial if the Proposed Rule is to replace credit ratings with meaningful alternative standards, as required by the Dodd-Frank Act. The basic test adopted in the Proposed Rule for credit-worthiness is framed in terms of a “minimal amount of credit risk.” **Standing alone, this is an exceedingly vague concept that allows for a wide range of interpretations.**

If government securities brokers and dealers are left to devise their own policies and procedures for applying this general standard, without specific, clear, and mandatory guidelines to limit their discretion, they can be expected to develop **formulae that will inevitably minimize credit risks** associated with commercial paper to minimize capital charges. Firms and their clients will consequently be subject to greater financial risks, which often come to light after it is too late or after a firm has already sustained irretrievable losses. A more prescriptive approach is required by the law and essential to establish critical boundaries.

Establishing an explicit and detailed list of factors that government securities brokers and dealers must consider will also promote uniformity. The Dodd-Frank Act expressly directs agencies “to establish, to the extent feasible, uniform standards of credit-worthiness for use by each such agency.”⁹ Regulatory uniformity enhances investor protection, fairness among market participants, and transparency in the marketplace. It also facilitates market surveillance and enforcement by regulators.

Without detailed and uniform standards to guide them, government securities brokers and dealers will generate divergent discounts or haircuts for purposes of calculating liquid capital requirements. This will place some government securities brokers and dealers in a more precarious financial condition than other firms, exposing some investors to significantly greater risks. Divergent methodologies must not be permitted to cause such inconsistent results; investors cannot be expected to analyze the quality of these disparate methodologies as a basis for differentiating among market participants. The 2008 financial crisis laid to rest any lingering uncertainty regarding the inability of even so-called “sophisticated” investors to analyze credit accurately.¹⁰

⁹ Dodd-Frank Act § 939A.

¹⁰ The increasing inability of investors to fend for themselves in the world of credit analysis stems largely from the increasing complexity of financial instruments. For example, economic analysis shows that some financial products such as derivatives are so complex that it may be impossible for **anyone** to price them accurately without unlimited computational power—a characteristic known as “computational intractability.” See Sanjeev Arora, Boaz Barak, Markus Brunnermeier, and Rong Ge,

Inconsistent methodologies will also disadvantage and in effect punish any government securities brokers and dealers that are inclined to choose a more conservative approach to the assessment of credit risk. Allowing such disparities to exist always threatens to trigger a race-to-the-bottom, as market participants seek to avoid the competitive disadvantages that arise from having more conservative risk evaluations.

By establishing concrete, mandatory standards, the Proposed Rule will not only comply with the statutory requirements, but also mitigate all of these practical problems, for the benefit of investors and the overall stability of the capital markets.¹¹

Moreover, it is important to remember that establishing mandatory standards—along with the other changes discussed below—will set an important precedent. If the rule implementing Section 939A with respect to government securities brokers and dealers is weak, then other financial entities subject to section 939A in other contexts will argue that a weak version of 939A should apply to them as well. Thus, a weak rule from Treasury may well be transmitted like a contagion throughout the entire regulatory structure. Treasury must not fire the starting gun of a race-to-the-bottom for such important standards.

The Proposed Rule must expand the list of factors used to assess credit-worthiness.

The Proposed Rule must also expand the list of factors that government securities brokers and dealers must consider when evaluating the credit risk associated with commercial paper. The items listed in the Release are positive and, once incorporated into the Proposed Rule, will provide a useful and more objective framework for government securities brokers and dealers to apply.

However, the list must be more comprehensive, and must contain a catchall provision that requires government securities brokers and dealers to consider all material factors that bear on the credit-worthiness of the commercial paper being evaluated, including the nature of the issuer, the terms of the security, and the financial and regulatory context in which the issuer is operating. In addition, the list of factors to be considered should include any enhancements or priorities associated with the

Computational Complexity and Information Asymmetry in Financial Products (Working Paper) (Oct. 19, 2009), available at <http://www.cs.princeton.edu/~rongge/derivative.pdf> (incorporated herein as if fully set forth).

¹¹ We recognize that, according to the Release, there are currently only three registered government securities brokers and dealers, none of which routinely hold commercial paper. Release at 59594. However, this does not lessen the need for Treasury to establish strong standards in the Proposed Rule. First, of course, the Dodd-Frank Act requires Treasury to do so. Second, appropriate implementation of the statutory requirement will help **prevent** future abuses that might arise if a lax rule were adopted for government securities brokers and dealers. Third, to the extent that government securities brokers and dealers do hold commercial paper, which in turn affects their risk profile, the risk mitigating effects of the Proposed Rule, properly framed, must be in place. Finally, as discussed in text, the Proposed Rule must not set a weak precedent that the financial industry may exploit as Section 939A is applied in other contexts.

commercial paper, such as collateral, security agreements, and creditors' rights provisions.

These changes will bring the Proposed Rule into compliance with the statute. They will also help ensure that credit risk assessments by government securities brokers and dealers are reliable and that liquid capital levels are adequate to protect investors and the markets more generally.

The Proposed Rule must fully eliminate continued reliance on credit ratings.

The list of factors in the Release must also be **narrowed** in one important respect. Under the Proposed Rule, among the factors that government securities brokers and dealers may consider when evaluating the credit risk associated with commercial paper are "credit risk assessments" developed either internally "**or externally by a credit rating agency, irrespective of its status as an NRSRO.**"¹² This factor would permit continued reliance on credit ratings, which conflicts with the letter and spirit of the Dodd-Frank Act.

The Dodd-Frank Act expressly requires Treasury and other agencies to remove references to credit ratings from their regulations, and to substitute **alternative** standards of credit-worthiness as each agency deems appropriate. Allowing government securities brokers and dealers to continue using credit ratings when assessing credit risk would violate this statutory mandate.

Allowing continued references to and reliance upon credit ratings also undermines the core objectives of Section 939A of the Dodd-Frank Act. By insisting that references to ratings be removed, Congress sought to eliminate the governmental imprimatur on credit ratings. Congress also sought to reduce actual reliance on credit ratings and to promote independent due diligence and credit analysis. It therefore required federal agencies to establish new standards that market participants would have to apply in making independent judgments about credit-worthiness. Establishing such new standards, while at the same time allowing market participants to continue their traditional reliance on credit ratings, would undercut both of these goals. It would only perpetuate the governmental endorsement of ratings, and it would not fully reduce reliance on credit ratings or promote independent credit analysis.

The Proposed Rule must address this problem by striking a balance between allowing **consideration**, in conjunction with the Release, of external ratings and prohibiting **reliance** on those ratings. It may not be possible or even desirable to prohibit market participants from considering credit ratings as they conduct their own credit analysis. For example, a significant discrepancy between a firm's internal credit analysis of a security and the external credit rating assigned to that security might serve as a useful signal that anomalies or flaws may exist in the firm's own credit evaluation. This would presumably have the positive effect of causing the firm—in this case a

¹² Release at 59593 (emphasis added).

government securities broker or dealer—to reexamine its credit analysis and make necessary corrections.

Recognizing a continuing, albeit more limited, role for credit ratings is consistent with the policies underlying the Dodd-Frank Act. As noted in the Introduction above, the Dodd-Frank Act sought not only to reduce statutory and regulatory reliance on credit ratings, but also to improve the quality and reliability of ratings and to foster more competition in the ratings field. Thus, Congress clearly anticipated that ratings would continue to play a role in credit analysis—**but not in the form of regulatory standards.**

In light of these considerations, the reference to credit risk assessments made by credit rating agencies should be deleted from the factors listed in the Proposed Rule that government securities brokers and dealers must consider. However, the **Release** should provide guidance by clarifying that government securities brokers and dealers may consider external credit ratings when conducting their own credit analysis, **provided** that all credit risk determinations with respect to commercial paper must be justifiable entirely on the basis of the factors enumerated in the Proposed Rule, without regard to credit ratings.¹³

Government securities brokers and dealers must be required to document each credit-worthiness determination.

Finally, the Proposed Rule must incorporate stronger documentation requirements. As currently drafted, the Proposed Rule would require each government securities broker or dealer to preserve for at least three years the written policies and procedures that the government securities broker or dealer establishes, maintains, and enforces for assessing credit risk for commercial paper.¹⁴

This requirement is necessary but not sufficient. The Proposed Rule must also require each government securities broker or dealer to create and maintain a record of each credit-worthiness determination that it makes. That record must include all factors considered in evaluating the credit risk of the security, an explanation of how those factors support the determination made, and an identification of the personnel involved in making the determination.

Furthermore, the recordkeeping requirements should provide, as noted above in the context of continued reliance on credit ratings, that market participants must

¹³ The same issue arose in connection with the SEC's effort to remove references to credit ratings from rules under the Investment Company Act. See References to Credit Ratings in Certain Investment Company Act Rules and Forms, Release Nos. 33-9193; IC-29592 (Mar. 3, 2011), 76 Fed. Reg. 12896 (Mar. 9, 2011). Those proposed rules, and the accompanying release, indicated that investment companies could continue to rely heavily on credit ratings when selecting permissible money market fund investments. *Id.* at 12898, -899, -900, -902, -903. Better Markets expressed opposition to that approach, and we advance the same objections above. Comment Letter from Better Markets, Inc. to the Securities and Exchange Commission, submitted April 25, 2011, *available at* <http://www.bettermarkets.com/sites/default/files/SEC-%20Comment%20Letter-%20Credit%20Ratings%20CL%204-25-11.pdf>, which is incorporated as if fully set forth herein.

¹⁴ Release at 59594.

document how a credit risk determination meets the new standards for credit-worthiness **without regard to credit ratings**.

This more detailed documentation requirement will serve two important purposes. First, these documentation standards will help promote actual compliance by government securities brokers and dealers. The process of documenting each credit risk determination will induce a more thorough and rigorous application of the firm's policies and procedures governing credit risk assessment. Second, requiring government securities brokers and dealers to create a record of their credit risk determinations will enable regulators to effectively monitor compliance with the liquid capital rule and take appropriate remedial action if the new credit assessment standards have been misapplied and net capital levels drop below required levels. Both of these goals are critical elements in the effort to reform the way credit ratings are used in our markets.

CONCLUSION

We hope these comments are helpful in your consideration of the Proposed Rule.

Sincerely,



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