GAO

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Highlights

Highlights of GAO-12-240, a report to congressional committees

Why GAO Did This Study

Over the past decade, concerns repeatedly have been raised about the accuracy of credit ratings provided by a number of nationally recognized statistical rating organizations (NRSRO). NRSRO critics often point to the conflict of interest created by the industry's predominant compensation model in which issuers of securities pay the rating agencies for their ratings (issuer-pays model). In 2006, Congress established Securities and Exchange Commission (SEC) oversight over NRSROs, and recently enhanced this authority through the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). This act also requires GAO to study alternative means for compensating NRSROs. This report discusses (1) alternative models for compensating NRSROs and (2) SEC's actions to implement the act's requirements specific to its oversight of NRSROs. To do this work, GAO leveraged its 2010 report on NRSROs (GAO-10-782), reviewed comment letters submitted to SEC as part of its study of alternative compensation models, proposed and finalized rules issued under the act; and interviewed SEC staff and authors of alternative compensation models.

What GAO Recommends

SEC should consult with the authors of the proposed models to obtain all available information as it considers the various alternative compensation models and any recommendations for statutory changes SEC determines should be made to implement the findings of its section 939F study. SEC agreed with the recommendation.

View GAO-12-240 and components.
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CREDIT RATING AGENCIES

Alternative Compensation Models for Nationally Recognized Statistical Rating Organizations

What GAO Found

As of January 2012, GAO identified seven alternative models for compensating NRSROs (see table below). These models generally were designed to address the conflict of interest in the issuer-pays model, better align the NRSROs' interest with users of ratings, or improve incentives NRSROs have to produce reliable and high-quality ratings. However, the amount of detail currently available for each model varies and none has been implemented. According to some of the authors of the models, there is little incentive to continue developing these models because it appears unlikely they will receive attention from regulators or legislators. For example, these authors noted that SEC had not reached out to them to further discuss these models as part of its ongoing study of alternative compensation models for credit rating agencies.

Identified Alternative Compensation Models for NRSROs

Name	Description
Random selection	Issuers continue to pay for ratings but payment is made to a ratings board that randomly assigns NRSROs to rate issuances.
Investor-owned	Institutional investors create and operate an NRSRO. Issuers are required to get two ratings, one from the investor-owned NRSRO and one from an NRSRO of their choice.
Stand-alone	NRSROs choose which issues to rate. A transaction fee for original issuance and fees from secondary market transactions pay for the ratings.
Designation	NRSROs choose which issues to rate and securities holders designate which NRSRO(s) would receive the fees they pay for rating(s). A third party collects and distributes fees.
User-pays	Third-party auditors determine who is "using" ratings and require that all "users" pay the NRSROs.
Alternative user-pays	Creditors' resources are pooled and a government agency or independent board uses these resources to solicit ratings. NRSROs bid on the right to rate products.
Issuer and investor-pays	Issuers and investors pay a fee on the issuance of new debt and secondary market trades. NRSROs are placed in a continuous queue and assigned to rate issues as their number comes up. Assignment eventually is based on an NRSRO's performance.

Source: GAO summary of alternative compensation models.

During debate on the Dodd-Frank Act, a model similar to the random-selection model was proposed through an amendment that would have added a section 15E(w) to the Securities Exchange Act of 1934 (15E(w) model). Although the amendment was not included in the final legislation, section 939F of the Dodd-Frank Act requires SEC to study, among other things, alternative means for compensating NRSROs. It also authorizes SEC to, upon completion of the study, establish by rule a system for assigning NRSROs to determine initial credit ratings and monitor the ratings of structured finance products in a manner that prevents the arranger from selecting the NRSRO that will determine the credit rating should SEC conclude that an alternative system is necessary or appropriate. In issuing any rule, SEC also must give thorough consideration to the section 15E(w) model and implement the model unless it determines that an alternative would better serve the public interest and protect investors. As part of its solicitation of comments for its ongoing study of alternative compensation models, SEC requested that interested parties use the framework GAO developed in the 2010 report on NRSROs to evaluate the section 15E(w) and other models. GAO created this evaluative framework to help identify the relative strengths and weaknesses and potential trade offs (in terms of policy goals) of the models (see table below). Based on GAO's analysis of comment letters to SEC, while a number of comment letters generally favored implementing the section 15E(w) model, slightly more opposed the implementation of any of the models. Those supporting the 15E(w) model highlighted the need to address the conflict of interests inherent in the issuer-pays model. Those opposed to the alternative compensation models cited concerns of replacing one set of conflicts of interest with another and the costs of implementation. A number of the letters either supported or made suggestions for improving existing SEC rules. A few comment letters also raised legal questions about the implementation or rulemaking for specific aspects of certain models.

In addition to studying alternative compensation models, SEC has begun to implement a number of Dodd-Frank Act requirements pertaining to NRSROs. These requirements include additional rulemakings related to NRSROs' disclosures of performance statistics, credit ratings methodologies, third-party due diligence for asset-backed securities, and analyst training and testing standards. Of nine rulemaking requirements, SEC has adopted three final rules that implement all or part of certain requirements and proposed rules for the remaining requirements. SEC also has been working to establish an Office of Credit Ratings as required by the act. Moreover, SEC examination staff completed the first cycle of annual examinations of each NRSRO as required by the Dodd-Frank Act and published their summary report in September 2011. As part of its study on alternative compensation models for NRSROs, SEC solicited comment on SEC's authority to implement various alternative compensation models. According to SEC staff, they are reviewing the comment letters received and evaluating authority issues. Any recommendations for regulatory or statutory changes SEC determines should be made to implement the findings of the study are to be included in their report to Congress, due in July 2012. The model authors' opinions of the extent to which statutory changes would be needed to implement their alternative compensation models vary, with one stating that current law provides SEC with the necessary authority and another anticipating the need for legislation. Given that NRSROs continue to primarily use the issuer-pays, and to a lesser extent, the subscriber-pays models, the use of any alternative model or models would likely have to be at the direction of SEC or Congress. However, the extent to which SEC's existing authorities would allow it to implement any of the alternative models by rule largely will depend on the alternative model or models selected. Obtaining as complete information on the models as available, such as by consulting with the models' authors, will be important for SEC to fully assess each model in order to make its decision and any recommendations for statutory changes SEC determines should be made to implement the findings of its section 939Fstudy.

Framework for Evaluating Alternative Models for Compensating NRSROs

Factors	Description
✓ **Independence**	The ability for the compensation model to mitigate conflicts of interest inherent between the entity paying for the rating and the NRSRO. Key questions include: What potential conflicts of interest exist in the alternative compensation model and what controls, if any, would need to be implemented to mitigate these conflicts?
✓ **Accountability**	The ability of the compensation model to promote NRSROs' responsibility for the accuracy and timeliness of their ratings. Key questions include: How does the compensation model create economic incentives for NRSROs to produce quality ratings over the life of an issuance? How is NRSRO performance evaluated and by whom?
✓ **Competition**	The extent to which the compensation model creates an environment in which NRSROs compete for customers by producing higher-quality ratings at competitive prices. Key questions include: To what extent does the compensation model encourage competition around the quality of ratings, ratings fees, and product innovation? To what extent does it allow for flexibility in the differing sizes, resources, and specialties of NRSROs?
✓ **Transparency**	The accessibility, usability, and clarity of the compensation model and the dissemination of information on the model to market participants. Key questions include: How transparent are the model's processes and procedures for determining ratings fees and compensating NRSROs? How would NRSROs obtain ratings business?
✓ **Feasibility**	The simplicity and ease with which the compensation model can be implemented in the securities market. Key questions include: What are the costs to implement the compensation model and who would fund them? Who would administer the compensation model? What, if any, infrastructure would be needed to implement it?
✓ **Market acceptance and choice**	The willingness of the securities market to accept the compensation model, the ratings produced under that model, and any new market players established by the compensation model. Key questions include: What role do market participants have in selecting NRSROs to produce ratings, assessing the quality of ratings, and determining NRSRO compensation?
✓ **Oversight**	The evaluation of the model to ensure it works as intended. Key questions include: Does the model provide for an independent internal control function? What external oversight does the compensation model provide to ensure it is working as intended?

Source: GAO.