

## COMMENT LETTER

August 8, 2011

# ICI Files Letter Concerning Nationally Recognized Statistical Rating Organizations (pdf)

August 8, 2011 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. S7-18-11) Dear Ms. Murphy: The Investment Company Institute<sup>1</sup> is pleased to comment on the Securities and Exchange Commission's ("Commission") proposal to implement provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") concerning nationally recognized statistical rating organizations ("NRSROs") and to enhance oversight of NRSROs.<sup>2</sup> ICI member funds are significant investors in the securities markets and they use credit ratings in a variety of ways as part of their investment process. Funds thus have a vital interest in the soundness of the credit rating system. Consequently, we have long supported Congressional and Commission efforts to address concerns about the credibility and reliability of credit ratings and to improve the quality of the credit ratings process.<sup>3</sup> The Commission's current proposal—shaped in large part by specific requirements in the Dodd-Frank Act—appears designed to promote goals we strongly support, including enhancing disclosure and transparency, addressing potential conflicts of interest, and increasing the accountability

<sup>1</sup> 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 \$13.1 trillion and serve over 90 million shareholders.

<sup>2</sup> Proposed Rules for Nationally Recognized Statistical Rating Organizations, SEC Release No. 34-64514 (May 18, 2011).

<sup>3</sup> See, e.g., Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth Murphy, Secretary, U.S. Securities and Exchange Commission, dated February 2, 2010 and Statement of Paul Schott Stevens, President and CEO, Investment Company Institute, SEC Roundtable on Oversight of Credit Rating Agencies, dated April 15, 2009 ("ICI 2009 Statement").

Ms. Elizabeth M. Murphy August 8, 2011 Page 2 of 7 of an NRSRO for its credit ratings. It is important that they do so without unintentionally regulating the substance of credit ratings or otherwise creating undue burdens for NRSROs that could lead firms to exit (or not enter) the business, which would result in fewer NRSROs, less competition, and less pressure to ensure the quality of ratings. In particular, ICI supports the proposed enhancements for additional disclosure and reporting requirements regarding ratings performance, ratings methodologies, and other qualitative and quantitative information about ratings as a means to further improve investors' access to information about the

quality and credibility of NRSROs and their ratings. We also support the proposed disclosure requirements relating to third-party due diligence service providers, although we are concerned, as discussed below, about the application of certain of these requirements to municipal entities. ICI believes that the Commission's proposed disclosures are integral to providing a complete picture so that investors better understand individual ratings, their reliability, and their limitations. Public Disclosure of Information about the Performance of Credit Ratings Consistent with provisions of the Dodd-Frank Act,<sup>4</sup> the Commission proposes significant enhancements to the current requirements for generating and disclosing information about credit rating performance statistics and ratings histories. On previous occasions, ICI has expressed support for enhancing disclosure surrounding performance statistics and ratings histories.<sup>5</sup> Accordingly, we generally support these portions of the Commission's proposal. Moreover, ICI has called for greater standardization of performance measurement statistics to facilitate the comparability of measurement statistics across all NRSROs.<sup>6</sup> We are pleased, therefore, that the Dodd-Frank Act specifically provides that the Commission's rules must require disclosures that "are comparable among [NRSROs], to allow users of credit ratings to compare the performance of ratings by different [NRSROs]." To this end, the Commission's proposal would create a new "Transition/Default Matrix" designed to require standardized disclosure of credit rating performance measurement statistics. NRSROs would have to provide on an annual basis a 1-, 3-, and 10-year Transition/Default Matrix for 4 See Section 932(a)(8) of the Dodd-Frank Act, which adds new subsection (q) to Section 15E of the Securities Exchange Act of 1934 ("Exchange Act"), concerning transparency of ratings performance. 5 See, e.g., Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Florence Harmon, Acting Secretary, U.S. Securities and Exchange Commission, dated July 25, 2008, at 12-14; Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth Murphy, Secretary, U.S. Securities and Exchange Commission, dated March 26, 2009 ("ICI March 2009 Letter"), at 3. 6 Id.; see also Letter from Elizabeth Krentzman, General Counsel, Investment Company Institute, to Nancy M. Morris, Secretary, U.S. Securities and Exchange Commission, dated March 12, 2007, at 3. Ms. Elizabeth M. Murphy August 8, 2011 Page 3 of 7 each applicable class and subclass of credit rating. ICI believes the presentation of performance measurement statistics in the format the Commission proposes will improve the ability of credit rating users and other interested parties to analyze and compare credit rating performance. For this reason, we support the proposed approach. To enhance disclosure of ratings histories, the Commission's proposal would, among other things, substantially broaden the scope of credit ratings that would be subject to the disclosure requirements and increase the number and scope of data fields that must be disclosed. ICI supports expanding ratings history disclosures in these ways. We are disappointed, however, that the proposal would maintain the current 12-month (issuer-paid credit ratings) and 24-month (subscriber-paid credit ratings) time lags for making this information public and reiterate our concern that such delay is excessive and severely diminishes the usefulness of the information.<sup>7</sup> Credit Rating Methodologies The Dodd-Frank Act provides that the Commission must prescribe rules with respect to the procedures and methodologies, including qualitative and quantitative data models, used by NRSROs that require each NRSRO to achieve various objectives identified in the statute.<sup>8</sup> ICI supports the Commission's proposal to implement this provision by requiring an NRSRO to establish, maintain, enforce, and document policies and procedures that are reasonably designed to ensure the specified objectives. Importantly, consistent with prior ICI recommendations, this proposed approach avoids regulating NRSROs' methodologies.<sup>9</sup> Instead, it appropriately recognizes that procedures and methodologies for determining credit ratings vary across NRSROs and thus provides flexibility for each NRSRO to establish policies and procedures that can be integrated with its own credit rating procedures and methodologies.

We also support the Commission's proposed approach to implementing certain portions of the above-referenced Dodd-Frank Act provisions concerning NRSROs' disclosure of information about material changes to procedures and methodologies they use to determine credit ratings. In particular, we support requiring that an NRSRO's policies and procedures with respect to the procedures and methodologies used to determine credit ratings be reasonably designed to ensure that an NRSRO promptly publishes on an easily accessible portion of its corporate Internet website: (1) material 7 See ICI March 2009 Letter, *supra* note 5, at 3-4 (suggesting, for example, a delay of three months after the date of the rating action). 8 See Section 932(a)(8) of the Dodd-Frank Act, which adds new subsection (r) to Section 15E of the Exchange Act. 9 See, e.g., Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth Murphy, Secretary, U.S. Securities and Exchange Commission, dated February 7, 2011, at 1 (stating that standardization and government intervention over the specific ratings methodology and components of ratings has the potential to undermine competition and decrease the value of ratings, thereby harming the market and investors). Ms. Elizabeth M. Murphy August 8, 2011 Page 4 of 7 changes to the procedures and methodologies, the reason for the changes, and the likelihood the changes will result in changes to any current ratings, and (2) significant errors identified in a procedure or methodology that may result in a change in current credit ratings. It is critical that NRSROs communicate this information to investors and users of credit ratings in a timely manner and we believe that use of an NRSRO's Internet website for this purpose should facilitate prompt disclosure.

**Form and Certifications to Accompany Credit Ratings** The Commission's proposal would require an NRSRO to publish certain qualitative and quantitative information about credit ratings whenever it takes a rating action. The required information would include, for example, the main assumptions and principles used in constructing the procedures and methodologies used to determine the credit rating, the potential limitations of the credit rating, information on the uncertainty of the credit rating, and a statement containing an overall assessment of the quality of information available and considered in determining the credit rating. Many of the proposed disclosure requirements directly track language in the Dodd-Frank Act. ICI supports the Commission's proposal. The proposed requirements should elicit disclosure that will assist investors and other users of credit ratings in understanding how the ratings were determined and in evaluating NRSROs' rating actions. In particular, disclosure of this information should allow investors to more effectively evaluate an NRSRO's capability and operations and the integrity and quality of the rating. We recommend that the Commission explicitly state, if it adopts the proposal, that the proposed disclosure regarding rating actions identifies the minimum information that must be provided by rule, but NRSROs are encouraged to provide additional information as they deem appropriate.

**Third Party Due Diligence for Asset-Backed Securities** The Commission's proposal would include new Form ABS Due Diligence - 15E, requiring certain public disclosures by third-party due diligence services related to asset-backed securities ("ABS").<sup>10</sup> An NRSRO would be required to include the Form ABS-Due Diligence with the publication of a credit rating. The proposed disclosures would require a description of the due diligence performed including, for example, the type of assets reviewed, the sample size, whether the quality or 10 Section 941 of the Dodd-Frank Act amended the Exchange Act by adding a definition for "asset-backed security." An "Exchange-Act ABS" would include "a fixed-income or other security collateralized by any type of self-liquidating asset (including a loan, a lease, a mortgage, or a secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset." See Section 941 of the Dodd-Frank Act, which adds new subsection (77) to Section 3(a) of the Exchange Act. The proposed due diligence disclosure would apply to Exchange-Act ABS, although the Commission explains that the most common use of third-party due

diligence services is for residential mortgage-backed securities. Ms. Elizabeth M. Murphy August 8, 2011 Page 5 of 7 integrity of information or data about the assets was reviewed, and whether the origination of the assets conformed to, or deviated from, stated underwriting or credit extension guidelines, standards, criteria or other requirements. It also would require a summary of the findings and conclusions that resulted from the due diligence review and certifications regarding the review. ICI believes that the proposed disclosures should help to ensure that providers of third-party due diligence services have conducted a thorough review of data, documentation, and other relevant information necessary for an NRSRO to provide an accurate rating for an Exchange-Act ABS. Consequently, the information should be useful to investors in gauging the accuracy of information being analyzed by an NRSRO and, thus, the NRSRO's ability to assess the creditworthiness of an Exchange-Act ABS. In addition, the proposed disclosure would complement the Commission's proposed form and certification requirements to accompany credit ratings, discussed above, that would require an NRSRO to disclose: (1) whether and to what extent it used third-party due diligence services, a description of the information that such third party reviewed, and a description of the findings or conclusions of such third-party; and (2) information on the uncertainty of the rating, including information on the reliability, accuracy and quality of the data relied on in determining the rating and any limitations on such data.<sup>11</sup> Together, these requirements should provide investors with a more complete picture of the quality and scope of information underlying an Exchange-Act ABS rating and the efforts undertaken by an NRSRO to evaluate that information.<sup>12</sup>

**Issuer/Underwriter Due Diligence for Asset-Backed Securities** The Commission's proposal would re-propose certain rules that would require an issuer or underwriter of an Exchange-Act ABS to make publicly available on Form ABS-15G the findings and conclusions of any third-party due diligence report relevant to the determination of an Exchange-Act ABS credit rating. The modifications would limit the reporting obligation from the originally proposed requirement to report any third-party due diligence review, regardless of the underlying purpose of the report. ICI appreciates that the proposed limitation may better reflect the intent of the Dodd-Frank Act provisions for disclosing due diligence reports related to NRSRO ratings. <sup>13</sup> We <sup>11</sup> See proposed paragraphs (a)(1)(ii)(E) and (F) of Rule 17g-7. <sup>12</sup> ICI has previously urged the Commission to require NRSROs to conduct due diligence on the information they review to issue ratings. See, e.g., ICI 2009 Statement, *supra* note 3, at 7. Although the proposal does not explicitly require such action, we believe that the mosaic of information proposed to be produced by the individual disclosure provisions adequately satisfies the need for investors to understand the quality of data being used in a rating. <sup>13</sup> ICI supported the Commission's proposal that would generally have required an Exchange-Act ABS issuer to perform a review of the assets underlying an ABS, disclose the nature, findings, and conclusions of its review, and disclose the findings and conclusions of any third-party review. See Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth Murphy, Secretary, U.S. Securities and Exchange Commission, dated November 15, 2010 ("ICI November 2010 Letter"), at 2. Ms. Elizabeth M. Murphy August 8, 2011 Page 6 of 7 continue to believe, however, that disclosure for Exchange-Act ABS should be improved, and support Commission efforts in this area.<sup>14</sup> The proposed requirements to complete Form ABS-15G would apply to a municipal entity that sponsors or issues Exchange-Act ABS. As strong advocates for improvements to disclosure for both municipal securities and ABS, we have previously cautioned the Commission against imposing any of its newly proposed ABS disclosure requirements on this portion of the municipal securities markets until such time as the Commission completes its staff report on the municipal securities market and the GAO completes its studies on municipal securities mandated by the Dodd-Frank Act.<sup>15</sup> The municipal securities markets and the ABS markets each have many unique facets which

may necessitate different disclosure regimes. Municipal securities have certain common characteristics, as do ABS. Because of the differences between the two broad categories, we believe that an individualized disclosure approach to each category may be necessary to ensure an efficient and effective regulatory framework. We therefore continue to recommend that at this time the Commission expressly exclude municipal securities from the proposed ABS disclosure requirements to avoid creating confusion for investors and issuers if different classes of municipal securities are subject to different disclosure requirements.<sup>16</sup> Electronic Submission of Form NRSRO ICI supports the Commission's proposal to require NRSROs to submit Form NRSRO and the information and documents contained in Exhibits 1 through 9 through the EDGAR system if the submission is made pursuant to paragraph (e), (f), or (g) of Rule 17g-1 (i.e., an update of registration, an annual certification, or a withdrawal from registration). We agree that it will be beneficial to investors and other users of credit ratings to have this information available—in electronic format—immediately <sup>14</sup> Id.; see also Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, U.S. Securities and Exchange Commission, dated August 2, 2010, at 2-5. <sup>15</sup> See ICI November 2010 Letter, *supra* note 13, at 2-3. <sup>16</sup> We recognize that, in response to commenters concerns, the Commission has delayed the compliance date for a period of three years for municipal securitizers that would be subject to new Commission rules related to representations and warranties in Exchange-Act ABS offerings. In so doing, the Commission stated that the delay would provide it with the opportunity to consider whether adjustments to the rule for municipal securitizers would be appropriate in light of the experience of other securitizers subject to the rule. See Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, SEC Release No. 34-63741 (January 20, 2011), at 17- 19. We continue to believe that a total or partial exemption from the ABS disclosure requirements may be more appropriate for municipal securities on a class-wide basis than delaying compliance with particular disclosure rules. If the Commission proceeds to adopt the proposed disclosure requirements for Exchange-Act ABS and determines to apply the requirements to a municipal entity that sponsors or issues Exchange-Act ABS, we recommend that, at a minimum, the Commission similarly delay the compliance period to further evaluate the appropriateness of that application. Ms. Elizabeth M. Murphy August 8, 2011 Page 7 of 7 and in one location. Electronic submission of the non-confidential portions of Form NRSRO should make it easier to access information, either directly or through a third party, about NRSROs and to make comparisons among the information provided by different NRSROs. \* \* \* \* \* If you have any questions on our comment letter, please feel free to contact me directly at (202) 326-5815, Frances Stadler at (202)326-5822, or Heather Traeger at (202) 326-5920. Sincerely, /s/ Karrie McMillan Karrie McMillan General Counsel cc: The Honorable Mary L. Schapiro The Honorable Kathleen L. Casey The Honorable Elisse B. Walter The Honorable Luis A. Aguilar The Honorable Troy A. Paredes Robert W. Cook, Director James Brigagliano, Deputy Director Division of Trading and Markets