

MEMO# 25468

September 8, 2011

Draft Letter on SEC Study on Assigned Ratings for Structured Finance Securities; Comments Due September 12

[25468]

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TO: DERIVATIVES MARKETS ADVISORY COMMITTEE No. 36-11
EQUITY MARKETS ADVISORY COMMITTEE No. 57-11
FIXED-INCOME ADVISORY COMMITTEE No. 65-11
MONEY MARKET FUNDS ADVISORY COMMITTEE No. 52-11
MUNICIPAL SECURITIES ADVISORY COMMITTEE No. 44-11
SEC RULES COMMITTEE No. 77-11 RE: DRAFT LETTER ON SEC STUDY ON ASSIGNED RATINGS FOR STRUCTURED FINANCE SECURITIES; COMMENTS DUE SEPTEMBER 12

As we previously informed you, the Securities and Exchange Commission ("SEC") is conducting a study on the credit rating process for structured finance products ("SFPs") pursuant to Section 939F of the Dodd-Frank Act, and has published a request for comments to inform its efforts. [\[1\]](#) The Institute has drafted a letter to the Commission addressing matters relating to credit ratings for SFPs and the feasibility of establishing a system in which a public or private utility or a self-regulatory organization would assign a nationally recognized statistical rating organization ("NRSRO") to determine credit ratings for SFPs ("SFP Assignment System" or "System"). The draft letter is attached and summarized below.

Comments for the study are due to the Commission on September 13. Please provide any comments on the draft letter to Heather Traeger (htraeger@ici.org or 202/326-5920) by the close of business on September 12.

The draft letter begins by stating that ICI has supported many of the NRSRO reforms contained in the Dodd-Frank Act, because they address concerns about the credibility and reliability of credit ratings and seek to improve the quality of credit ratings procedures. It raises concerns, however, that the SFP Assignment System under review in the study may conflict with certain of the goals of the Dodd-Frank Act, create confusion for investors, and hinder competition in the NRSRO space. It suggests that the Commission's study should conclude that a separate system for the assignment of NRSROs to determine the initial

credit ratings of SFPs is unnecessary for the protection of investors. Rather, it recommends that the Commission take several steps to incentivize NRSROs to produce credible and reliable ratings for SFPs, including: (1) implement the other NRSRO provisions of the Dodd-Frank Act, including the legal accountability sections and its recently proposed changes to the regulatory framework for NRSROs; (2) enhance the Rule 17g-5 Program for unsolicited ratings; and (3) improve issuer disclosures for SFPs.

I. Current Process for Rating SFPs and Associated Conflicts of Interest

The draft letter advises the Commission, in conducting its study, to be mindful of the continuing role of ratings in the debt market and to be cautious not to disrupt the entire ratings marketplace and the improvements it is undergoing. It states that even if the regulatory emphasis on ratings is diminished, the use of ratings likely will persist because of the increasing complexity of the capital markets. Accordingly, NRSROs must be incentivized to provide market participants and investors with high-quality reliable ratings.

The letter explains that the failures by the rating agencies to accurately analyze the risks of SFPs and manage conflicts of interest leading to the 2008 credit crisis were a function of weaknesses in the general credit-rating process and the related regulatory controls. They were not specific to SFPs. The draft letter argues that effective and meaningful reform of the regulatory structure for NRSROs must include enhancements to disclosure and transparency, address potential conflicts of interest, and increase the accountability of an NRSRO for its credit ratings. Further, such reforms should be applied in a uniform and consistent manner that applies equally to all types of rated securities.

II. Proposed SFP Assignment System

The draft letter states that, contrary to the design of the Dodd-Frank Act, the SFP Assignment System would harm the ratings process for SFPs. The letter then identifies a series of problems and concerns inherent in the System. It notes, for example, that the System would provide for the creation of a Credit Rating Agency Board (“Board”) to assign “qualified NRSROs” to provide initial ratings for SFPs. [\[2\]](#) The letter explains that assigning an NRSRO in this way would stifle competition by denying the market of two or more ratings on a security and perhaps differing opinions and insights. It also explains that the SFP Assignment System likely would create an additional barrier to entry for NRSROs interested in rating SFPs because classification as a “qualified NRSRO” would require satisfaction of additional regulatory burdens.

In addition, the draft letter raises the issue of moral hazard and states that the SFP Assignment System creates the appearance of a “seal of approval” for the assigned rating by placing a government imprimatur on the rating. Alternatively, it argues that the existence of the System may act as a disincentive for some market participants to invest in these products, by tainting all SFPs as more risky without adequately differentiating between the risks each issuance may entail. Importantly, the letter identifies the fact that the System would face its own conflicts of interest because, for example, Board members may have a strong interest in ensuring favorable ratings for a particular issuer or security. It also raises numerous concerns with respect to operations, surveillance, fees and costs.

III. Recommendation: Implement Provisions of Dodd-Frank Act with the exception of the SFP Assignment System, Enhance Rule 17g-5 Program, and Improve Issuer Disclosure

Taking into consideration the various costs and benefits of the numerous models for rating securities, including SFPs, the draft letter states that the best solution to improve the credit rating system for SFPs while serving the public interest and the protection of investors involves multiple parts:

- Implement the rules necessary to effectuate the provisions of the Dodd-Frank Act, with the exception of the SFP Assignment System, paying particular attention to the provisions on legal accountability and those designed to provide investors with a better understanding of individual ratings, their reliability and their limitations;
- Enhance the existing Rule 17g-5 Program for unsolicited ratings; and
- Improve issuer disclosure for SFPs.

A. Implement Dodd-Frank Act Provisions - Accountability and Oversight Framework

The draft letter reflects ICI's support for the majority of provisions in the Dodd-Frank Act, including those calling for (1) greater legal accountability for NRSROs for their ratings and (2) improvements to disclosure, transparency and conflicts of interest regarding ratings and the ratings process. It recommends that the Commission actively pursue actions against NRSROs for failures to comply with their stated policies and procedures and urges the Commission to fully implement the Dodd-Frank Act provisions related to NRSRO liability as a means to improve the quality of NRSRO ratings and analysis. In addition, the draft letter recommends that the Commission move forward with its recently proposed, comprehensive set of rules to resolve weaknesses in the ratings process and NRSRO structures that contributed to the ratings inaccuracies related to the 2008 financial crisis. It further recommends that the Commission allow such rules to operate for a meaningful amount of time (e.g., at least a year) before again considering whether to impose the SFP Assignment System or a similar system on the SFPs market.

B. Enhance Rule 17g-5 Program

While supporting the existing Rule 17g-5 Program, which creates a mechanism for unsolicited initial ratings for SFPs, the draft letter recommends several enhancements to the Program. First, it suggests that the Commission increase the percent of "free peaks" for unsolicited NRSROs, to account for the scope of the SFP market and the numerous variables associated with rating a SFP (e.g., from 10 percent to 25 percent). Second, it encourages the Commission to evaluate the confidentiality considerations and limitations that have arisen around the Rule 17g-5 Program. It specifically recommends that the Commission prohibit terms of use on an Internet website by an unsolicited NRSRO that would differ from terms agreed to by any NRSRO hired to produce a SFP rating because such terms are contrary to the goal of enhancing the accuracy of ratings and ratings procedures.

C. Improve Issuer Disclosure

In addition to improving investor access to information about ratings, the draft letter urges the Commission to require more rigorous disclosure of issuers for offerings of SFPs to

ensure that investors are able to formulate their own informed investment decisions at the time of initial purchases and on an ongoing basis.

Heather L. Traeger
Associate Counsel

[Attachment](#)

endnotes

[1] Solicitation of Comment to Assist in Study on Assigned Credit Ratings, SEC Release No. 34-64456 (May 10, 2011).

[2] The SFP Assignment System would require the Commission to establish the Board, which would be an SRO, private utility or public utility, and select the initial members of the Board. The Commission also would be required to establish a schedule to ensure that the Board begins assigning “qualified NRSROs” to provide initial ratings not later than one year after the selection of the members of the Board. The method of selecting the “qualified NRSRO” to provide the initial rating would be based on an evaluation by the Board of a number of alternatives, including a lottery or rotating assignment system.

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