INVESTMENT COMPANY INSTITUTE

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December 14, 2009

Ms. Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: *Concept Release on Possible Rescission of Rule 436(g) Under the Securities Act of 1933 (File No. S7-25-09)*

Dear Ms. Murphy:

The Investment Company Institute[1] supports the Commission's continuing efforts to address longstanding concerns regarding credit ratings, the oversight of Nationally Recognized Statistical Rating Organizations ("NRSROs"), and the role of credit rating agencies in the securities markets. The Commission's concept release on the possible recission of the exemption for NRSROs from the liability scheme for experts under Section 11 of the Securities Act is another example of these efforts.[2] As significant investors in the securities markets,[3] Institute members have a keen interest in ensuring that the regulation of NRSROs is robust, particularly in light of recent events in the credit markets. The Institute therefore has consistently supported initiatives to improve the credibility and reliability of

[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 $11.33 trillion and serve almost 90 million shareholders.

[2] *Concept Release on Possible Rescission of Rule 436(g) Under the Securities Act of 1933*, SEC Release No. 33-9071 (October 7, 2009), 74 FR 53115 (October 15, 2009) ("Concept Release"). In a companion release, the Commission is proposing to require disclosure by registrants regarding credit ratings in their registration statements if the registrant uses the rating in connection with a registered offering. *See Credit Ratings Disclosure,* SEC Release No. 33-9070 (October 7, 2009), 74 FR 53086 (October 15, 2009) ("Companion Release"). We will be filing a separate comment letter on the Companion Release.

[3] As of June 2009, registered investment companies held 27 percent of outstanding U.S. issued stock; 47 percent of outstanding U.S. commercial paper; 33 percent of U.S. tax-exempt debt; 9 percent of U.S. corporate and foreign bonds; and 14 percent of U.S. Treasury and government agency debt. Our comments in this letter focus on the impact of the issues raised in the Concept Release on funds as investors.

credit ratings and to strengthen the incentives for NRSROs and rating agencies to produce quality ratings.[4]

I. Introduction

The recent credit crisis has exposed numerous weaknesses in the framework of our financial markets. One of the primary vulnerabilities has involved credit ratings and the credit ratings process. Regulators and rating agencies have taken a number of steps to improve the credit rating system by enhancing transparency and disclosure relating to ratings and reinforcing measures for credit rating agencies to avoid conflicts of interest.[5] We believe that the Commission has correctly identified an additional critical step to be taken that would measurably improve the quality of ratings – requiring credit rating agencies to 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. Greater legal accountability would appropriately task NRSROs with responsibility for their ratings' quality.[6]

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[4] *See, e.g.,* Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Florence Harmon, Acting Secretary, Securities and Exchange Commission, dated July 25, 2008 ("ICI July 2008 Letter") and Statement of Paul Schott Stevens, President and CEO, Investment Company Institute, SEC Roundtable on Oversight of Credit Rating Agencies, April 15, 2009 ("ICI Roundtable Statement").

[5] The Commission recently proposed and adopted a number of measures designed to increase transparency regarding ratings performance and rating methodologies to permit market participants to compare the performance of ratings. The Commission also has proposed and adopted requirements to provide investors with increased disclosures regarding the assumptions used in ratings, the potential limitations of ratings, the information reviewed in the rating process, and the potential volatility of the rating. *See, e.g., Amendments to Rules for Nationally Recognized Statistical Rating Organizations*, SEC Release No. 34-61050 (November 23, 2009) and *Proposed Rules for Nationally Recognized Statistical Rating Organizations*, SEC Release No. 34-61051 (November 23, 2009).

[6] Our comments focus on the issues raised by the Concept Release. To be effective, however, legal accountability should come in several forms. In addition to rescinding the exemption for NRSROs from Section 11 liability, the Commission and Congress should consider other measures to increase incentives for NRSROs to produce quality ratings. These include subjecting NRSROs to private rights of action, eliminating the exemption for NRSROs from Regulation Fair Disclosure ("Regulation FD"), clarifying that ratings are not forward looking statements under the Exchange Act, and ensuring that the Commission has the requisite authority to fine NRSROs for regulatory failures. In addition, as we have previously recommended, NRSROs should be required to conduct "due diligence" assessments of the information they review to issue ratings and should be subject to liability for failure to satisfy their due diligence policies and procedures. *See* ICI July 2008 Letter, *supra* note 4. Several pieces of legislation associated with financial services regulatory reform have proposed certain of the above measures. The Administration also has recommended that NRSROs be required to develop due diligence policies and procedures. *See* "A New Foundation: Rebuilding Financial Supervision and Regulation," Department of the Treasury, 2009, available at http://www.financialstability.gov/docs/regs/FinalReport_web.pdf.

II. Eliminate Exemption for NRSROs from Section 11 Liability

As the Concept Release discusses, Congress enacted Section 11 of the Securities Act to impose a rigorous standard of liability on those persons with a direct role in a registered offering to assure that disclosure regarding securities is accurate and to give investors additional protection due to the barriers to recovery presented by the common law fraud requirements of scienter, reliance, and causation.[7] Typically, an expert's opinion may be published in a Commission registration statement only (1) with the expert's consent and (2) if the expert is liable to investors for negligent and misleading opinions. Rule 436(g) under the Securities Act, however, provides that NRSRO ratings included in a prospectus are not to be deemed part of a registration statement for purposes of Section 11 of the Securities Act. Consequently, issuers do not have to get consent to state NRSRO ratings and NRSROs are not liable for negligent or misleading ratings.

Such a liability scheme has left investors with insufficient legal recourse against NRSROs for the issuance of erroneous ratings or even failures to comply with their stated policies and practices for rating securities. As we have stated in the past, as a starting point, we believe that the exemption for NRSROs from Section 11 of the Securities Act should be reconsidered.[8] Currently, NRSROs are the only "experts" to enjoy an exemption from liability for statements in registration documents. We therefore believe that the exemption for NRSROs from Section 11 of the Securities Act should be rescinded and that, similar to other experts, NRSROs should be held legally accountable for their actions.

A. Original Reasons for Exemption are No Longer Warranted

The Concept Release provides several reasons why it may now be appropriate to rescind Rule 436(g) and reconsider whether NRSROs should continue to be insulated from liability under Section 11. The Institute wholeheartedly agrees with these reasons.

Current Liability for NRSROs is Insufficient

When Rule 436(g) was adopted, the Commission believed that the liability that was already applicable to NRSROs was sufficient for the protection of investors. At the time, the Commission noted that NRSROs were subject to anti-fraud liability under both Section 10(b) of the Exchange Act and under the Investment Advisers Act. As the Release notes, NRSROs are no longer required to register under the Investment Advisers Act and, although they remain subject to liability under Section 10(b) of the Exchange Act, they are held liable infrequently.

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[7] Section 11 under the Securities Act creates liability for issuers and certain professionals ("experts") who prepare or certify any part of the registration statement for any materially false statements or omissions in a registration statement.

[8] *See* ICI Roundtable Statement, *supra* note 4.

In addition, while NRSROs may 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 accountability for ratings issued in contravention of their own disclosed procedures and standards. 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.

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 of the First Amendment.

Elimination of Exemption Would Better Protect Investors

The Institute believes that it may no longer be consistent with investor protection to exempt NRSROs from the provisions of the Securities Act applicable to experts. When credit ratings are used to sell securities, investors rely on NRSROs and other credit rating agencies as a form of "expert" and on the information provided by credit rating agencies for a key part of their investment decision. It therefore would be appropriate for the liability scheme for experts to apply to NRSROs.

Similarly, as discussed above, rescinding Rule 436(g), and therefore potentially increasing the risk of liability under the federal securities laws, could significantly improve investor protection by encouraging NRSROs to improve the quality of their ratings and analysis in order to reduce the risk of liability under Section 11.

Elimination of Exemption Should Not Cause any Problems in Obtaining Consents

One of the other purposes underlying the adoption of Rule 436(g) was the Commission's concern that, without the exemption provided by Rule 436(g), registrants would not voluntarily disclose security ratings in their registration statements because NRSROs would not grant the necessary consent. However, as the Release notes, in light of the required disclosure regarding credit ratings that the Commission is proposing in the Companion Release if a credit rating is used in connection with a registered offering, this concern may no longer be valid. We also believe the Commission has set forth a number of workable solutions in the Concept Release for timely delivery of consents and to address concerns relating to the costs and burdens of obtaining and filing consents.

B. Impact on Competition

The Concept Release requests comment on several issues relating to the impact of rescinding the exemption for NRSROs from Section 11 liability on, among other things, competition among NRSROs and other rating agencies.

The Institute believes that rescinding the exemption for NRSROs from Section 11 liability, and therefore leveling the playing field between NRSROs and other rating agencies that are already subject to liability under Section 11, should help to improve the competitive landscape for rating agencies and, consequently, ratings quality. We believe that competition must be partnered with accountability. Competition alone has the potential to lead to a market share struggle that may result in a "race to the bottom" for standards of rating quality. On the other hand, we believe that a credible threat of liability would force NRSROs to be more vigilant in striving for ratings accuracy. Similarly, because rating agencies that do not have NRSRO status would be on equal footing under Section 11 with those that do, there may be greater incentive for these ratings agencies to challenge the existing NRSRO oligopoly by ensuring the production of high quality ratings.

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We look forward to working with the Commission 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 Heather Traeger at (202) 326-5920.

Sincerely,

/s/ Karrie McMillan

Karrie McMillan
General Counsel

cc: The Honorable Mary L. Schapiro, Chairman
The Honorable Kathleen L. Casey
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