The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

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October 15, 2009

SEC Proposes Disclosure Requirements and Considers Enhanced Liability for Rating Agencies; Conference Call October 21

[23877]

October 15, 2009

TO: CLOSED-END INVESTMENT COMPANY COMMITTEE No. 24-09
EQUITY MARKETS ADVISORY COMMITTEE No. 44-09
FIXED-INCOME ADVISORY COMMITTEE No. 22-09
MONEY MARKET FUNDS ADVISORY COMMITTEE No. 42-09
MUNICIPAL SECURITIES ADVISORY COMMITTEE No. 48-09
SEC RULES COMMITTEE No. 60-09 RE: SEC PROPOSES DISCLOSURE REQUIREMENTS AND CONSIDERS ENHANCED LIABILITY FOR RATING AGENCIES; CONFERENCE CALL OCTOBER 21

The Securities and Exchange Commission has proposed a series of amendments to its disclosure rules to provide investors with additional information to understand the scope and meaning of credit ratings as well as their limitations. [1] In particular, the proposal would require disclosure of: (1) specific information regarding credit ratings used by registrants, including closed-end funds, in connection with a registered offering of securities; (2) certain information about potential conflicts of interest; (3) preliminary credit ratings; and (4) changes to credit ratings. In a companion release, the Commission is seeking comment on whether it should propose to repeal the exemption for credit ratings provided by nationally recognized statistical rating organizations ("NRSROs") from being considered a part of the registration statement for purposes of liability under Section 11 of the Securities Act of 1933 ("Securities Act"). [2]

Comments on the proposed amendments are due to the Commission by December 14,

2009. We will hold a conference call on Wednesday, October 21, at 3:00 p.m. Eastern time to discuss the Institute's comments relating to the Commission's proposal. The dial-in number for the conference call will be 1- 866-541-3298 and the passcode for the call will be 6501781. If you plan to participate on the call, please contact Ruth Tadesse by email at rtadesse@ici.org or by phone at 202-326-5836.

1. **Credit Ratings Disclosure Proposal**

   A. *Mandatory Disclosure of Credit Ratings*

The proposal would mandate that registrants disclose credit ratings, and certain general information about those ratings, assigned by rating agencies to classes of debt securities, convertible debt securities, and preferred stock in registration statements and periodic reports. [3] The proposal would require this disclosure only when a registrant uses the rating to offer or sell securities. It would not mandate that registrants obtain a credit rating on any security.

The proposal would extend to credit ratings of senior securities issued by closed-end funds registered under the Investment Company Act of 1940. Closed -end funds would be required to include the proposed disclosures in their prospectus, unless the prospectus relates to securities other than senior securities that have been rated by a rating agency. In such cases, disclosure would be permissible in the statement of additional information, unless the rating criteria would materially affect the registrant's investment policies. [4]

Specifically, the proposal would require disclosure of the following information regarding the scope of the rating and any limitations on the rating:

- the identity of the credit rating agency assigning the rating and whether such organization is an NRSRO;
- the credit rating assigned by the credit rating agency;
- the date the credit rating was assigned;
- the relative rank of the credit rating within the credit rating agency's classification system;
- a credit rating agency's definition or description of the category in which the credit rating agency rated the class of securities;
- all material scope limitations of the credit rating;
- how any contingencies related to the securities are or are not reflected in the credit rating;
- any published designation reflecting the results of any other evaluation done by the credit rating agency in connection with the rating, along with an explanation of the designation's meaning and the relative rank of the

designation;

- any material differences between the terms of the securities as assumed or considered by the credit rating agency in rating the securities and (i) the minimum obligations of the security as specified in the governing instruments of the security; and (ii) the terms of the securities as used in any marketing or selling efforts;
- a statement informing investors that a credit rating is not a recommendation to buy, sell, or hold securities; that it may be subject to revision or withdrawal at any time by the assigning credit rating agency; that each credit rating is applicable only to the specific class of securities to which it applies; and that investors should perform their own evaluation as to whether an investment in the security is appropriate; and
- any changes in the credit ratings.

The proposal would require the listed disclosures regarding credit ratings if the registrant, any selling security holder, any underwriter, or any member of a selling group uses a rating from a rating agency in connection with a registered offering. A credit rating would be "used" when it is disclosed in a prospectus or a term sheet, including closed-end fund advertisements that, under Rule 497(i) of the Securities Act, are considered to be filed with the Commission upon filing with a national securities association. A credit rating also would be "used" in connection with a private offering of securities that is made in reliance on an exemption from registration under the Securities Act when the privately offered securities are exchanged shortly thereafter for substantially identical registered securities, and disclosure would be required even if the rating was not disclosed in the registered exchange offer. The proposal would apply to oral and written selling efforts, including any responses to an inquiry from an investor. [5]

Request for Comment

The Commission seeks comment generally on whether the proposal should apply to closed-end funds, and specifically on whether it is appropriate to apply the proposed instruction to closed-end funds that a credit rating would be considered "used" if it is used in connection with a private offering but not used in a subsequent registered exchange offering for substantially identical securities. The Commission also requests comment on whether current fund disclosure requirements adequately address the meaning and limitations of ratings of portfolio securities. [6] In addition, the Commission asks whether the proposal should apply to the disclosure of ratings used by funds in other contexts, such as credit quality ratings for fixed-income funds, volatility ratings related to a fund's shares' market value, or principal stability ratings for money market funds, if the ratings are used in connection with the offer or sale of a fund's securities, and, if so, what disclosures should be required.

B. *Potential Conflicts of Interest*

The proposal would require disclosure of the identity of the party who is compensating the rating agency for providing the credit rating. If, during the registrant's last completed fiscal year and any subsequent interim period up to the date of the filing, the rating agency or any of its affiliates has provided non-rating services to the registrant or its affiliates, the proposal would require a description of the non-rating services, disclosure of the fee paid for the credit rating, and disclosure of the aggregated fees paid for the non-rating services. [7]

Request for Comment

The Commission requests comment on whether the proposed fee disclosures would have an effect on the quality of ratings and whether disclosure of the fee paid for the rating should be required regardless of whether additional services have been provided.

C. *Ratings Shopping*

The proposal would require that a registrant that has obtained a credit rating, and is required to disclose that rating, also disclose all preliminary credit ratings of the same class of securities as the final rating that are obtained from rating agencies other than the rating agency providing the final credit rating. [8] The registrant also must disclose any rating it obtains even if it is not used. The term "preliminary credit rating" would be read broadly to include any rating that is not published, any range of credit ratings, any oral or other indications of a potential credit rating or range of ratings and all other preliminary indications of a credit rating.

Request for Comment

The Commission seeks comment on whether the disclosure of preliminary ratings would be misleading to or confusing for investors. It also questions whether the disclosure should distinguish among users of corporate debt, structured finance products and/or closed-end funds, and requests comment on whether these issuers engage in credit ratings shopping equally or in the same manner.

D. *Disclosure in Securities Exchange Act Reports*

The proposal would require disclosure on Form 8-K when a credit rating, that was previously disclosed, has been changed, including when a rating has been

withdrawn or is no longer being updated. A registrant, including a closed-end fund, [9] would be required to file a report within four business days of receiving a notice or other communication from any rating agency that it has determined to change or withdraw a rating. [10] Specifically, the disclosure would include the date that the registrant received the notice or communication from the rating agency, the name of the rating agency, and the nature of the rating agency's decision. Any discussion of a material impact of the change in credit rating would be required to be disclosed in a registrant's periodic reports, not in the Form 8-K.

Request for Comment

The Commission seeks comment on whether it should require disclosure of other ratings actions, such as placing an issuer on "credit watch" or assigning a different outlook to the registrant's rating. It also seeks comment on whether it is appropriate to require closed-end funds to file reports on Form 8-K, or whether they should be permitted to disclose rating changes through other methods.

2. **Rating Agency Liability Concept Release**

The concept release explores whether the Commission should rescind the exemption for NRSROs from Section 11 liability under the Securities Act. Rescinding the exemption would cause NRSROs to be treated as experts when a rating is included in a registration statement – as is currently the case with rating agencies that do not possess the NRSRO designation. As experts, NRSROs generally would be subject to potential liability for an untrue statement, or an omission, of material fact related to the credit rating incorporated into the registration statement. This liability would be independent of the liability NRSROs are exposed to under the antifraud provisions of the securities laws. If the exemption for NRSROs from Section 11 were removed, NRSROs would have to consent to inclusion of a credit rating by a registrant in a registration statement. [11]

Request for Comment

The Commission seeks comment on many aspects of the concept release, including the potential effect on registrants and access to capital, the impact on rating agencies and their willingness to provide consents, and the implications for investors. Specifically, the Commission requests comment on whether any costs of increasing potential liability for NRSROs would be passed on to investors and whether the Commission should distinguish between issuers of corporate debt, structured products, and closed-end funds when treating NRSROs as experts. The Commission

also seeks comment on whether eliminating the exemption would improve or harm the quality of ratings, and whether investors with guidelines that require them to invest in rated securities would be able to continue to invest.

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endnotes

[1] See SEC Release Nos. 33-9070; 34-60797; and IC-28942 (October 7, 2009) (“proposal”), available at: http://www.sec.gov/rules/proposed/2009/33-9070.pdf.

[2] See SEC Release Nos. 33-9071; 34-60798; and IC-28943 (October 7, 2009) (“concept release”), available at: http://www.sec.gov/rules/concept/2009/33-9071.pdf.

[3] Commission rules currently permit voluntary disclosure of credit ratings assigned by rating agencies.

[4] The proposed requirements would replace current Item 10.6 of Form N-2, although many of the disclosures would be similar.

[5] The proposal would not apply if the only disclosure of a credit rating in a filing with the Commission is related to changes to a rating, the liquidity of the registrant, the cost of funds for a registrant, or the terms of agreements that refer to credit ratings, and the credit rating is not otherwise used in connection with a registered offering.

[6] In posing this question, the Commission notes that funds – closed-end funds and mutual funds – sometimes represent that they invest only in securities that have a specified credit rating, but that investors may not have sufficient information to understand what those credit ratings mean.

[7] Disclosure of the fee paid for the rating would only be required if disclosure of other non- rating services is required.

[8] The proposal would provide that registrants could rely on Rule 409 under the Securities Act to disclose information about preliminary ratings only if the requisite information can be obtained without unreasonable effort or expense.

[9] A closed-end fund would not be required to file a Form 8-K if substantially the same information has been previously reported by the fund pursuant to Rule 12b-20 under the Securities Exchange Act of 1934.

[10] The proposed disclosure regarding changes to a credit rating would apply only to credit ratings that were disclosed pursuant to this proposal.

[11] The concept release suggests specific timing and circumstances for when consents would need to be provided if the exemption for NRSROs were rescinded.