

**MEMO# 25485**

September 14, 2011

# **ICI Letter to Assist in SEC Study on Assigned Credit Ratings for Structured Finance Products**

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TO: DERIVATIVES MARKETS ADVISORY COMMITTEE No. 37-11  
EQUITY MARKETS ADVISORY COMMITTEE No. 58-11  
FIXED-INCOME ADVISORY COMMITTEE No. 67-11  
MONEY MARKET FUNDS ADVISORY COMMITTEE No. 53-11  
MUNICIPAL SECURITIES ADVISORY COMMITTEE No. 45-11  
SEC RULES COMMITTEE No. 79-11 RE: ICI LETTER TO ASSIST IN SEC STUDY ON ASSIGNED CREDIT RATINGS FOR STRUCTURED FINANCE PRODUCTS

ICI has filed a letter in response to the Securities and Exchange Commission's ("SEC") request for comment to inform its study on the credit rating process for structured finance products ("SFPs"). Pursuant to Section 939F of the Dodd-Frank Act, the SEC must review the ratings process for SFPs, including 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"). [\[1\]](#) ICI's letter is attached and summarized below.

## **Summary**

The 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 confuse investors, hinder competition among NRSROs, and harm the SFP market. Instead, ICI's letter suggests that a more effective and appropriate manner to improve the quality of SFP ratings would involve a combination of steps designed to address the credit-rating process and the related regulatory controls for all rated securities. Such measures would include: (1) implementing the NRSRO provisions of the Dodd-Frank Act (with the exception of the SFP Assignment System), including the legal accountability sections and its recently proposed changes to the regulatory framework for NRSROs; (2) enhancing the Rule 17g-5

Program for unsolicited ratings; and (3) improving issuer disclosures for SFPs.

## **I. Proposed SFP Assignment System**

ICI's 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 precluding the possibility of multiple initial ratings on a security and perhaps a range of differing opinions and insights for investors to consider. 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 over and above becoming an NRSRO.

In addition, the 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. It also argues that separate assignment system for ratings of SFPs 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.

## **II. Recommendations for Improving the Credit Rating System**

Taking into consideration the various costs and benefits of the numerous models for rating securities, including SFPs, the 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 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, ICI's 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 letter recommends several enhancements to the Program. First, it suggests that the Commission increase the percent of “free peeks” 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 of the issued securities for which it accessed information 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 are more stringent than terms agreed to by any NRSRO hired to produce a SFP rating.

## **C. Improve Issuer Disclosure**

In addition to improving investor access to information about ratings, ICI’s 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.

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### [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.