

## COMMENT LETTER

February 2, 2010

# ICI Files Letter on SEC Proposal to Add Additional Requirements on Credit Rating Agencies (pdf)

February 2, 2010 Ms. Elizabeth M. Murphy Secretary U.S. Securities and Exchange Commission 100 F Street, N.E. Washington, D.C. 20549-1090 Re: Proposed Rules for Nationally Recognized Statistical Rating Organizations (File No. S7-28-09) Dear Ms. Murphy: The Investment Company Institute<sup>1</sup> supports the Securities and Exchange Commission's continuing efforts to address longstanding concerns regarding credit ratings and the oversight of Nationally Recognized Statistical Rating Organizations ("NRSROs") and credit rating agencies in general. As we have stated on a number of occasions in connection with initiatives to reform the regulation and operation of rating agencies, increasing disclosure and transparency are critical elements of reform in this area and are essential to ensuring the credibility and reliability of credit ratings.<sup>2</sup> The SEC's current proposal,<sup>3</sup> which would further advance the goals of the SEC's oversight program for NRSROs, including increasing disclosure and transparency, and diminishing conflicts of interest, is another step toward the formulation of a more effective regulatory scheme for rating 1 The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of \$11.82 trillion and serve almost 90 million shareholders. 2 For an in-depth discussion of our views on reform of NRSRO regulation, see e.g., Statement of Paul Schott Stevens, President and CEO, Investment Company Institute, SEC Roundtable on Oversight of Credit Rating Agencies, dated April 15, 2009 ("April 2009 Roundtable Statement"); Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated March 26, 2009 ("March 2009 ICI Letter"); and Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Florence Harmon, Acting Secretary, Securities and Exchange Commission, dated July 25, 2008 ("2008 ICI Letter"). 3 See Proposed Rules for Nationally Recognized Statistical Rating Organizations, SEC Release No. 34-61051 (November 23, 2009), 74 FR 63866 (December 4, 2009) ("Release"). Ms. Elizabeth Murphy February 2, 2010 Page 2 of 6 agencies. The Institute supports the overarching goals of the proposal and urges the SEC to promptly approve these and other pending proposals regarding the reform of rating agencies.<sup>4</sup> New Annual Compliance Report for NRSROs The SEC's proposal would require an NRSRO to furnish a new unaudited annual report to the SEC describing the steps taken by the NRSRO's designated compliance officer during the fiscal year to fulfill the compliance officer's responsibilities under Section

15E(j) of the Securities Exchange Act of 1934.<sup>5</sup> The Release explains that this requirement is in response to issues identified during examinations of the three largest NRSROs with respect to each NRSRO's policies and procedures. Although the Institute believes that requiring an NRSRO's designated compliance officer to prepare an annual compliance report would encourage a more rigorous compliance program and, thereby, promote the identification and prompt remediation of compliance failures and weaknesses in the NRSRO's policies and procedures, we question the proposed requirement that the report be submitted to the SEC. We believe that such a requirement could have a chilling effect on even the most compliance- oriented organization to perform a comprehensive and in depth review of the NRSRO's activities, policies, and procedures, or to identify material compliance matters. As the Release notes, other areas of the SEC's rules and regulations also require an annual report by a chief compliance officer with respect to investment companies and investment advisers; however, these rules do not require that such reports be submitted to the SEC.<sup>6</sup> Rather, the SEC can look at these reports when it conducts its examinations. Indeed, even without SEC reporting, for the fund industry, annual compliance reviews have fostered a greater focus on compliance controls and procedures, to the benefit of fund shareholders. We believe a similar requirement can bring the same benefits to NRSROs and the users of NRSRO ratings without the possible detrimental effects to an NRSRO's compliance efforts of requiring it to furnish its annual compliance report to the SEC.

**Disclosure Relating to Sources of Revenue** The SEC is proposing to amend the instructions for Exhibit 6 of Form NRSRO to require a credit rating agency in an application for registration as an NRSRO or an NRSRO providing its annual 4 We are particularly pleased that the SEC at its Open Meeting on January 27, 2010 regarding money market reform recognized the critical role that NRSROs play in Rule 2a-7 and voted to retain credit ratings in the rule. For an in-depth discussion of our views on the role credit ratings play in Rule 2a-7, see e.g., Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated September 8, 2009, at 13-17. 5 Specifically, the proposed amendments would require that the report include: (1) a description of any compliance reviews of the activities of the NRSRO; (2) the number of material compliance matters found during each review of the activities of the NRSRO and a brief description of each such finding; (3) a description of any remediation measures implemented to address material compliance matters found during the reviews of the activities of the NRSRO; and (4) a description of the persons within the NRSRO who were advised of the results of the reviews. 6 See Rule 38a-1 under the Investment Company Act of 1940 and Rule 206(4)-7 under the Investment Advisers Act of 1940. Although these rules do not require funds and advisers to submit their annual reviews to the SEC, under Rule 38a-1, funds must provide an annual report to their boards. Ms. Elizabeth Murphy February 2, 2010 Page 3 of 6 update to disclose: (1) the percentage of the net revenue of the applicant/NRSRO attributable to the 20 largest users of credit rating services of the applicant/NRSRO; and (2) the percentage of the net revenue of the applicant/NRSRO attributable to services and products other than credit rating services. The Institute supports this disclosure. By requiring the inclusion of this information on Form NRSRO, investors will have a better understanding of the relationship between the largest users of credit ratings and the rating agency, including areas in which conflicts of interest may be present. It also would provide investors more specific information about the extent to which NRSRO revenue are from a concentrated group of clients. Significantly, the proposed disclosure regarding the sources of revenue should highlight for investors potential revenue-related conflicts of interest that could influence an NRSRO's objectivity in determining credit ratings.

**New Rule 17g-7—Credit Rating Reports on Revenue** The Institute supports the SEC's proposed new Rule 17g-7 that would require an NRSRO on an annual basis to make publicly available on its Internet website a consolidated report

containing information about the revenues earned by the NRSRO and, if applicable, its affiliates as a result of providing services and products to persons that paid the NRSRO to issue or maintain a credit rating.<sup>7</sup> This information would provide users of credit ratings with information to assist them in evaluating the potential risk to the integrity of a credit rating that arises from the conflict inherent when an NRSRO is paid to determine a credit rating for a specific obligor, security, or money market instrument. Indeed, we believe that providing users of credit ratings with this information would enable them to better assess whether the revenue generated from the person soliciting the NRSRO to determine the credit rating could compromise the NRSRO's objectivity. Improve Disclosure about Credit Ratings and the Ratings Process In connection with the proposal, the SEC also requests comment as to whether it would be appropriate to require that specific information be reported when a credit rating action is made publicly available (i.e., more than a generic statement of where relevant information can be located). On a number of occasions, the Institute has made specific recommendations on improving disclosure about credit ratings and the ratings process.<sup>8</sup> Institute members continue to emphasize the importance to them, as investors, of access to information about a credit rating agency's policies, procedures, and other practices relating to rating decisions. Public disclosure of this information allows investors to more effectively evaluate a rating agency's independence, objectivity, capability, and operations. Such disclosure also serves as an additional mechanism for ensuring the integrity and quality of the credit

<sup>7</sup> Specifically, with respect to each person that paid the NRSRO to issue or maintain a credit rating, the proposal would require information regarding (1) the percent of the net revenue attributable to the person earned by the NRSRO during the most recently ended fiscal year from providing services and products other than credit rating services; (2) the relative standing of the person in terms of the person's contribution to the NRSRO's net revenue as compared with other persons that contributed to the NRSRO's net revenues; and (3) the identity of all outstanding credit ratings issued by the NRSRO and paid for by the person. <sup>8</sup> For a list of these recommendations, see April 2009 Roundtable Statement, *supra* note 2. Ms. Elizabeth Murphy February 2, 2010 Page 4 of 6 ratings themselves. To realize the full potential of such a disclosure regime, the Institute also has recommended that the SEC require rating agencies, as a condition of rating a security, provide investors with a standardized presale report.<sup>9</sup> Equally important to improved disclosure about credit ratings and the ratings process, however, is a requirement that credit rating agencies conduct better due diligence and verification. Under current SEC rules, it is difficult for a user of a rating to gauge the accuracy of the information being analyzed by the rating agency and, thus, the rating agency's ability to assess the creditworthiness of the underlying security.<sup>10</sup> To address these concerns, we have recommended that credit rating agencies be required to conduct due diligence on the information they review to issue ratings.<sup>11</sup> Differentiating Structured Finance Credit Ratings The SEC is deferring consideration of action with respect to a proposed rule that would have required an NRSRO to include, each time it published a credit rating for a structured finance product, a report describing how the credit ratings procedures and methodologies and credit risk characteristics for structured finance products differ from those of other types of rated instruments, or alternatively, to use distinct ratings symbols for structured finance products that differentiate them from the credit ratings for other types of financial instruments.<sup>12</sup> In our comment letter on this proposal, although we supported the use of such a report, we opposed the use of a special identifier or symbol for structured finance products.<sup>13</sup> The SEC, however, is soliciting comments on how the risk characteristics of structured finance products and credit ratings differ from the risk characteristics of corporate, municipality, and sovereign nation debt instruments and their credit ratings.<sup>14</sup> <sup>9</sup> See April 2009 Roundtable Statement, *supra* note 2, at 4; March 2009 ICI Letter, *supra* note 2, at 6-7. <sup>10</sup> Current rules only require that rating

agencies provide a description of (1) the public and nonpublic sources of information used in determining credit ratings, including information and analysis provided by third-party vendors; (2) whether and how information about verification performed on assets underlying structured finance securities is relied upon in determining credit ratings; and (3) whether and how assessments of the quality of originators of structured finance securities factor into the determination of credit ratings. 11 See April 2009 Roundtable Statement, *supra* note 2, at 5. 12 See Proposed Rules for Nationally Recognized Statistical Rating Organizations, SEC Release No. 34-57967 (June 17, 2008), 73 FR 36211 (June 25, 2008). 13 Specifically, we supported the goal of increasing transparency in the ratings process for structured finance products and believed the proposed report would achieve this goal; however, we believed that users of ratings would gain very little from a special identifier or symbol because such a device would not add to the quality, integrity, or clarity of a structured finance product credit rating. See 2008 ICI Letter, *supra* note 2. 14 Specifically, the SEC requests market participants and others to provide their views in the following four areas: (1) the differences between structured finance products and other debt instruments; (2) the differences between credit ratings for structured finance products and credit ratings for other types of debt instruments; (3) potential measures to communicate differences in structured finance products to investors; and (4) potential measures to communicate differences in structured finance credit ratings to investors. Ms. Elizabeth Murphy February 2, 2010 Page 5 of 6 We support further examination of these issues, but suggest that the SEC's disclosure requirements be sufficiently comprehensive and flexible to address concerns that may arise in the future relating to other debt instruments as well. Indeed, as discussed above, more rigorous disclosure requirements are needed for offerings of all debt instruments to ensure that investors are able to formulate their own informed investment decisions at the time of initial purchases and on an ongoing basis. This is particularly true for municipal securities where there is a significant disparity in the amount and quality of information available on municipal securities as compared with corporate debt securities.<sup>15</sup> The Institute also believes that issuers, in addition to credit rating agencies, have a role to play in the effort to increase transparency and disclosure about structured finance products, as well as for other debt instruments. To this end, the Institute has supported efforts by the SEC to enhance such disclosure by amending rules under the Securities Act of 1933. Specifically, the Institute has recommended (1) expanding the scope of Regulation AB<sup>16</sup> to include the various collateralized and pooled products that fall within the SEC's broad definition of "structured finance product" under the rating agency rules<sup>17</sup> so that investors receive, at a minimum, disclosure equivalent to that required of asset-backed securities under Regulation AB; (2) increasing the information being disclosed pursuant to Regulation AB; and (3) requiring that disclosure under Regulation AB be ongoing.<sup>18</sup> Similarly, to truly improve disclosure in the municipal securities market, we also have called for steps to be taken to improve the content and timing of required issuer disclosure for municipal securities.<sup>19</sup> In addition to providing investors with more information regarding an offering, these disclosures can provide insights on the development and meaning of an assigned rating, and the limitations of a rating. This, in turn, would allow investors, as well as other market participants and competing rating agencies, to evaluate in greater detail the analysis and assumptions of the hired rating agency, and to perform a more thorough analysis of their own. 15 For an in-depth discussion of our views on improving disclosure and transparency regarding municipal securities, see Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated September 8, 2009 ("September 2009 ICI Letter"); see also April 2009 Roundtable Statement, *supra* note 2, at 9-10 and 2008 ICI Letter, *supra* note 2, at 17-18. 16 Regulation AB sets forth the disclosure requirements for the registration of the sale of "asset-backed securities" under the Securities Act, as well as the disclosures

pursuant to the reporting requirements imposed under the Securities Exchange Act for those securities sold in public offerings. The disclosure for other structured finance products is not specifically addressed in SEC rules or regulations (other than to the extent that they are subject to general rules about antifraud and material information) because the vast majority of those products are sold in transactions that are exempt from registration. 17 The SEC recently adopted the phrase “any security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction” to define the scope of structured finance products subject to certain provisions in the rating agency rules. Simultaneously, the SEC proposed the use of this definition of structured finance product for additional provisions in the rating agency rules. 18 See April 2009 Roundtable, *supra* note 2, at 7-9 and March 2009 ICI Letter, *supra* note 2, at 7-10. 19 See April 2009 Roundtable, *supra* note 2, at 9-10 and September 2009 ICI Letter, *supra* note 15, at 10-13. Ms. Elizabeth Murphy February 2, 2010 Page 6 of 6 \* \* \* \* \* We look forward to working with the SEC as it continues to examine these critical issues. In the meantime, if you have any questions, please feel free to contact me directly at (202) 326-5815, Ari Burstein at (202) 371-5408, or Jane Heinrichs at (202) 371-5410. Sincerely, /s/ Karrie McMillan Karrie McMillan General Counsel cc: The Honorable Mary L. Schapiro, Chairman The Honorable Kathleen L. Casey The Honorable Elisse B. Walter The Honorable Luis A. Aguilar The Honorable Troy A. Paredes Robert W. Cook, Director Michael Macchiaroli, Associate Director Division of Trading and Markets Andrew J. Donohue, Director Robert E. Plaze, Associate Director Division of Investment Management Meredith Cross, Director Paula Dubberly, Associate Director Division of Corporation Finance