

## ICI Comment Letter on NRSRO Approval Process, June 2005

June 9, 2005

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

**Re: Definition of Nationally Recognized Statistical Rating Organization (File No. S7-04-05)**

Dear Mr. Katz:

The Investment Company Institute<sup>1</sup> is writing to comment on the Securities and Exchange Commission's proposed new rule that defines the term "nationally recognized statistical rating organization" ("NRSRO").<sup>2</sup> The Institute supports the adoption of a formal definition of "NRSRO," as it would facilitate much needed competition among credit rating agencies. At the same time, however, we believe the Commission must ensure that a regulatory oversight process is in place to protect the integrity and quality of the credit ratings process.

The Institute and its members have a longstanding interest in the oversight of credit rating agencies given the significant role that they play in the U.S. securities markets. As we noted in several previous comment letters on Commission proposals relating to NRSROs<sup>3</sup> and in other statements relating to NRSRO oversight,<sup>4</sup> the ratings published by credit rating agencies play an important part in the investment decisions of institutional investors, and the Commission and other regulatory agencies rely upon these ratings as assessments of investment risk for several regulatory purposes.<sup>5</sup> Given the importance of these credit ratings, we believe that maintaining the integrity and quality of the credit ratings process is essential to investor confidence and to the proper functioning of our capital markets.

In order to achieve this goal, the Institute, in our previous comment letters, outlined ways to enhance the current regulatory structure for credit rating agencies. Most significantly, we supported Commission regulatory authority over NRSROs and specifically recommended that the Commission (1) strengthen the system of oversight of credit rating agencies; (2) require public disclosure of the resources, standards, procedures and policies employed by the agencies in their ratings process; (3) institute a new public comment and review process regarding rating agencies' performance, standards, and methodologies; and (4) hold rating agencies legally accountable for their ratings.

While we support the proposed definition of "NRSRO," the proposal does not enhance the Commission's current regulatory structure and oversight of these entities. In fact, the proposal may diminish the Commission's oversight by eliminating the need for credit rating agencies to seek no-action letters in order to be designated as an NRSRO. The Release notes that, due to concerns raised regarding the extent of the Commission's legal authority to regulate or impose requirements on NRSROs, in the absence of Congressional action, it is unclear whether the Commission can take actions to enhance its current NRSRO regulatory structure. Nevertheless, given the reliance of many provisions of the securities laws on NRSRO ratings and the utilization of these ratings by investors in their investment decisions, we believe there must be some meaningful oversight of NRSROs.<sup>6</sup>

Consequently, absent Commission authority to impose a more stringent regulatory structure over NRSROs, the Institute recommends that, in addition to adopting a formal definition of "NRSRO," the Commission continue to require that credit rating agencies obtain NRSRO designation through the no-action process. At the same time, in order to facilitate competition among credit rating agencies, we recommend that the Commission institute several changes to the current no-action process. Our specific comments follow.

### Continue to Require No-Action Letters

The Commission's proposal is self-executing. Once a credit rating agency determines that it satisfies the three components of the proposed definition of NRSRO, it would be considered an NRSRO.<sup>7</sup> In contrast, currently, a credit rating agency must seek NRSRO designation by obtaining a no-action letter from the Commission staff. This process requires the rating agency to undergo an examination by the staff, including providing detailed information on the criteria making up the three components of the proposed NRSRO definition. In addition, Commission staff conducts an on-site meeting with senior management, analysts, and others to discuss the firm's policies and procedures and contacts references to assess their use of the credit rating agency's ratings and the ratings' credibility and reliability. We believe requiring credit rating agencies to continue to seek no-action letters and to undergo such an examination by Commission staff would achieve an appropriate level of NRSRO oversight.

## Recommended Changes to the No-Action Process

We acknowledge the concerns expressed regarding the current no-action process for NRSROs, such as the length of time necessary to obtain a no-action letter and the restricted types of credit rating agencies eligible for NRSRO status through this process. We believe that those concerns can be adequately addressed through changes to the no-action process and by the proposal itself.

Specifically, we support the establishment of a time period within which Commission staff would act on credit rating agency no-action requests for NRSRO status. The Release states that the Commission expects that no-action requests would be considered, and resolved, "in a timely fashion" and that, if it were to adopt a definition of the term NRSRO, the staff should be able to act on NRSRO no-action requests within 90 days after a credit rating agency has submitted all the necessary information. We believe establishing a time period for staff action would address concerns regarding the current length of time necessary to obtain a no-action letter and would facilitate the designation of credit rating agencies as NRSROs.

In addition, the Institute recommends that the Commission, in a timely manner, alert applicants of any perceived deficiencies in their no-action requests and facilitate an open dialogue between the applicant and the Commission staff responsible for review of the application. The Institute also supports granting no-action letters for a specified period of time, after which the no-action relief granted by Commission staff would have to be reconsidered. We believe such a provision would help ensure that the facts and representations made by the credit rating agency and relied upon by Commission staff still satisfy the conditions necessary in order to be considered an NRSRO.

The Institute also supports allowing credit rating agencies that confine their activities to limited sectors of the debt market or to limited geographic areas to be deemed an NRSRO. Our members report that there are several credit rating agencies that have developed an expertise in certain areas. We believe such entities should be provided the opportunity, assuming they meet the components of the proposed definition of NRSRO, to be considered as an NRSRO in their specific area of expertise and should be eligible for a no-action letter recognizing them as an NRSRO for such purposes.

Finally, the proposed definition of NRSRO, by codifying the components of an NRSRO that Commission staff currently considers in the no-action process, and thereby clarifying the elements necessary to be considered an NRSRO, should assist credit rating agencies seeking no-action letters in filing a complete no-action request and meeting the proposed definition, thereby expediting the process necessary to become an NRSRO.

Together, we believe these changes would significantly improve the current no-action process and facilitate competition for credit rating agencies, while at the same time ensure that there is the minimum amount of NRSRO oversight necessary to ensure adequate investor protections and an efficient NRSRO process.

## Proposed Definition of NRSRO

As discussed above, the Institute supports adopting a formal definition of "NRSRO" and codifying the components currently evaluated by Commission staff when reviewing a credit rating agency's request for a no-action letter. Most significantly, we believe it is very important for an NRSRO to have the proper procedures in place to ensure credible and reliable ratings, to manage potential conflicts of interest, and to prevent the misuse of nonpublic information.

The transparency of these procedures also is very important to investors. Specifically, our members report that it would be helpful for NRSROs to disclose their policies and procedures addressing conflicts of interest to investors (as well as the conflicts themselves) and periodically disclose information necessary for investors to evaluate whether they have the necessary national recognition, staffing, resources, structure, internal procedures and issuer contacts to serve as NRSROs. Given their unique role, it also would be useful to require that NRSROs disclose certain general and structural elements of their operations.

The Institute therefore recommends that the Commission consider, as an additional factor for assessing whether a credit rating agency meets the third component of the proposed NRSRO definition, the level of disclosure of these factors to investors. We believe

the public disclosure of these factors would allow investors a continuous opportunity to appraise the NRSROs' independence, their capabilities as NRSROs and their unique operations.

\* \* \*

The Institute appreciates the opportunity to comment on the proposal. 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  
Robert L.D. Colby, Deputy Director  
Michael A. Macchiaroli, Associate Director  
Division of Market Regulation

Meyer Eisenberg, Acting Director  
Robert E. Plaze, Associate Director  
Division of Investment Management

#### ENDNOTES

<sup>1</sup> The Investment Company Institute is the national association of the American investment company industry. The Investment Company Institute's membership includes 8,541 open-end investment companies ("mutual funds"), 653 closed-end investment companies, 143 exchange-traded funds and 5 sponsors of unit investment trusts. Its mutual fund members manage assets of about \$7.838 trillion. These assets account for more than 95 percent of assets of all U.S. mutual funds. Individual owners represented by ICI member firms number 87.7 million as of mid 2004, representing 51.2 million households. Many of the Institute's investment adviser members render investment advice to both investment companies and other clients. In addition, the Institute's membership includes 188 associate members, which render investment management services exclusively to non-investment company clients. These Institute members and associate members manage a substantial portion of the total assets managed by registered investment advisers.

<sup>2</sup> SEC Release Nos. 33-8570; 34-51572; IC-26834 (April 19, 2005), 70 FR 21306 (April 25, 2005).

<sup>3</sup> See Letter from Paul Schott Stevens, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated December 6, 1994 (SEC Concept Release Concerning Nationally Recognized Statistical Rating Organizations and Proposed Rules Concerning Disclosure of Securities Ratings); [Letter from Craig S. Tyle, General Counsel, Investment Company Institute](#), to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated March 2, 1998 (Proposed Definition of Nationally Recognized Statistical Rating Organization); and [Letter from Amy B.R. Lancellotta, Senior Counsel, Investment Company Institute](#), to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated July 28, 2003 (Concept Release Regarding Rating Agencies and the Use of Credit Ratings Under the Federal Securities Laws).

<sup>4</sup> See, e.g., [Statement of Amy Lancellotta, Senior Counsel, Investment Company Institute](#), for the SEC Hearings on Issues Relating to Credit Rating Agencies, dated November 21, 2002.

<sup>5</sup> Most significant for the fund industry is the role of credit ratings in Rule 2a-7 under the Investment Company Act of 1940. Rule 2a-7 limits money market funds to investing in "high quality" securities and contains minimum quality standards based, among other things, on ratings issued by NRSROs.

<sup>6</sup> At the Commission open meeting discussing the NRSRO proposal, SEC Commissioner Goldschmid stated that, "credit rating agencies, like other key gatekeepers, deserve scrutiny and oversight commensurate with their role and importance in the securities markets and with the potentially serious problems – for example, various conflicts of interest and misuses of information – that can arise in the operation of the business." Statement at Open Meeting Regarding NRSRO Rule Proposal (March 3, 2005).

<sup>7</sup> The Commission is proposing to define the term “NRSRO” as an entity that (1) issues publicly available credit ratings that are current assessments of the creditworthiness of obligors with respect to specific securities or money market instruments; (2) is generally accepted in the financial markets as an issuer of credible and reliable ratings, including ratings for a particular industry or geographic segment, by the predominant users of securities ratings; and (3) uses systematic procedures designed to ensure credible and reliable ratings, manage potential conflicts of interest, and prevent the misuse of nonpublic information, and has sufficient financial resources to ensure compliance with those procedures.