Comment Letter on SEC Proposal to Define Statistical Rating Organizations, March 1998

March 2, 1998

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: Proposed Definition of Nationally Recognized Statistical Rating Organization (File No. S7-33-97)

Dear Mr. Katz:

The Investment Company Institute [1] appreciates the opportunity to comment on proposed amendments to the Securities and Exchange Commission's net capital rule (Rule 15c3-1) under the Securities Exchange Act of 1934.[2] The proposed amendments would define the term "nationally recognized statistical rating organization" ("NRSRO").[3]

While the scope of this proposal is fairly narrow—to provide a definition of the term "NRSRO" that sets forth the criteria that a rating entity must satisfy to be an NRSRO—it must be evaluated in the context of broader policy issues regarding the role and status of NRSROs under the federal securities laws. In this regard, mere codification of the designation process should not be viewed as effective regulation of NRSROs, particularly since NRSROs are shielded from so-called "expert liability" under Section 11 of the Securities Act of 1933 if their ratings appear in a security's prospectus. Moreover, absent more comprehensive regulation of NRSROs, the Commission should exercise caution in relying too heavily on NRSRO ratings in regulating the securities industry.

The ICI generally supports the proposal to the extent that it formalizes the NRSRO designation process for the purpose of issuing credit ratings relied upon by the Commission in certain limited instances, such as distinguishing different grades of debt securities under Rule 15c3-1. Nevertheless, the Commission should more actively oversee NRSROs to ensure continued compliance with the criteria included in the rule, including, most importantly, periodically soliciting public comment on the performance of NRSROs. In addition, as discussed below, it is extremely important that the NRSRO designation process not be expanded to cover other types of ratings issued by rating agencies where such agencies' credit ratings expertise is not a meaningful qualification to issue such other ratings. The rule should also be modified to authorize the Commission staff to make limited purpose NRSRO designations for rating agencies whose experience and expertise are limited to certain types of securities. Finally, the Commission should consider rescinding NRSROs' exemption from expert liability under Section 11 of the Securities Act. The Institute's specific comments on the proposed amendments to Rule 15c3-1 and on the broader issues regarding NRSROs generally are set forth below.

Commission Reliance on NRSROs

Rating agencies have been rating securities in the United States since the early part of this century. However, the concept of regulatory reliance on ratings issued by NRSROs did not arise until 1975, when the Commission adopted amendments to Rule 15c3-1 to require broker-dealers, when computing net capital, to deduct from their net worth certain percentages of the market value ("haircuts") of their proprietary securities positions.[4] These deductions are intended to serve as a buffer against the risks associated with price fluctuations of a broker-dealer's proprietary securities. Rule 15c3-1 allows broker-dealers to take reduced haircuts for certain commercial paper, nonconvertible debt securities and nonconvertible preferred stock that are rated investment grade by at least two NRSROs.[5] At the time Rule 15c3-1 was amended to provide for such reduced haircuts, however, it did not define the term NRSRO, nor did the rule specify what criteria would be used in designating NRSROs. Instead, NRSROs are designated through the Commission staff's no-action process.[6]

Since 1975, the Commission has expanded the use of the term NRSRO into other regulatory areas. The Commission's reliance upon NRSRO credit ratings may be appropriate where credit quality, or factors highly dependent upon credit quality, are important considerations (although, as discussed below, reliance on rating agencies in Commission regulations requires that the rating agencies themselves should be subject to greater oversight). For example, Rule 2a-7 under the Investment Company Act of 1940 uses NRSRO ratings to determine which securities are eligible for investment by a money market fund in order for the fund to use the amortized cost or penny-rounding methods of pricing portfolio securities.[7] However, such reliance upon NRSRO credit ratings is not appropriate where credit quality is not among the most important considerations, such as in Rule 3a-7 under the Investment Company Act, and the important protections provided by the federal securities laws should not be further eroded by such inappropriate reliance in the future.[8] Indeed, the ratings agencies themselves have acknowledged that NRSRO ratings should not be used as a substitute for actual financial market regulation and market discipline. As one Moody's official stated in a 1995 speech before the Commission, "[b]y using securities ratings as a tool of regulation governments fundamentally change the nature of the product agencies sell. Issuers pay rating fees to purchase, not credibility with the investor community, but a license from a government. . . . And if the present trends of regulatory use of ratings are not arrested, the credibility and integrity of the rating system itself will inevitably be eroded."[9]

NRSROs Should Be Subject to Greater Oversight

Credit ratings play a significant role in the investment decisions of both retail and institutional investors. In many instances, investors lack the expertise and resources necessary to adequately evaluate an issuer's creditworthiness, and thus credit ratings can provide useful information to such investors in making investment decisions. However, NRSROs' importance in the marketplace also raises issues concerning the extent to which they require regulatory oversight and monitoring.

Although NRSROs are required to register as investment advisers under the Investment Advisers Act of 1940, as two former SEC Commissioners aptly observed, "the investment adviser registration system applies awkwardly at best" to NRSROs.[10] Moreover, the no-action letters allowing ratings agencies to serve as NRSROs leave to it the NRSROs to self-police their own activities. The letters simply require NRSROs to advise the Commission of any material change in facts that serve as the basis for granting the no-action relief. Because of the substantial financial impact that withdrawal of NRSRO designation could have on a rating agency, NRSROs have a strong disincentive to report any such change in circumstances.

Given the prominent role that NRSROs play—and apparently will continue to play—in the regulation of the securities markets, it is important that the Commission subject NRSROs to meaningful oversight and not merely codify their past no-action letters. Thus, the Commission should be required to more actively oversee NRSROs to ensure continued compliance with the criteria included in the rule, including periodically soliciting public comment on the performance of NRSROs. In addition, the Commission should emphasize that the NRSRO designation applies only with respect to credit ratings. Finally, the Commission should authorize the Commission staff to grant limited-purpose NRSRO designations for rating agencies whose expertise and experience in rating securities is limited to certain types of securities. Each of these recommendations is discussed below.

Ongoing Monitoring of NRSROs

The proposal provides that, once it had been designated an NRSRO, a rating agency would be required to notify the Commission when it experiences material changes that may affect its ability to continue to meet any of the requisite criteria. Thus, the Commission is assuming that rating agencies will readily divulge any shortcomings within their organizations that could jeopardize their NRSRO status without the need for ongoing Commission oversight. Given the enormous financial impact that a loss of NRSRO designation could have on a rating agency, ratings agencies will have strong incentives not to report such deficiencies. Although this condition is consistent with representations in prior Commission no-action letters granting NRSRO status, we are not aware of any rating agency reporting such information and subsequently losing its status as an NRSRO. It seems doubtful that this self-policing structure will ensure that NRSROs will maintain the necessary attributes to continue to function as an NRSRO.

Accordingly, the proposal should be revised to require greater Commission oversight of NRSROs as a condition to maintaining that status. The Commission should conduct periodic reviews of NRSROs to ensure that they have necessary national recognition, staffing, resources, structure, internal procedures, and issuer contacts to serve as an NRSRO. In particular, given that some NRSROs are now also recommending securities to clients (including the same securities which are rated by the NRSRO), it is critical that NRSROs have internal procedures designed to prevent the misuse of confidential information obtained through the rating process. For example, NRSROs should have in place ethical walls and other internal control procedures to prevent information divulged by a rated issuer from being used in recommending that issuer's securities. The Commission may wish to provide more specific requirements with respect to such procedures. The Commission also should inspect NRSRO records relating to past ratings to ensure that the ratings were based on sound reasoning, and that the ratings were issued free from economic pressures and controls by the issuer being rated. To ensure the economic independence of NRSROs, as required by the proposal, such examinations should include review of fee arrangements between issuers and NRSROs.

As part of its ongoing monitoring of NRSROs, the Commission should solicit public comment on the reliability and quality of the ratings issued by a particular NRSRO. In the Proposing Release, the Commission notes that the most critical attribute for an NRSRO is that it is a nationally recognized issuer of credible and reliable credit ratings by the users of securities ratings in the U.S. It would seem that the best way to ensure that an NRSRO continues to meet this attribute would be to periodically solicit public comment on that particular rating agency. To the extent that its national reputation is slipping, the Commission would have first-hand evidence which would assist it in determining whether the NRSRO's designation should be revoked.

Additionally, NRSROs are playing an increasingly important role in setting industry-wide standards for structured obligations. For many types of structured obligations, issues of structure and credit quality are inexorably intertwined. If a mutual fund disagrees with an NRSRO's credit analysis, it can simply avoid a particular security or issuer. However, if a fund disagrees with an NRSRO's evaluation of structural risk, frequently the only way to avoid the risk may be to exclude whole categories of investments.[11] Because the negotiations over these requirements involve NRSROs and issuers, but not investors, the Commission should be more proactive in ensuring that investors can influence NRSRO structural standards. The periodic review and public comment process we propose could help make NRSROs more sensitive to investors' structural concerns.

This solicitation of public comment is not without precedent for private organizations that serve a quasi-public function, such as NRSROs. For example, television and radio stations that receive broadcast licenses from the Federal Communications Commission must periodically reapply for their license renewals, at which time the station must publish notice of its renewal application and solicit public comment to the FCC on the station's performance.[12] Given the very important role that NRSROs serve in the regulation of the U.S. securities markets (and the enormous benefit attached to NRSRO designation), it seems appropriate to impose a public comment and review process on a periodic basis (such as every two years) to ensure that rating agencies that have received the special designation of NRSRO should be entitled to continue receiving such a designation.

Application to Credit Ratings Only

The Proposing Release states that the designation of an agency as an NRSRO would apply only to a rating organization's opinion concerning the creditworthiness of debt instruments, and that other opinions and views of the rating organization would be outside the scope of the NRSRO designation.[13] The ICI strongly supports limiting the scope of the proposed amendments in this manner.

Allowing NRSRO ratings to be used for other purposes would be highly inappropriate. For instance, NASD Regulation, Inc. recently filed a proposal with the Commission to allow volatility ratings in mutual fund supplemental sales literature, so long as the volatility rating is issued by an NRSRO. Nevertheless, the expertise that NRSROs have in issuing credit ratings of debt securities is not at all indicative of their ability to predict the expected volatility of a bond mutual fund. This expansion of the use of NRSROs in securities regulation underscores the importance of limiting the NRSRO designation to ratings expressing an opinion of the creditworthiness of debt instruments.

Limited Purpose NRSRO Designations

Finally, it may be appropriate to modify the proposal to authorize the Commission staff to issue limited NRSRO designations permitting a rating agency to issue credit ratings with respect to only certain securities with which the rating organization has the necessary experience and expertise. By issuing limited purpose NRSRO designations, the Commission ensures that an NRSRO will not issue ratings on securities that are outside of its knowledge and experience. For example, some ratings agencies may have expertise in rating the credit of U.S. issuers, but do not have experience in rating securities issued by foreign corporations. Similarly, some rating agencies may be familiar with rating ordinary debt offerings but do not have significant experience in rating asset-backed securities. A limited purpose NRSRO designation would prevent such an NRSRO from issuing ratings for which it is not qualified.[14]

NRSROs Should be Accountable for Their Ratings

In addition to being free from all but minimal government regulation, the rating agencies are also relieved of any legal accountability for their ratings. NRSROs are shielded from expert liability under Section 11 of the Securities Act if their ratings appear in a securities prospectus. In 1982, Rule 436 under the Securities Act was amended to provide that ratings assigned to debt securities, convertible debt securities or preferred stock by an NRSRO would not be deemed part of a registration statement under Sections 7 and 11 of the Securities Act. As a result, issuers do not have to obtain the consents from NRSROs before publishing their ratings and NRSROs are exempt from Section 11 liability if their ratings are included in a registration statement. The broad exemption of NRSROs from the normal liability provisions of Section 11 of the Securities Act means that NRSROs are not held to a negligence standard of care. The rating agencies also maintain that they are members of the "media" that are providing their "opinions," and thus claim that they can only be liable if their conduct can be said to have been "reckless."[15] As a result, the exemption from expert liability pursuant to Rule 436(g) lessens the incentives of NRSROs to issue credible and reliable securities ratings.

The NRSROs' exemption from Section 11 liability represents a significant 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. Quite frankly, it is difficult to conceive of the rationale for providing this exemption when NRSRO credit ratings are relied upon so heavily by the Commission and the investing public, while at the same subjecting NRSROs to only minimal government regulation.[16] Accordingly, the Institute believes that, at the very least, the Commission should seriously consider, and invite public comment on, rescinding the NRSROs' exemption from expert liability under Rule 436. If this is not done, the need for greater oversight of NRSROs is even more compelling.

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We appreciate the opportunity to comment on this proposal. If you have any questions, please do not hesitate to telephone me at (202) 326-5815.

Sincerely,

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ENDNOTES

[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes 6,742 open-end investment companies ("mutual funds"), 442 closed-end investment companies, and 10 sponsors of unit investment trusts. Its mutual fund members have assets of about $4.359 trillion, accounting for approximately 95% of total industry assets, and have over 59 million individual shareholders.

[2] SEC Release No. 34-39457 (Dec. 17, 1997), 62 Fed. Reg. 68018 (Dec. 30, 1997) (the "Proposing Release").

[3] In particular, the proposed amendments would for the first time include within Rule 15c3-1a formal list of attributes to be considered by the Commission in designating rating organizations as NRSROs. NRSROs that have already received no-action assurances regarding NRSRO status would retain this status without having to reapply with the Commission, although the Commission has stated that it would conduct reviews of current NRSROs to ensure that they meet the requirements of the proposed definition.

[4] SEC Release No. 34-11497 (June 26, 1975), 40 Fed. Reg. 29795 (July 16, 1975).

[5] See 17 C.F.R. § 240.15c3-1(c)(2)(vi)(E), (F) and (H).

[6] Currently, there are five rating agencies that have this designation: Moody's Investors Service, Inc. ("Moody's), Standard and Poor's Corporation ("S&P"), Fitch IBCA, Inc., Duff & Phelps Credit Rating Co., and Thomson BankWatch, Inc. Proposing Release at 6-7.

[7] See id. § 270.2a-7. Specifically, Rule 2a-7 restricts the securities eligible for purchase by a money market fund to those that have received certain high NRSRO ratings or which, if unrated, are of comparable quality to such highly rated securities. Other examples of Commission rules that rely on NRSRO ratings that are cited in the Proposing Release include: Regulation S-K (17 C.F.R.

§ 229.10) and Forms S-3, F-2 and F-3 (17 C.F.R. §§ 239.13, 239.32 and 239.33) under the Securities Act; Rule 101 (17 C.F.R. § 242.101) and Form 17-H (17 C.F.R. § 249.328T) under the Exchange Act; and Rules 10f-3 (17 C.F.R. § 270.10f-3) and 3a-7 (17 C.F.R. § 270.3a-7) under the Investment Company Act. These rules are premised on the availability of reliable ratings from multiple sources. If events occur that limit the availability of such ratings (e.g., a decrease in the number of NRSROs), these requirements would need to be promptly revisited.

[8] In this regard, Rule 3a-7 under the Investment Company Act, which provides an exemption from the Act for certain issuers of asset-backed securities that have received an investment grade rating from an NRSRO, extends NRSROs beyond their traditional role of evaluating debt securities' risk of default to determining what level of disclosure and other protections investors are entitled to receive.

[9] "Ratings in Regulation: A Petition to the Gorillas," speech by Thomas J. McGuire, Executive Vice President and Director of Moody's Corporate Department, before the U.S. Securities and Exchange Commission (April 28, 1995).

[10] Letter from Mary L. Schapiro and Richard Roberts to Congressman John D. Dingell, dated August 12, 1992.

[11] This result would significantly impact the supply of high quality money market instruments. The majority of municipal money market obligations involve some structural elements to achieve the liquidity, maturity or credit quality required by Rule 2a-7 under the Investment Company Act. For municipal money market mutual funds, therefore, structural issues are particularly important.

[12] See 47 C.F.R. § 73.3584.

[13] Proposing Release at 10.

[14] The Commission has already made such a limited-purpose NRSRO designation with respect to Thomson BankWatch, which is recognized as an NRSRO only for the purposes of rating debt issued by banks, bank holding companies, non-bank banks, thrifts, broker-dealers, and broker-dealers' parent companies. See Proposing Release at 7 note 10.

[15] See, e.g., First Equity Corporation of Florida v. Standard & Poor's Corporation, 869 F.2d 175 (2d Cir. 1989).

[16] These concerns are exacerbated by the fact that in more than several instances, reliance on NRSRO credit ratings has been questionable at best and injurious at worst. For example, over the years, both S&P and Moody's have been heavily criticized for failing to downgrade the ratings of various bonds, such as those issued by the City of New York that defaulted in April 1975, bonds issued by Washington Public Power Supply System that defaulted in 1983, and bonds issued by First Executive Life Insurance Company that defaulted in 1991. See Francis A. Bottini, Jr., An Examination of the Current Status of Rating Agencies and Proposals for Limited Oversight of Such Agencies, 30 San Diego L. Rev. 579, 583-594 (1993). More recently, NRSROs have been strongly criticized for failing to respond in a timely manner to the Asian crisis. See Steven Irvine, Caught with their pants down?, Euromoney, Jan. 1998, at 51-53.
