IDC Independent Directors Council

Promoting Excellence in Fund Governance

SEC Roundtable on Oversight of Credit Rating Agencies

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Statement of

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Oral Statement

Thank you, Chairman Schapiro and members of the Commission, for the invitation to appear today. I'd also like to join others in thanking Director Sirri for organizing this roundtable, and for his years of service on behalf of investors and efficient markets. We will miss his experienced leadership and economist's perspective, and we wish him continued success as he returns to academic life.

On behalf of the Investment Company Institute, the 8,000 funds we represent, and the 93 million shareholders that they serve, I'd like to commend the Commission for its continuing interest in improving the integrity of credit ratings. Funds use credit ratings in a wide variety of ways in their investment process. It is no overstatement to say that our member funds have a vital interest in the soundness of the credit ratings system.

Ratings should provide investors with high-quality, reliable assessments of the creditworthiness of a particular issuer or financial instrument. As the capital markets have grown more complex, the need for ratings has grown—and the rating system should have grown more robust to meet that need. Unfortunately, neither is the case. The current financial crisis underscores a stark reality—the long history of poor performance by rating agencies in analyzing the risks of debt securities. This crisis confirms, once again, that the current credit rating system is deeply flawed and requires serious reforms.

Despite their track record, rating agencies continue to enjoy virtual immunity from accountability that is unknown to any other participant in our securities markets. Moreover, in many instances, investors are not free simply to disregard these ratings, even if investors question the ratings' accuracy or value. Despite their deficiencies, ratings remain deeply entrenched in financial regulations and in the process for accessing capital. For all these reasons, the credit-rating process must be improved.

How to do so poses an array of thorny issues that the Commission must grapple with. We recognize and appreciate how difficult these issues are. But the goals of this exercise should be absolutely clear. The Commission, as always, should ask: What actions best protect the interests of investors? Those interests—and not the commercial concerns of the credit rating agencies—must guide your activities in this area.

In our written statement, the Institute spells out a number of steps that we believe will advance investors' interests. These actions fall into four key areas.

First, and most important, investors need better disclosure about credit ratings and the ratings process. We commend the Commission for its significant strides in increasing the transparency of ratings. But more remains to be done. Our written submission lays out a number of specific ideas, many of which we have previously addressed to the Commission:

- to improve ratings surveillance,
- to make ratings more comparable,
- to enhance disclosure on ratings stability and conflicts of interest, and
- to make disclosure of ratings actions more timely.

We also urge the Commission to ensure that users of ratings on all debt securities receive this same improved disclosure. And we call for a standardized presentation of ratings information by all rating agencies on all rated securities in a “presale report.”

Second, the Commission should take steps to strengthen the incentives to produce quality ratings—because those incentives are simply inadequate today. Credit rating agencies should be required to conduct due diligence on the information they review when they issue ratings, and to disclose the gaps in that information. Another way to bolster these incentives would be to hold credit rating agencies legally liable for the representations they make about their ratings process. Currently, they are the only “experts” to enjoy an exemption from liability for statements in registration documents. At the very least, investors should have legal recourse if a ratings agency issues a rating without following its own disclosed procedures and standards.

Third, we believe that the rules should be uniform and consistent. These necessary regulatory reforms must apply to all types of credit rating agencies, whether issuer-paid, subscriber-paid, or some new business model. Uniformity and consistency in the rules will help investors identify and assess potential conflicts of interest as they arise under any business model. They will also increase competition among rating agencies.

Finally, we recommend that the Commission improve disclosure not just for ratings agencies, but also for issuers of structured finance products, asset-backed securities, and municipal securities. Better disclosure will assist investors in making their own risk assessments and should foster better quality ratings. For example, we recommend that you expand the scope of Regulation AB beyond asset-based securities to other structured products, and urge that Regulation AB require ongoing disclosure by issuers.

The Institute also commends Chairman Schapiro for joining the growing call for improved disclosure for municipal securities. As active participants in the municipal securities markets, our members are keenly interested in having timely access to relevant and reliable information relating to municipal securities offerings. Currently, disclosure on municipal securities is limited, non-standardized, and often stale. Fixing that may require legislative action on the Tower Amendment. We would strongly support such action and would urge the Commission to do the same.

On behalf of ICI, I again commend the Commission for organizing this roundtable. We look forward to working with you as you move forward on these vital reforms.

Thank you.

Executive Summary

The Investment Company Institute[1] appreciates the opportunity to participate in the Securities and Exchange Commission’s Roundtable on issues relating to the oversight of credit rating agencies. As

significant investors in the securities markets,[2] funds have a vital interest in the soundness and integrity of the credit rating system and in timely access to information about policies, procedures, and other practices that bear on credit rating decisions.

Ratings should provide investors with high-quality, reliable assessments of the creditworthiness of a particular issuer or financial instrument. As the capital markets have grown more complex, the need for ratings has grown and the rating system should have grown more robust to meet that need. Unfortunately, neither is the case. The current financial crisis underscores a stark reality – the long history of poor performance by rating agencies in analyzing the risks of debt securities. It confirms, once again, that the current credit rating system is deeply flawed and requires serious reforms.

Despite their track record, rating agencies continue to enjoy virtual immunity from accountability that is unknown to any other participant in our securities markets. Moreover, for various reasons, investors are not free simply to disregard the ratings they produce even if investors question the accuracy or value of these ratings. Despite their deficiencies, ratings remain deeply entrenched in financial regulations and in the process for accessing capital.

Legislators, regulators, investors, and other market participants have been struggling with these very difficult issues for years. We commend the continuing efforts of the Securities and Exchange Commission to address the shortcomings with ratings and the ratings process. The Institute, too, has been committed to the objective of improving the rating process to make ratings more accurate and useful to investors and to promote the sound functioning of our capital markets. We recommend several measures to improve the quality, accuracy, and integrity of ratings and the rating process. Generally speaking, our recommendations would enhance disclosure, address conflicts of interest, and hold rating agencies accountable for their ratings.

Specifically, we recommend that the Commission improve disclosure about credit ratings and the rating process for structured finance securities and other debt securities. Public disclosure of information about a credit rating agency's policies, procedures, and other practices relating to rating decisions will allow investors to evaluate more effectively a rating agency's independence, objectivity, capability, and operations. Disclosure will serve as a powerful additional mechanism for ensuring the integrity and quality of the credit ratings themselves. To realize the full potential of such a disclosure regime, the Commission should require the standardized presentation of this information in a presale report issued by the rating agencies.

The Commission also should take steps to strengthen the incentives to produce quality ratings – because such incentives are clearly insufficient in the current system. To this end, the Commission should require rating agencies to conduct "due diligence" assessments of the information they review to issue ratings. This should help build investor confidence in ratings and the rating process over time, by enabling users of ratings to gauge both the accuracy of the information being analyzed by the rating agency and the rating agency's ability to assess the creditworthiness of the underlying security. We also recommend that rating agencies have greater legal accountability to investors for their ratings.

Both of these recommendations should encourage rating agencies to improve the quality of their ratings.

Today's rating system is dogged by deep concerns about conflicts of interest, poor disclosure, and lack of accountability. To address these concerns effectively, the Commission should apply necessary regulatory reforms in a consistent manner to all types of credit rating agencies. A consistent approach is not only critical to improving ratings quality and allowing investors to identify and assess potential conflicts of interest, but also to increasing competition among rating agencies.

Finally, we recommend that the Commission address the need for better disclosure by certain issuers – i.e., expand issuer disclosure for structured finance products, expand and standardize issuer disclosure for asset-backed securities, and require that disclosure for asset-backed securities be ongoing. In addition, we recommend that the Commission improve issuer disclosure for municipal securities. Better disclosure will assist investors in making their own risk assessments and should foster better quality ratings.

I. Introduction

On behalf of the Investment Company Institute,[3] I am pleased to submit this statement and to participate in the Securities and Exchange Commission's Roundtable on issues relating to the oversight of credit rating agencies.[4]

The Institute commends the Commission for holding this Roundtable. We believe it will provide a better understanding of the role of credit rating agencies in our securities markets, will assist in evaluating the adequacy of recent initiatives to reform the regulation of those agencies, and will help identify further regulatory improvements.

As significant investors in the securities markets,[5] funds have a vital interest in the soundness and integrity of the credit rating system and access to information about policies, procedures, and other practices that bear on credit rating decisions. Funds employ credit ratings in a variety of ways – to help make investment decisions, to inform investment strategies, to communicate with their shareholders about credit risk, and to refine the process for valuing securities.[6] Most significantly, funds utilize ratings issued by credit rating agencies in analyzing the credit risks of securities. Rated securities form an important component of many of the portfolios that funds manage for the benefit of their shareholders. Importantly, however, ratings are just one of many considerations funds use to inform their investment decisions. For example, under Rule 2a-7 of the Investment Company Act, ratings serve simply as a baseline from which money market funds start their own internal credit review process.[7]

The Institute historically has been an active commentator on the role of credit rating agencies in the investment process and expressed its concern about enhancing the regulation governing their activities.[8] Because the credit ratings published by rating agencies help inform the investment

decisions of funds, these ratings must provide credible indications of the risk characteristics of those instruments in which funds invest. Further, credit ratings of high integrity and quality bolster investor confidence and promote the sound functioning of our capital markets.

II. Recommendations for Improvements to Credit Rating Agency Regulation

In light of the need to further enhance credit rating agency regulation, we believe the Commission should give serious consideration to strengthening regulatory controls over rating agencies in at least four ways: (1) improve disclosure about credit ratings and the rating process; (2) require credit rating agencies to conduct better due diligence and verification; (3) hold credit rating agencies to greater legal accountability; and (4) apply regulation uniformly to all credit rating agency models.

A. Improve Disclosure About Credit Ratings and the Rating Process

Improving disclosure about ratings and the ratings process may be the most important reform for improving the quality and reliability of ratings. 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 ratings themselves.[9]

1. Enhance Credit Rating Agency Disclosure Obligations

The Commission, through rulemaking since the enactment of the Credit Rating Agency Reform Act of 2006, has taken significant steps to improve disclosure related to the rating processes. Nevertheless, there are several recommendations that the Institute has put forth in our comment letters on credit rating agency reform that either have not yet been addressed by the Commission or that the Commission has addressed in a manner that we believe will not improve disclosure for investors in a meaningful way. For example, we recommend that:

- Rating agencies should be required to provide public disclosure of any material deviations from the credit rating implied by a rating model and the final credit rating issued.[10]
- Rating agencies should make timely disclosure of their rating actions.[11]
- Rating agencies should disclose additional information regarding staffing issues, including personnel turnover and resource levels.
- Rating agencies should disclose certain information regarding ratings surveillance including whether the timing and nature of a surveillance review will depend on external facts; how soon after the rating agency receives updated data it will review the data and, if appropriate, act upon the new information by updating or confirming a rating; whether rating changes were due to public or nonpublic information; and, whether the team or analyst conducting the surveillance is different from the party who was involved in assigning the initial rating, and, if so, why.[12]

- Rating agencies should disclose additional information regarding rating stability, including when and how downgrades are conducted and the severity of potential downgrades.
- Rating agencies should disclose additional information regarding conflicts of interest including: (1) any material ancillary business relationships between the rating agency and an issuer; (2) the number of other products rated by a rating agency for a particular arranger; (3) information regarding the separation of a rating agency's consulting and rating activities; and (4) the fees paid for a rating (within ranges).
- Rating agencies should be required to use standardized performance measurement statistics to facilitate comparability.

2. Expand Credit Rating Agency Disclosure Requirements to Other Debt Securities

The Commission's recent proposals would improve disclosure regarding credit ratings only of structured finance products. While we are supportive of enhancements for these types of securities, more rigorous disclosure requirements are needed by users of ratings for other types of debt securities as well. We therefore strongly urge the Commission to increase disclosure to users of ratings for other types of instruments, particularly municipal securities. As discussed below, there is a significant disparity in the amount and quality of information available on municipal securities as compared with corporate debt securities.[13]

3. Create a Standardized Credit Rating Agency Presale Report

While the quality and totality of information disclosed by rating agencies is important to investors, the presentation of this information in a standardized format may be just as important. Some rating agencies currently compile information in a "presale report" that they provide to investors during the offering process for structured finance products. These presale reports, however, are not provided by all rating agencies or on all rated securities. The timing of distribution of the report also varies, driven by the issuers and underwriters and their provision of information to the rating agencies. The Institute recommends that the Commission require that rating agencies, as a condition of rating a security, provide investors with a presale report providing specified information for each sector of structured finance products. The information to be included in the presale report could be based on a subset of information provided by the issuer to the rating agency.

B. Require Credit Rating Agencies to Conduct Better Due Diligence and Verification

Under current Commission 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 structured finance product.[14] Rating agencies are required neither to verify the information underlying a structured finance product received from an issuer nor to compel issuers to perform due diligence or to obtain reports concerning the level of due diligence performed by issuers of

structured finance products.

To address these concerns, we recommend that credit rating agencies be required to conduct due diligence on the information they review to issue ratings.[15] In addition, to raise investor confidence in the quality of ratings and the rating process as a whole, the due diligence requirements should apply (as appropriate) to all rated debt securities, not only structured finance products. Specifically, we recommend that:

- Rating agencies be required to have policies and procedures in place reasonably sufficient to assess the credibility of the information they receive from issuers and underwriters.
- Rating agencies disclose these policies and procedures, the specific steps taken to verify information about the assets underlying a security, and the results thereof.
- Rating agencies disclose the limitations of the available information or data, any actions they take to compensate for any missing information or data, and any risks involved with the assumptions and methodologies they use in providing a rating.
- Rating agencies be required to provide a certification statement in a credit rating agency term sheet (discussed above) verifying that the rating agency has satisfied its stated policies and procedures for performing due diligence on the security being rated.

C. Hold Credit Rating Agencies to Greater Legal Accountability

Given the role of ratings in the investment process and the use of ratings by investors, the Institute believes that credit rating agencies should have greater legal accountability for their ratings. Currently, investors do not have sufficient legal recourse against rating agencies if, for example, a rating agency issues an erroneous rating.

As a starting point, we believe that the exemption for NRSROs from Section 11 of the Securities Act should be reconsidered.[16] Under current regulations, the Commission exempts NRSROs, but not other rating agencies, from treatment as experts subject to liability under Section 11 and, thus, allows NRSRO ratings in prospectuses and financial reports. Although the Commission has stated that NRSROs remain subject to antifraud rules, the NRSROs have steadfastly maintained that, under the First Amendment, they cannot be held liable for erroneous ratings absent a finding of malice.

While it may be argued that rating agencies should not be liable for an erroneous rating as such, they should, at a minimum, have some accountability for ratings issued in contravention of their own disclosed procedures and standards. As we have stated in the past, even if the First Amendment applies to credit ratings, it should not immunize rating agencies for false or misleading disclosures to the Commission and to the investing public. Quite simply, if a rating agency obtains an NRSRO designation based on, for example, a specific ratings process, it should be held accountable to the Commission and to investors if it fails to follow that process.[17]

A rating agency's ability to continue to claim First Amendment rights also has been questioned based on the business decisions and the roles undertaken by rating agencies over the last decade. Rating

agencies have abandoned their former practice of rating most or all securities whether or not hired to do so, and rating agencies have become deeply involved in the structuring of complex securities, which are normally not sold to retail investors. These changes warrant serious consideration when considering whether rating agencies still merit the protection the First Amendment may have provided them in their more traditional role.[18]

D. Apply Regulation Uniformly to All Credit Rating Agency Models

The Commission's most recent rule amendments and proposals make certain distinctions between issuer-paid rating agencies and subscriber-paid rating agencies. To properly address concerns about conflicts of interest, poor disclosure, and lack of accountability, the Institute believes the reform of the regulatory structure for rating agencies must be applied in a uniform and consistent manner and should apply equally to all types of credit rating agencies.

Issuer-paid and subscriber-paid models each pose concerns and harbor conflicts of interest. For issuer-paid rating agencies, conflicts can arise because issuers or underwriters are paying rating agencies to determine credit ratings with respect to securities they issue or underwrite. For subscriber-paid rating agencies, conflicts can arise because investors have a strong interest in improving their existing portfolio values or establishing new portfolio positions through favorable ratings. Indeed, it is not clear that one model poses fewer risks of conflicts or invariably produces higher quality ratings. We therefore are not advocating for one credit rating agency model over the other.[19] We believe the Commission's role should be to ensure that requirements discussed above relating to disclosure, due diligence, and legal accountability apply to both rating models. This uniformity and consistency is not only critical to improving ratings quality and allowing investors to identify and assess potential conflicts of interest, but also to increasing competition among rating agencies.[20]

We recognize concerns by some rating agencies that recent Commission rules may uniquely impact them, depending on their business models. We believe, however, that the benefits of providing current and prospective investors with timely information and sound ratings from all rating agencies outweighs the inconsistent application of Commission rules.

III. Increase Disclosure by Issuers for Debt Products

The Institute 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.

A. Improve Issuer Disclosure for Structured Finance Products

The Commission acknowledged in its recent proposal that investors and other market participants may benefit from greater disclosure of information directly by issuers regarding structured finance products. The Commission determined, however, that the more appropriate mechanism to enhance such

disclosure would be to amend rules under the Securities Act.

The Institute supports reform of the current disclosure rules to achieve this goal. Specifically, as discussed more fully in our most recent comment letter, we recommend that the Commission address the current disparity in disclosure requirements between "asset-backed securities" and instruments that fall outside that definition by expanding the scope of Regulation AB[21] to include the various collateralized and pooled products that fall within the Commission's broad definition of "structured finance product" under the rating agency rules.[22] In particular, we believe there should be corresponding disclosure requirements for these securities so that investors receive, at a minimum, disclosure equivalent to that required of asset-backed securities under Regulation AB.

In addition to expanding the scope of Regulation AB, we recommend that the Commission require that additional information be disclosed pursuant to Regulation AB. This information should be standardized for each category of structured finance product and disseminated in a manner that provides sufficient specificity to be meaningful. This standardized information also would need to be regularly evaluated and updated to account for newly developed structured finance products that might raise new risks.

Further, we recommend that the Commission require that disclosure under Regulation AB be ongoing. Section 15(d) of the Securities Exchange Act allows for the suspension of reporting obligations, and therefore disclosure, after one year, which occurs with many asset-backed securities sold in registered offerings. Although legislative action would be necessary to change Section 15(d), the Commission could take a number of steps to require continued reporting by asset-backed issuers selling securities in a registered sale. For example, the Commission could modify the Form S-3 eligibility standards to require that the classes of asset-backed securities being registered under the Securities Act on the form must be registered pursuant to Section 12(g) of the Securities Exchange Act for a finite term or the life of the security.

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.[23]

B. Improve Issuer Disclosure for Municipal Securities

The Institute also strongly urges that the Commission increase the disclosure to users of ratings of municipal securities. We commend Chairman Schapiro for joining the growing call for improved disclosure in this area.[24] To truly improve disclosure in the municipal securities market, steps must be taken to improve the content and timing of required disclosures for municipal securities.

The Tower Amendment, adopted in 1975, prohibits the Commission and the Municipal Securities Rulemaking Board from directly or indirectly requiring issuers of municipal securities to file documents

with them before the securities are sold. As we have stated numerous times, because of these restrictions, the disclosure regime for municipal securities is woefully inadequate,[25] and the regulatory framework is insufficient for investors in today's complex marketplace.[26] The disclosure is limited, non-standardized, and often stale, and the disparities from the corporate issuer disclosure regime are numerous. As active participants in the municipal securities markets, our members are keenly interested in having timely access to relevant and reliable information relating to municipal securities offerings.

Legislative action regarding the Tower Amendment will be necessary to fully develop an adequate disclosure regime for municipal securities. We would strongly support such action and would urge the Commission to do the same.[27]

Endnotes

[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") (collectively, "funds"). 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 $9.47 trillion and serve over 93 million shareholders.

[2]As of year-end 2008, registered investment companies held 27 percent of outstanding U.S. issued stock; 44 percent of outstanding commercial paper; 33 percent of tax-exempt debt; 9 percent of U.S. corporate and foreign bonds; and 15 percent of U.S. Treasury and government agency debt. See 2009 Investment Company Fact Book, 49th Edition (forthcoming May 2009).

[3]ICI members include mutual funds, closed-end funds, exchange-traded funds ("ETFs"), and unit investment trusts ("UITs") (collectively, "funds").

[4]With one exception, we will use the terms "credit rating agency" and "rating agency" throughout this submission to refer to credit rating agencies, including nationally recognized statistical ratings organizations ("NRSROs"). We will use the term NRSRO during our discussion of legal liability because of the statutory distinction between NRSROs and rating agencies in Section 11 of the Securities Act of 1933.

[5]As of year-end 2008, registered investment companies held 27 percent of outstanding U.S. issued stock; 44 percent of outstanding commercial paper; 33 percent of tax-exempt debt; 9 percent of U.S. corporate and foreign bonds; and 15 percent of U.S. Treasury and government agency debt. See 2009 Investment Company Fact Book, 49th Edition (forthcoming May 2009).

[6]For a more detailed discussion of funds' use of credit ratings, see Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Florence Harmon, Acting Secretary, Securities and Exchange Commission, dated July 25, 2008 ("July 2008 ICI Letter").

[7]The Commission has proposed to remove references to credit ratings from many of its rules. See References to Ratings of Nationally Recognized Statistical Rating Organizations, SEC Release No. IC-28327 (July 1, 2008), 73 FR 40124 (July 11, 2008), References to Ratings of Nationally Recognized Statistical Rating Organizations, SEC Release No. 34-58070 (July 1, 2008), 73 FR 40087 (July 11, 2008) and Security Ratings, SEC Release No. 33-8940 (July 1, 2008), 73 FR 40106 (July 11, 2008). We support the Commission's decision to review the appropriateness of using references to credit ratings in its rules. Nevertheless, we strongly oppose the Commission's proposal to remove reference to ratings from Rule 2a-7. In the ICI's recent Report of the Money Market Working Group, we discussed in detail the relevance and importance of credit ratings to Rule 2a-7. See Report of the Money Market Working Group, Investment Company Institute (March 17, 2009).

[8]See Statements of Paul Schott Stevens, President, Investment Company Institute, on the "Credit Rating Agency Duopoly Relief Act of 2005," before the Committee on Financial Services, U.S. House of Representatives (November 29, 2005) and on "Assessing the Current Oversight and Operation of Credit Rating Agencies," before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate (March 7, 2006). See also July 2008 ICI Letter, supra note 6; Letter from Paul Schott Stevens, President and CEO, Investment Company Institute, to Florence Harmon, Acting Secretary, Securities and Exchange Commission, dated September 5, 2008 ("September 2008 ICI Letter"); and Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated March 26, 2009 ("2009 ICI Letter").

[9]Although we strongly support the goal of increasing transparency in the rating process for structured finance products, we do not support the Commission's pending proposal to require differentiating rating symbols for these products. See Proposed Rules for Nationally Recognized Statistical Rating Organizations, SEC Release No. 34-57967 (June 17, 2008), 73 FR 36211 (June 25, 2008). We believe users of ratings will gain very little from a special identifier or symbol, because such a device will not add to the quality, integrity or clarity of a structured finance product credit rating. Rather, we believe it may act as a disincentive for some market participants to invest in these products, by tainting all structured finance products as more risky without adequately differentiating between the types of risks each issuance may entail. We believe the more appropriate approach to highlighting the type and associated risks of a rated product would be to require a credit rating agency to publish a description of how the credit ratings procedures and methodologies and credit risk characteristics for structured finance products differ from those of other types of rated instruments when it publishes a credit rating for products. This description could be published as an independent report or as disclosure in our recommended standardized credit rating agency term sheet discussed below.

[10]The current rules require only that a rating agency make and maintain a record of the rationale for any material deviation between the two ratings.

[11]As noted in our 2009 ICI Letter, this disclosure should be provided within a few months (e.g., 3 months). See 2009 ICI Letter, supra note 8. See also July 2008 ICI Letter, supra note 6.

[12]With respect to surveillance, the current rules provide that a rating agency must provide a general description of its procedures for monitoring, reviewing, and updating credit ratings. We are in agreement with recent SIFMA recommendations that this requirement is wholly inadequate. See Recommendations of the Securities Industry and Financial Markets Association Credit Rating Agency Task Force, SIFMA (July 2008).

[13]There have been suggestions that rating agencies adopt a single ratings scale for municipal and corporate debt securities. See, e.g., H.R. 6308, "Municipal Bond Fairness Act," 110th Congress, 2nd Session, introduced by Representative Barney Frank (D-MA) and Moody's Investment Services, "Moody's U.S. Public Finance, Announcement: Moody's to Recalibrate its US Municipal Bond Ratings to the Company's Global Rating Scale" September 2008 (both discussing a single ratings scale). The Institute questions the practicalities, benefits, and timing of merging the municipal and corporate rating scales given the significant differences between the issuers of these securities (i.e., risk profiles, disclosure regimes, and the methodologies employed in determining their ratings) and the financial challenges that the current economic downturn and market disruptions have imposed on the municipal market. In fact, some of the rating agencies considering a single scale for debt securities have delayed implementation of their proposals because of current economic difficulties. See, e.g., "Fitch, Moody's to Delay Recalibrations," Jack Herman, Bond Buyer (October 8, 2008) and "Fitch says no date for changing muni rating scale," Lisa Lambert, Thomson Financial News (March 4, 2009). We believe that a unified rating scale would align corporate and municipal ratings in name only because many market participants will continue to differentiate between issuers. At the very least, if rating agencies determine to implement a single ratings scale for municipal and corporate ratings, it is imperative that the disclosure requirements for both sets of issuers first be made similar to facilitate comparative purposes.

[14]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.

[15]We also recommend that the Commission require issuers, underwriters, and/or sponsors of structured finance products to perform due diligence reviews (and disclose the steps taken to investors and rating agencies). See July 2008 ICI Letter, supra note 6.

[16]Section 11 under the Securities Act creates liability for issuers and certain professionals who prepared or certified any part of the registration statement for any materially false statements or omissions in a registration statement.

[17]The Commission should consider whether rating agencies should be placed on a regular and frequent review cycle (e.g., every three years) similar to the Commission's review of high-risk

investment advisers.

[18]Rating agencies have cited the First Amendment in statements to Congress, the courts, and the investing public, stating that their ratings are opinions only – not "recommendations or commentary on the suitability of a particular investment." See, e.g., Statement of Deven Sharma, President, Standard & Poor's, on "Credit Rating Agencies and the Financial Crisis," before the Committee on Oversight and Government Reform, U.S. House of Representatives (October 22, 2008). See also Not "The World's Shortest Editorial": Why the First Amendment Does Not Shield Rating Agencies From Liability for Over-Rating CDOs, David J. Grais and Kostas D. Katsiris, Grais & Ellsworth, Bloomberg Law Reports (November 2007).

[19]While the focus of the current debate has been on issuer-paid versus subscriber-paid models, we recognize that there may be other compensation models worthy of consideration that may better incentivize rating agencies to produce high-quality ratings. For example, payment for public ratings could be linked to "quality provided" as determined by the end-user – the investors. In this model, initial rating fees would be deducted from proceeds of the offering and maintenance rating fees would be paid by the issuer along with its coupon/amortization payments. Both sets of payments would be directed to the rating agencies by the buyer (investor) of the bonds, not the issuer, based on investor preferences.

[20]We are concerned that investors not be made to subsidize the Commission's efforts to increase competition in this area. Our members report that some rating agencies are adjusting their fee schedules in a manner that reflects the SEC's new credit rating agency rules. For example, some rating agencies are classifying information required by the Commission's rules as "base" information. Anything outside of that category, including information previously provided within the same subscriber package, is being categorized as "premium" information warranting a higher fee.

[21]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 of 1934 for those securities sold in public offerings. The disclosure for other structured finance products is not specifically addressed in Commission 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.

[22]The Commission 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 Commission proposed the use of this definition of structured finance product for additional provisions in the rating agency rules.

[23]While we believe that it would be beneficial for investors to receive much of the same information that issuers provide to rating agencies, we are cognizant of concerns that such disclosure may, among other things, have a chilling effect on information that an issuer is willing to provide to a rating agency. To address these issues, the Commission could require public disclosure of a subset of certain standardized items provided by issuers to credit rating agencies in the form of a term sheet or other document, similar to the "informational and computational materials" permitted under Regulation AB. At a minimum, if the Commission does not proceed with an issuer template or term sheet, it should require distribution of the "information and computational materials" in a reasonable time prior to sales being effected, which would ensure that investors are provided with material information about an offering in a timely fashion. This would create a two-tier disclosure regime in which issuers would provide information to rating agencies as they currently do and issuers would distribute to investors standardized information of a more summary nature.

[24]See Statement of Mary L. Schapiro, Chairman, Securities and Exchange Commission, on "Enhancing Investor Protection and the Regulation of Securities Markets – Part II," before the Committee on Banking, Housing and Urban Affairs, U.S. Senate (March 26, 2009).

[25]See, e.g., July 2008 ICI Letter, supra note 6 and Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Florence Harmon, Acting Director, U.S. Securities and Exchange Commission, September 22, 2008 ("2008 ICI Municipal Letter") and see Statement of Arthur Levitt, former Chairman, Securities and Exchange Commission, on "Enhancing Investor Protection and the Regulation of Securities Markets – Part II," before the Committee on Banking, Housing and Urban Affairs, U.S. Senate (March 26, 2009).

[26]See, e.g., Securities and Exchange Commission, "Disclosure and Accounting Practices in the Municipal Securities Market," White Paper to Congress, July 2007 and "Integrity in the Municipal Market," speech by Christopher Cox, Chairman, Securities and Exchange Commission, Town Hall, Los Angeles, California, July 18, 2007 (commenting on need to improve municipal securities disclosure framework to meet current needs of the marketplace).

[27]As discussed more fully in our 2008 ICI Municipal Letter, there are some steps, however, that can be taken now, without legislative action, to improve disclosure within the current regulatory regime including several reforms to Rule 15c2-12 under the Securities Exchange Act. See 2008 ICI Municipal Letter, supra note 25.

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