U.S. Securities and Exchange Commission
Fixed Income Market Structure Advisory Committee

Recommendation Regarding Ways to Mitigate Conflicts of Interest in Credit Ratings

June 1, 2020

The Credit Ratings Subcommittee ("Subcommittee") of the Fixed Income Market Structure Advisory Committee ("FIMSAC" or "Committee") was formed to consider the role of credit ratings issued by Nationally Recognized Statistical Ratings Organizations (NRSROs) in the corporate bond and municipal securities markets. One main area of exploration has been conflicts of interest in the industry payment model (i.e., issuer pays for the credit ratings assignment and maintenance) and any potential impact on market structure and efficiency. The Subcommittee heard from many industry participants on this topic and hosted panels at FIMSAC meetings to expose the broader Committee to its deliberations.

This recommendation is the culmination of work the Subcommittee performed over the past months. It leverages some ideas that surfaced through our research, and it attempts to mitigate some of the perceived potential conflicts of interest associated with the current issuer-pay model, without being overly prescriptive or recommending structural changes to the current NRSRO selection process.

The recommendation has three elements that reinforce each other to mitigate potential conflicts. The Subcommittee believes that all three elements likely would be beneficial and would improve transparency and potential outcomes for investors. Broadly, the recommendations include:

- Increased NRSRO disclosure
- Enhanced issuer (corporate and securitized) disclosures
- A mechanism for bondholders to vote on the issuer-selected NRSROs

The Subcommittee sincerely thanks the interested parties who contributed to our research over the past months. We benefited from their significant expertise in a variety of areas, and we appreciate their insights.

Increased NRSRO Disclosure

While various disclosure requirements for NRSROs currently exist, either to the SEC or publicly (or both), the Committee believes additional disclosures will benefit users of credit ratings. More specifically, the SEC should require NRSROs to disclose more in-depth information about their models and how the models differ by industry.

In deriving a methodology or model, there may be qualitative inputs in the application of a model. These inputs should be disclosed by the NRSRO to improve transparency and understanding of the development of model-implied ratings.

NRSROs should disclose the credit ratings produced by their model-implied ratings and discuss the rationales for any material differences between their model-implied credit rating and their final issued rating (currently a recordkeeping requirement of Exchange Act Rule 17g-2,). Also, if an NRSRO does not use a systematic approach which can be captured by model-implied ratings disclosure, the NRSRO should disclose the information and qualitative inputs considered to derive their ultimate rating, to provide context to investors. This information should be disclosed publicly, as well as to the SEC.

The Committee recognizes that NRSROs sometimes have good reasons to deviate from pure quantitative scores, but it also believes that NRSROs should provide more in-depth disclosures of when and how the NRSRO's modeling approach changes and why.

The Committee believes that additional summary statistics on how often, and to what extent, NRSROs deviate from their stated methodologies will allow interested users to analyze and incorporate this information into their evaluation of the relevance of ratings. Also, the increased transparency into the development of model-implied and ultimate ratings, including the objective and subjective elements that go into a rating, may contribute to better outcomes by allowing for additional clarity in ratings development.

Enhanced Issuer Disclosure

Corporate Credit

The Committee recognizes that many corporate credit issuers currently institute disclosure practices that may be considered "best practices." Further enhancing disclosure of how issuers select credit rating agencies will be beneficial for investors. Such disclosure will provide greater insights into each issuer's process for choosing NRSROs and will also encourage wider adoption of "best practices." We encourage the SEC to partner with appropriate trade groups to develop a set of best practices for choosing NRSROs and, once established, to require corporate issuers to disclose if/why they deviated from them in their annual reports.

Securitized Products

The Committee recognizes that many securitized issuers currently institute voluntary NRSRO rotation and other "best practices." Like the recommendation above, we believe enhancing disclosure on how securitized issuers select NRSROs would benefit investors. Establishment of a set of "best practices," and subsequent disclosures of deviations from them by issuers, would improve transparency and potentially add insight into potential conflicts. Additionally, issuers should disclose any non-disclosed NRSROs that rated the deal, to enable investors to gauge potential ratings shopping.

Bondholder Vote on "Ratification" of Issuer-Selected NRSRO

The Committee recommends that the SEC explore a "ratification" of issuer-selected NRSROs. Periodically, holders of publicly-issued bonds should vote to ratify—or simply confirm confidence in—the NRSROs chosen by each issuer. Like the vote to ratify the public auditor, the election would be a simple up/down vote. The risk of censure that these votes would place on credit rating agencies could provide additional discipline to the quality of their work.

Outstanding Issues

The Committee recognizes that, even with the implementation of these recommendations, issues remain. For example, some investors use benchmarks that require issues rated by specific NRSROs or investor guidelines that specifically reference NRSROs. These requirements contribute to the persistence of NRSRO market concentration. Additionally, some investors own bonds that strictly meet their guidelines (e.g., investment grade, or "IG"), but which market participants know should be high yield bonds. Such bonds trade with wider spreads than other IG bonds and expose investors to the risks of high yield bonds despite guidelines that may restrict such holdings.

We also recognize that existing statutory, regulatory, or legal constructs could prevent the implementation of these recommendations. We urge the SEC to explore these recommendations further and work to establish the needed legal or regulatory authority.