Dissenting Statement at SEC Open Meeting on Nationally Recognized Statistical Rating Organizations

Commissioner Daniel M. Gallagher

Aug. 27, 2014

Thank you, Chair White. Before I begin, I'd like to extend my thanks to the staff from the Commission's various divisions and offices that worked so diligently on today's release. In particular, I'd like to thank Randall Roy, Ray Lombardo, and Rose Wells from Trading and Markets; Harriet Orol and Kevin Vasel from the Office of Credit Ratings; and Keith Higgins, Kathy Hsu, Rolaine Bancroft, Raquel Fox, and Michelle Stasny from Corp Fin. And, as always, I'd like to thank the Division of Economic and Risk Analysis as well as the Office of the General Counsel.

As was the case with our Reg AB 2 rulemaking, the path from proposal to adoption of our rules implementing the Dodd-Frank Act mandates regarding nationally recognized statistical rating organizations has been a long one. Unlike today's earlier rulemaking, however, the extended delay of our NRSRO rulemaking has not resulted in thoughtful refinements of the excellent work product that was sent to the Commission by our expert staff. Unfortunately, today's release reflects the last-minute imposition of ill-conceived and hastily drafted rule provisions that upend the staff's efforts. It brings to mind -- in many ways -- the terrible precedent of the Commission's August 2012 rulemaking lifting the ban on general solicitation, in which countless hours of expert staff work were abandoned in the days preceding the Commission's vote in order to appease special interests.

It did not need to turn out this way. Indeed, I have believed from the start that the concerns that led to the radical changes from the proposing release are valid and important ones that needed to be addressed by the Commission. These concerns were best set forth in a comment letter the Commission received that laid out, among other things, a pair of weighty concerns the Commission purports to address today with regard to internal control requirements and the prohibition on allowing sales and marketing considerations to influence the rating process.[1] Recognizing that they would require the Commission to "extensively revise" the proposing release, the commenter rightfully called for a re-proposal of the rules that are the subject of today's vote.

I supported this call for a re-proposal. I believed that the concerns expressed in the letter were valid enough, and the changes necessary to address them would be extensive enough, that the tenets of good government required us to re-propose. I was ready to engage in a dialogue with my colleagues to determine the best way to address concerns that I believed we all shared, even if a re-proposal was not the politically expedient thing to do given external pressure to get as many Dodd-Frank rulemakings completed as quickly as possible.

I eventually, however, acceded to proceeding without a re-proposal based on an understanding that the Commission would take a two-step approach in which we would finalize the rules proposed in May 2011 with appropriate discussion -- and where possible, resolution -- of the concerns raised in the comment letter, while indicating our expectation that we would revisit the concerns in a subsequent rulemaking in the near future.

In the case of internal controls, the concern expressed was that the proposed rule failed sufficiently to set standards for such controls, leaving too much discretion to the NRSROs themselves. Despite my misgivings with the Dodd-Frank mandates themselves, I shared this concern, and when it became clear that we would not be issuing a re-proposal of the rule, I supported two key changes. First, I supported better elucidating our requirements and expectations by adding a detailed list of factors that NRSROs should consider and a robust discussion thereof in the release's discussion of internal controls. More importantly, however, I supported making it clear that our staff examiners – statutorily required to conduct a thorough examination of each and every NRSRO on an annual basis – would be closely examining the internal controls structure of each NRSRO and, based on their firsthand, real-world experience, reporting back to the Commission on any enhancements to our rules they believed were necessary. In this manner, we would have signaled to NRSROs our firm commitment to ensuring that they developed robust and meaningful internal control structures and made it clear that if we found that they had not satisfactorily done so, we would revisit our rules to address any shortcomings.

Instead, today's rule advances a compromise that a majority of the Commission appears to believe is a Solomonic solution. I, too, believe that the changes to the rule text are indeed Solomonic – not, however, in the sense of a solution marked by wisdom and reason, but instead as one that splits the baby to everyone's detriment. We could have left the detailed discussion of factors to be considered in the text of the adopting release, or we could have even added them to the rule itself but as an explanatory note, in either case making it clear that an inadequate response by NRSROs to this guidance would result in the Commission considering far more prescriptive amendments in a subsequent rulemaking.

Instead, a decision was made effectively to cut and paste release text discussion into the language of Rule 17g-8 itself, awkwardly and ineffectually imposing upon NRSROs a mandate to "take into consideration" the listed factors. By placing these factors in the rule text and declaring the concern addressed, the Commission has effectively signaled that this is a settled issue.

The added rule language also inappropriately places the focus on the *process* by which an NRSRO develops and maintains its internal control structure rather than the controls themselves. Worse, it signals – unintentionally, I expect – the possibility of a safe harbor. Regardless of the Commission's intent, the practical effect of placing the factors in the rule text will be to provide an NRSRO deemed to have inadequate internal controls with a new tool and tactic: that is, the ability to defend itself by pointing to the factors in the rule text and demonstrating that it did indeed take them all into consideration.

This flies in the face of the commenter's emphasis on the controls themselves, rather than the process used to establish them. I am sure that a potential safe harbor for NRSROs on internal controls – allowing for the possibility of an NRSRO with poor internal controls defending itself by touting the appropriateness of the process it used to establish those controls – is the last thing the commenter wanted.

In short, instead of issuing explanatory guidance while indicating our willingness to impose more specific rules in the future if necessary, we have imposed that explanatory guidance in rule text, creating a new concept of what could be called "prescriptive guidance" that fails seriously to address the important concerns that could have been considered in a re-proposal.

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The second concern today's hastily rewritten rules purport to address is the perceived narrowness of the prohibition against allowing sales and marketing concerns to influence the rating process. Put another way, this is a concern regarding potential unintentional "loopholes" in our rules establishing this absolute prohibition. Here, again, despite my misgivings with the overall statutory mandates, I supported addressing this concern through a re-proposal, acknowledging that as with many potential loopholes in our complex and intricate rule set, doing so would involve a careful, thoughtful iterative process to ensure that the cure would not be worse than the disease.

Instead, a majority of the Commission has taken the novel approach of establishing what amounts to a thoughtcrime.[2] In doing so, the Commission will establish a terrible, dangerous precedent that I am sure we will soon come to regret. Instead of taking the time to issue a re-proposal seeking more information on ways to address potential loopholes in our sales and marketing prohibitions, the Commission has created a new catchall prohibition addressing a person within an NRSRO participating in the rating process who "is influenced by sales or marketing considerations."

Let's be very clear about what the Commission is doing today. This is not analogous to our rules that require scienter to establish a violation of the federal securities laws. This new prohibition is solely based on state of mind – there is no requirement that any action be taken. Even if the rating process is effectuated without any abuse, we could theoretically still pursue the analyst unfortunate enough to display evidence that a stray thought related to sales and marketing considerations crossed his or her mind. Remember, the rating process, much less the rating itself, does not have to be influenced by such considerations to violate this new rule.

This wonderfully expedient device, conveniently devoid of any limiting principle to curtail its universal application, could solve all of our problems. Insider trading abuses, for example, could be policed by clamping down on traders who, like rating analysts deemed by the Commission to be "under the influence," are deemed to have ill intent, regardless of their actions or the outcomes thereof. I can't imagine any court in the land not striking down this vague and unverifiable "influence" clause.

It is difficult to overstate my disappointment at the last-minute changes that have forced me to withdraw my support for a rulemaking that should have been unanimous. I have been deeply involved in the Commission's oversight of NRSROs since, as counsel to Commissioner Paul Atkins, I worked on the draft rules to implement the Credit Rating Agency Reform Act of 2006, which first gave the Commission regulatory authority over credit rating agencies registered as NRSROs. In my later role as Deputy Director of Trading and Markets, I was responsible for the division's NRSRO rulemaking and oversight and served as the first ever chair of IOSCO's Standing Committee 6 on credit rating agencies.

The Credit Rating Agency Reform Act of 2006, which gave the Commission broad authority to regulate NRSROs, gave the Commission broad discretion on how to exercise that authority as well. It's important to remember something that Congress did not while promulgating the Dodd-Frank Act -- the vast majority of the failed ratings that contributed to the financial crisis were issued before the Commission had statutory oversight authority over NRSROs. Over the course of several years, we took the lessons learned from those failures and the knowledge and insight gained by our staff as we built out our oversight program and promulgated three separate rulemakings, each building upon the last.

In the Dodd-Frank Act, however, Congress chose to cobble together a long list of mandates, many of which merely restated or clarified our existing authority and amounted, essentially, to micromanaging our oversight of NRSROs. This displays a lamentable "book club" mentality in which self-appointed experts set aside the experience of those who have been dealing directly with an issue in favor of advancing their own unproven theories. As a result, instead of continuing the iterative series of rulemakings refining our NRSRO oversight program based on staff experience and knowledge, the Commission was forced to redirect staff efforts to fulfilling Dodd-Frank mandates.

As for the NRSROs themselves, the plethora of new regulatory requirements will weigh especially heavily on smaller NRSROs and new aspirants to NRSRO status, which will have far fewer resources and therefore will be forced to devote a far higher percentage of those resources to compliance than will the larger NRSROs. One of the overarching, stated goals of the Credit Rating Agency Reform Act of 2006 was to foster competition in the ratings industry. The more burdensome NRSRO status becomes, the greater the chance of smaller NRSROs deregistering and potential new NRSROs eschewing registration altogether.

All of this brings to mind a quote attributed to King Alfonso the Wise, who is alleged to have said, "Had I been present at the creation, I would have given some useful hints for the better ordering of the universe." Speaking as someone who was present at the creation of the Commission's regulatory

oversight program for NRSROs, had the 111th Congress asked me for hints as to how Dodd-Frank should have addressed credit rating agencies – and needless to say, they most definitely did not ask – my answer would have been simple. The Dodd-Frank Title IX NRSRO mandates should have consisted solely of what became Section 939A: the mandate to remove all references to credit ratings not just from the Commission's rules, but from those of every other federal agency as well.

Over four years after the enactment of the Dodd-Frank Act – and over *six* years after the Commission first proposed, on its own initiative, removing references to credit ratings from its rules – the task of removing such references from our rules remains incomplete. The thousands of Commission staff hours spent fulfilling the myriad NRSRO mandates contained in Dodd-Frank could have been put to far better use focusing on our Section 939A responsibility to strip all references to credit ratings from our rules. The last-minute imposition of the terrible new rule provisions I discussed earlier renders the situation even worse by throwing out the staff efforts that led to reasonable, workable solutions.

I will close by quoting the assessment of the Dodd-Frank Act's NRSRO provisions offered by an NRSRO in a comment letter on our proposed rules. That NRSRO stated, "[A] contradiction lies in the fact that, while directing the Commission to impose costly and onerous new obligations on rating agencies who choose to register as NRSROs, the Dodd-Frank Act also directs the Commission to remove all references to credit ratings from the federal securities regulations."[3]

Under the best of circumstances, the rules before the Commission today would have been unable to address this dangerous incongruity pursuant to which we carry out our congressional mandate exponentially to increase the burdens of NRSRO registration even as we limit – however appropriately – the benefits arising from such registration. Through no fault of the Commission staff, whose dedicated and thoughtful work would have at least mitigated this imbalance, these are hardly the best of circumstances. Instead, they mark a missed opportunity and a fundamental abandonment of the tenets of good government.

As I do not wish to place the staff in the position of having to defend the last-minute changes that undid much of their hard work, I have no questions.

[1] Letter from Micah Hauptman, Financial Services Counsel, and Barbara Roper, Director of Investor Protection, Consumer Federation of America, dated Mar. 3, 2014.

[2] *See* Orwell, George, *Nineteen Eighty-Four*.

[3] Letter from Daniel Curry, President, and Mary Keogh, Managing Director, Regulatory Affairs, DBRS, Inc., dated Aug. 8, 2011.

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