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Comment Letter on SEC Concept Release on Credit Rating Agencies, July 2003

July 28, 2003

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549-0609

Re: Concept Release Regarding Rating Agencies and the Use of Credit Ratings under the Federal Securities Laws (File No. S7-12-03)

Dear Mr. Katz:

The Investment Company Institute[1] appreciates the opportunity to comment on the Securities and Exchange Commission's concept release regarding rating agencies and the use of credit ratings under the federal securities laws.[2]

The Institute and its members have a significant interest in the role that credit rating agencies play in the U.S. securities markets. As we testified at the hearings held last year by the Commission on issues relating to credit rating agencies,[3] institutional investors are substantial users of information from credit rating agencies and the credit ratings published by rating agencies play a key role in their investment decisions. It is therefore essential that the quality and integrity of these ratings are maintained.

In order to maintain the quality of credit ratings, the Institute believes that the Commission should reevaluate the current regulatory structure for ratings agencies.[4] We therefore commend the Commission for issuing the Concept Release, which discusses a number of significant regulatory issues relating to rating agencies—the most significant of which to the fund industry is the continuing role of credit ratings in certain Commission rules, in particular, Rule 2a-7 under the Investment Company Act of 1940. The Institute believes that it is vital to continue to require that credit ratings issued by NRSROs be used as a basis for minimum quality standards under Rule 2a-7. At the same time, however, if credit ratings are to continue to be relied upon in Commission rules, the current regulatory structure governing NRSROs should be improved.

In particular, we believe that there are several means by which the Commission can improve the current regulatory structure for credit rating agencies, including: (1) strengthening the system of oversight of credit rating agencies; (2) requiring public disclosure of the resources, standards, procedures and policies employed by the agencies in their rating process; (3) instituting a new public comment and review process regarding rating agencies' performance, standards, and methodologies; and (4) holding rating agencies legally accountable for their ratings.

Our specific comments follow below.

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I. Regulatory Reliance on NRSRO Ratings

As the Concept Release notes, regulatory reliance on the role of NRSROs has increased substantially over the years. The Concept Release raises the possibility of ceasing to use the NRSRO designation for certain regulatory purposes and devising alternatives capable of achieving the regulatory objectives currently served by the use of the NRSRO designation in certain Commission rules. One example of such a rule is Rule 2a-7 under the Investment Company Act. Rule 2a-7 currently limits money market funds to investing in “high quality” securities and contains minimum quality standards based on an objective test, determined by ratings issued by NRSROs,[5] and on a subjective test, based on the credit analysis performed by the investment adviser to the money market fund. The Concept Release requests comment on whether the Commission should eliminate the objective test from Rule 2a-7, and rely solely on the subjective test. The Institute would strongly object to the elimination of the objective test from Rule 2a-7.

The Institute believes that the Commission’s reliance upon NRSRO credit ratings is appropriate where credit quality, or factors highly dependant upon credit quality, are important considerations.[6] While possession of a certain rating by an NRSRO does not provide a “safe harbor” for purposes of Rule 2a-7, the objective test plays a vital role in providing a regulatory benchmark for funds to meet in order to comply with Rule 2a-7.[7] The objective test, for example, prevents money market funds from taking greater risks to increase yield and from “stretching” the minimal credit risk definition to any number of investment opportunities that could be inappropriate for maintaining a stable net asset value. By increasing the safety of the securities held by money market funds, the objective test serves to enhance the confidence that investors have in money market funds. For these reasons, we recommend that the Commission continue to rely on the NRSRO designation for purposes of Rule 2a-7.

II. Examination and Oversight of NRSROs

A. Initial Recognition Process

As the Concept Release notes, before recognizing a credit rating agency as an NRSRO, the Commission must first determine that the rating agency satisfies certain established criteria and must review the operational capability and reliability of the rating agency. The Institute believes that, in light of increased investor and Commission reliance upon NRSROs, the Commission should strengthen the process by which rating agencies are recognized as NRSROs. The Institute would therefore support, as discussed in the Concept Release, improving the transparency of this process by, among other things, recognizing NRSROs through formal Commission action rather than through staff no-action letters[8] and by seeking public comment on the credibility and reliability of an applicant’s ratings.

B. Continuing Examination and Oversight

The Institute also believes that the Commission’s continuing oversight over NRSROs should be improved. Currently, once a rating agency has been designated an NRSRO, it is only required to notify the Commission when it experiences material changes that may affect its ability to meet any of the original recognition criteria. However, given the substantial financial impact that a loss of NRSRO designation would have on a rating agency, NRSROs have a strong disincentive to report any such changes and it is therefore unrealistic to premise regulation on self-policing and self-reporting.

For these reasons, we believe that more direct, ongoing Commission oversight of ratings agencies is warranted. We would support several of the approaches suggested in the Concept Release including, among other things, conditioning NRSRO recognition on a rating agency's agreeing to file annual certifications with the Commission that it continues to comply with all of the NRSRO criteria; soliciting public comment annually on the performance of each NRSRO, including whether the NRSRO's ratings continue to be viewed as credible and reliable;[9] and conditioning NRSRO recognition on a rating agency's agreeing to maintain specified records relating to its ratings business, including those relating to ratings decisions.

In order to more vigorously monitor compliance with the criteria it employs in the initial designation of an NRSRO, Commission staff should schedule more frequent examinations of credit rating agencies: the current examination schedule is every five years, which is the same schedule followed for the smallest advisers subject to the Commission’s jurisdiction under the Investment Advisers Act of 1940.

III. Transparency of Ratings Information

The Commission’s report on the role of credit rating agencies required by the Sarbanes-Oxley Act of 2002 notes that at the Commission’s credit rating agency hearings, representatives of buyside firms, including mutual funds, stressed the importance of increasing transparency in the ratings process.[10] Toward this end, we recommend that the Commission require NRSROs to disclose various types of information. In particular, we recommend increased disclosure of the methodologies used to evaluate the material risks involved with types of financial instruments. The NRSROs also should disclose their policies and procedures addressing

conflicts of interest.[11]

In order to facilitate increased disclosure, the Commission should consider adopting for NRSROs a specialized form, which would require the periodic disclosure of the information discussed above. Such public disclosure would allow investors and regulators a continuous opportunity to better appraise the NRSROs and would serve as an effective mechanism for enforcing continued compliance with the criteria considered by the Commission in its initial designation process.

IV. Legal Accountability for NRSRO Ratings

The Commission has effectively relieved NRSROs from the accountability that would otherwise apply under the federal securities laws by exempting them from expert liability under Section 11 of the Securities Act of 1933, if their ratings appear in a security's prospectus.[12] The exemption of NRSROs from the normal liability provisions of Section 11 means that they are not held to a negligence standard of care. As a result, we believe the exemption lessens the incentives of NRSROs to issue reliable securities ratings.[13]

The Institute therefore recommends that the Commission rescind the NRSROs' exemption from Section 11 expert liability. The NRSROs' exemption from liability represents a departure from the normal requirement that an expert's opinion may be published in a registration statement only with the expert's consent and if the expert is liable to investors for negligently misleading opinions.

* * *

The Institute appreciates the opportunity to comment on the Concept Release. Any questions regarding our comments may be directed to the undersigned at 202-326-5824 or to Ari Burstein at 202-371-5408.

Sincerely,

Amy B.R. Lancellotta
Senior Counsel

cc: The Honorable William H. Donaldson
The Honorable Paul S. Atkins
The Honorable Roel C. Campos
The Honorable Cynthia A. Glassman
The Honorable Harvey J. Goldschmid

Annette L. Nazareth, Director
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ENDNOTES

[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,678 open-end investment companies ("mutual funds"), 555 closed-end investment companies, 106 exchange-traded funds, and six sponsors of unit investment trusts. Its mutual fund members have assets of about $6.697 trillion, accounting for approximately 95 percent of total industry assets, and 90.2 million individual shareholders.

[2] SEC Release Nos. 33-8236; 34-47972; IC-26066 (June 4, 2003), 68 FR 35257 (June 12, 2003) ("Concept Release").

[3] See Statement of Amy Lancellotta, Senior Counsel, Investment Company Institute, for the SEC Hearings on Issues Relating to Credit Rating Agencies (November 21, 2002).

[4] The Institute has commented on previous occasions on enhancing the regulations governing the activities of rating agencies. See Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission (March 2, 1998) (Proposed Definition of Nationally Recognized Statistical Rating Organization) and Letter from Paul Schott Stevens, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission (December 6, 1994) (SEC Concept Release Concerning Nationally Recognized Statistical Rating Organizations and Proposed Rules Concerning Disclosure of Securities Ratings).

[5] Under Rule 2a-7, an “eligible security” is, among other things, a security that has received a short-term rating by the requisite NRSROs in one of the two highest short-term rating categories or, if unrated, is of comparable quality to a security meeting the rating requirements.

[6] The Commission relies, inappropriately in the view of the Institute, upon NRSRO ratings for purposes beyond assessment of credit risk. For example, Rule 3a?7 under the Investment Company Act provides an exemption from substantive regulation under that Act for certain issuers of asset-backed securities if, among other things, fixed-income securities sold by the issuer are rated in one of the four highest categories by at least one NRSRO. The rule therefore extends NRSROs beyond their traditional role of evaluating debt securities’ risk of default to determine what level of disclosure and other protections investors are entitled to receive. The Institute encourages the Commission to consider revisiting the Rule 3a-7 exemption.

[7] See Testimony of Deborah A. Cunningham, Senior Vice President and Senior Portfolio Manager, Federated Investors, Inc., at the SEC Hearings on the Current Role and Function of the Credit Rating Agencies in the Operation of the Securities Markets, (“[T]he rating agencies’ input is absolutely of importance … from a regulatory standpoint, that before we can start the process with our own internal analysis, we have to meet the hurdles of … the NRSRO ratings…”).

[8] Currently, the Commission does not vote on whether or not to recognize a rating agency as an NRSRO.

[9] We recommend that public comment also be solicited on the NRSROs’ risk evaluation methodologies and the industry-wide standards that the NRSROs effectively set for structured obligations. Commission staff could then examine the NRSROs’ responsiveness to these comments. If the NRSROs are not sufficiently responsive in particular instances, the Commission should consider limiting specific regulatory reliance upon such ratings.

[10] Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets, U.S. Securities and Exchange Commission, January 2003, at 33.

[11] In addition to increased transparency regarding conflicts of interest, we would support more stringent requirements for NRSROs to manage their conflicts of interest, including, among other things, conditioning initial NRSRO recognition on a rating agency’s developing and implementing processes and procedures to address issuer and subscriber influence.

[12] Although NRSROs remain subject to liability under the anti-fraud provisions of the securities laws, the Institute does not believe that this is an adequate substitute for Section 11 liability.

[13] In a recent letter to the Commission, Congressman Richard Baker (R-LA) expressed concern that the securities laws shield NRSROs from prospectus liability and that, in turn, the NRSROs are not subject to the checks that the threat of legal accountability would provide. See Letter from Congressman Richard H. Baker, Chairman, House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, to William H. Donaldson, Chairman, Securities and Exchange Commission, dated April 10, 2003.
