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July 25, 2008

Ms. Florence Harmon  
Acting Secretary  
U.S. Securities and Exchange Commission  
100 F Street, N.E.  
Washington, D.C. 20549-1090

Re: Proposed Rules for Nationally Recognized Statistical Rating Organizations (“NRSROs”), File No. S7-13-08

Dear Ms. Harmon:

The Investment Company Institute<sup>1</sup> strongly supports the Commission’s examination of the need for additional regulatory requirements for NRSROs to address continuing concerns about the credit ratings process.<sup>2</sup> In light of recent events in the credit markets, further reforms to the oversight and operation of credit rating agencies are critical to ensure the continued proper functioning of our securities markets. Increased regulatory oversight by the Commission is an important part of these reforms and is necessary to ensure the credibility and reliability of credit ratings which, in turn, are critical to our members as users of ratings.

To promote the integrity and quality of the credit ratings process, more must be done to increase disclosure and transparency surrounding an NRSRO’s policies and procedures for issuing ratings and the accountability of an NRSRO for its ratings. The first part of the Commission’s proposal, which would impose additional disclosure, reporting and recordkeeping requirements on an NRSRO for structured finance products that it rates, is a step forward in achieving this goal and restoring investor confidence in the integrity of credit ratings. The Institute therefore strongly supports this proposal. We believe, however, that more must be done to increase disclosure and

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<sup>1</sup> 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 \$12.90 trillion and serve almost 90 million shareholders.

<sup>2</sup> See *Proposed Rules for Nationally Recognized Statistical Rating Organizations*, SEC Release No. 34-57967 (June 17, 2008), 73 FR 36211 (June 25, 2008).

transparency not only in this area but also with respect to other debt securities, particularly municipal securities. We therefore urge the Commission to expand many of the proposed requirements to these types of securities and to support legislation that would extend many of the proposed requirements aimed at increased disclosure and accountability to the *issuers* of these instruments.

We have several concerns about the second part of the Commission's proposal relating to structured finance products rating symbology. In particular, we are concerned that appending identifying characters or using a different rating symbol for these products may have adverse consequences for the securities markets and for users of ratings.

Finally, the third part of the Commission's proposal, which would remove credit ratings from SEC rules, is the subject of a separate release.<sup>3</sup> If the Commission proceeds with that proposal, in whole or in part, the issues raised in this Release will be even more significant.

Our specific recommendations are discussed in detail below.

## **I. Summary of Recommendations**

### *Conflicts of Interest*

- We support requiring NRSROs to disclose information regarding the conflict of being paid by certain "arrangers" to rate structured finance products and recommend that the proposed disclosures be expanded to include issuers of municipal securities.
- We recommend that the Commission require additional disclosures by NRSROs including: (1) any material ancillary business relationships between the NRSRO and an issuer; (2) the number of other products rated by an NRSRO for a particular arranger; (3) information regarding the separation of an NRSRO's consulting and rating activities; and (4) the fees paid for a rating (within ranges).
- We recommend that NRSROs be the party that is responsible to disclose the required information and that this requirement be expanded to include *all* of the information that NRSROs are provided to aid in their determination of an initial credit rating and to perform credit rating surveillance (as opposed to disclosure of only the information NRSROs use).
- We recommend that the Commission require issuers, underwriters, and sponsors of structured finance products to perform due diligence reviews (and disclose the steps taken to investors and NRSROs). We also recommend that the Commission require NRSROs to have policies and

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<sup>3</sup> 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).

procedures to assess the credibility of this information and to disclose the steps (and results of the steps) undertaken to verify information about the assets underlying a security.

- We support the proposed prohibitions on issuing ratings relating to conflicts of interest arising from fee discussions and gifts. We recommend the prohibition relating to fee discussions be extended to cover supervisory personnel. We also recommend that the proposed prohibition relating to recommendations by an NRSRO about the structure of a product be addressed instead through disclosure and procedures to manage that conflict.

#### *Recordkeeping Requirements*

- We support the proposed amendments to require NRSROs to make and retain records of: (1) material deviations from the credit rating implied by a model and the final credit rating issued; and (2) any complaint regarding the performance of a credit rating analyst in determining credit ratings, and recommend that the Commission expand the scope of the proposal to require that both of these records be publicly disclosed.
- We support the proposed amendment to require NRSROs to make public a record showing all of their ratings actions but oppose the proposed six-month delay before requiring disclosure of such information.

#### *Form NRSRO*

- We support the proposed amendment to enhance disclosure regarding rating performance measurement statistics and recommend that the Commission expand the disclosure to include policies and procedures articulating how and when NRSROs conduct downgrades and the potential severity of downgrades.
- We recommend that the Commission adopt standardized performance measurement statistics to facilitate comparability across all NRSROs.
- We support the proposed amendment to enhance disclosure surrounding the methodologies an NRSRO uses to determine credit ratings and recommend that the proposed disclosures be required for types of debt other than structured finance products.
- We recommend the Commission require NRSROs to disclose additional information regarding staffing issues, including personnel turnover and resource levels.

#### *Differentiating Credit Ratings for Structured Finance Products*

- We support the proposed report that would describe how the credit ratings procedures and methodologies and credit risk characteristics for structured finance products differ from those of other types of rated instruments.
- We oppose the proposed alternative to a report, *i.e.*, requiring an NRSRO to use ratings symbols for structured finance products that differentiated them from the credit ratings for

other types of debt securities.

### *Increase Municipal Securities Disclosure*

- We recommend that the Commission improve municipal securities disclosure within the current regulatory regime (*e.g.*, Securities Exchange Act Rule 15c2-12).
- We recommend that Congress consider imposing certain disclosure requirements directly on municipal issuers.
- We recommend that Congress clarify the legal responsibilities of officials of municipal issuers for the disclosure documents they authorize.

### *Unified Ratings Scale*

- We question the practicalities, benefits and timing of regulatory, legislative and other proposals that would have NRSROs adopt a single ratings scale for municipal and corporate debt securities.
- We recommend that the disclosure inadequacies in the municipal securities market be resolved before adoption of any proposals that would have NRSROs employ a single ratings scale for municipal and corporate debt securities.

## **II. Uses of Credit Ratings by Funds**

Funds employ credit ratings in a variety of ways – to help make investment decisions, to define investment strategies, to communicate with their shareholders about credit risk, and to inform the process for valuing securities. For these reasons, funds and fund shareholders have a significant stake in the soundness and integrity of the credit rating system.

Most significantly, funds utilize ratings issued by credit rating agencies in analyzing the credit risks of securities. NRSRO-rated securities form an important component of many of the portfolios that funds manage for the benefit of their shareholders. Thus, the ratings issued by NRSROs must provide credible indications of the risk characteristics of those instruments in which funds invest.

Credit ratings also play an important role in communications between funds and their shareholders. Many funds incorporate ratings criteria into shareholder disclosures regarding the investment policies and strategies of the fund. For example, funds may illustrate the methods by which they limit the risks of their investments by including disclosure in a fund prospectus of the percentage of its portfolio invested in bonds rated in a particular category by an NRSRO. Many corporate and municipal bond funds now provide shareholders with a graph or table showing the percentage of the portfolio invested in each rating category of one or more NRSROs. Some funds even provide the

ratings of individual securities in the schedule of investments provided to shareholders as a method of communicating with shareholders about the credit risks taken by a fund.

Ratings also play a role in the valuation of fund shares. Many funds use pricing services in valuing debt securities, some of which trade only infrequently. The rating assigned to securities by a rating agency may influence the valuation determinations of pricing services and ultimately the calculation of the net asset value of funds that hold such securities. Finally, some investment companies, particularly institutional money market funds, obtain credit ratings for their own shares.

### **III. Previous Institute Positions on Credit Rating Agency Reform**

Because of the multiple ways in which funds employ credit ratings, funds and fund shareholders have a significant stake in the soundness and integrity of the credit rating system. For this reason, the Institute has had a longstanding interest in regulatory and legislative initiatives to reform the regulation and oversight of rating agencies. For well over a decade, the Institute has commented on Commission proposals and concept releases, as well as participated in a Commission hearing, relating to credit rating agencies, their role in the operation of the securities markets, the importance of increasing transparency in the ratings process, and maintaining the integrity and quality of credit ratings.<sup>4</sup>

Most significant for the current proposal, in both 2005 and 2006, the Institute testified before Congress on the oversight and operation of credit rating agencies. In testimony before the Committee on Financial Services in the U.S. House of Representatives, the Institute supported the goals of the “Credit Rating Agency Duopoly Relief Act of 2005,” including increased competition among NRSROs, appropriate SEC oversight, greater transparency, and heightened accountability. Similarly, in testimony before the Senate Committee on Banking, Housing and Urban Affairs on the Credit Rating Agency Reform Act of 2006, the Institute highlighted the need for increased disclosure and transparency in the credit ratings process.<sup>5</sup>

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<sup>4</sup> See Letter from Paul Schott Stevens, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated June 6, 1994 (Concept Release Concerning Nationally Recognized Statistical Rating Organizations); 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); Statement of Amy B.R. Lancellotta, Senior Counsel, Investment Company Institute, for the SEC Hearings on Issues Relating to Credit Rating Agencies, dated November 21, 2002; 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); and Letter from Amy B.R. Lancellotta, Senior Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated June 9, 2005 (Proposed Definition of Nationally Recognized Statistical Rating Organization).

<sup>5</sup> See Statements of Paul Schott Stevens, President, Investment Company Institute, 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) and on the “Credit Rating Agency Duopoly Relief Act of 2005,” before the Committee on Financial Services, U.S. House of Representatives (November 29, 2005). See also Letter from Paul Schott Stevens, President, Investment Company

Most recently, in 2007, the Institute commented on the Commission's proposal to promulgate rules to implement the Credit Rating Agency Reform Act of 2006.<sup>6</sup> In that letter, the Institute noted the importance of maintaining the integrity and quality of the credit ratings process and the critical importance of the role that credit rating agencies and NRSROs play in the regulation and operation of money market funds.

The Institute also is closely following the review of the role of credit rating agencies in the global capital markets and the related recommendations for reform made by several organizations.<sup>7</sup>

#### **IV. Proposed Disclosure, Reporting and Recordkeeping Requirements**

Institute members continue to emphasize the importance to them, as investors, of access to information about an NRSRO's policies, procedures and other practices relating to credit rating decisions. The public disclosure of this information would allow investors to more effectively evaluate an NRSRO's independence, objectivity, capability and operations. Such disclosure also would serve as an additional mechanism for ensuring the integrity and quality of credit ratings. We therefore support the Commission's proposal to impose additional disclosure, reporting and recordkeeping requirements on NRSROs.

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Institute, to the Honorable Richard Shelby (R-AL), Chairman, Committee on Banking, Housing and Urban Affairs, U.S. Senate and the Honorable Paul Sarbanes (D-MD), Ranking Minority Member, Committee on Banking, Housing and Urban Affairs, U.S. Senate, dated July 31, 2006 (urging support of the Credit Rating Agency Reform Act of 2006) and Letter from Paul Schott Stevens, President, Investment Company Institute, to the Honorable Mike Oxley (R-OH), Chairman, Committee on Financial Services, U.S. House of Representatives and the Honorable Barney Frank (D-MA), Ranking Minority Member, Committee on Financial Services, U.S. House of Representatives, dated June 13, 2006 (urging approval of H.R. 2990, the Credit Rating Agency Duopoly Relief Act of 2005).

<sup>6</sup> See Letter from Elizabeth Krentzman, General Counsel, Investment Company Institute, to Nancy M. Morris, Secretary, Securities and Exchange Commission, dated March 12, 2007 (Proposed Rules for Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations).

<sup>7</sup> See, e.g., The Committee of European Securities Regulators, *CESR's Second Report to the European Commission on the Compliance of Credit Rating Agencies with the IOSCO Code and the Role of Credit Rating Agencies in Structured Finance*, May 2008; Financial Stability Forum, *Report on Enhancing Market and Institutional Resilience*, April 15, 2008; Institute of International Finance, *Interim Report of the IIF Committee on Market Best Practices*, April 9, 2008; The International Organization of Securities Commissions ("IOSCO"), *The Role of Credit Rating Agencies In Structured Finance Markets*, March 26, 2008; and The President's Working Group on Financial Markets, *Policy Statement on Financial Market Developments*, March 2008.

**A. Conflicts of Interest**

The proposed amendments would amend Rule 17g-5 to require the disclosure and creation of procedures regarding an additional conflict of interest and to prohibit certain other conflicts that arise from the business of determining credit ratings.

1. Proposed Additional Disclosures

The Commission is proposing to amend Rule 17g-5 to add to the list of conflicts that must be disclosed and managed the additional conflict of repeatedly being paid by certain “arrangers” to rate structured finance products.<sup>8</sup> As the Release explains, some arrangers, as sources of constant deal-based revenue, have the potential to exert greater influence on an NRSRO than, for example, a corporate issuer that may bring far less ratings business to the NRSRO. The proposal therefore would require that as a condition to the NRSRO rating a structured finance product,<sup>9</sup> the information provided to the NRSRO and used by the NRSRO in determining the initial credit rating and in performing credit rating surveillance be disclosed through a means designed to provide reasonably broad dissemination of the information. The Release states that the intent behind this disclosure is to create the opportunity for other NRSROs also to use the information to rate the instrument.

The Institute strongly supports the proposal. Public disclosure of this information, including the characteristics and performance of the assets in the pool underlying structured finance products, the legal documentation setting forth the capital structure of the trust, payment priorities with respect to the tranches, and all applicable covenants regarding the activities of the trust, should improve transparency surrounding the information and processes used by NRSROs for rating structured finance products. It should also assist investors and other market professionals (*e.g.*, credit desks at money management firms) to perform an independent assessment of these products. In addition, any resulting “unsolicited ratings” by other NRSROs could be used by market participants to evaluate the ratings issued by the NRSRO hired to rate the product.

In combination with the proposed disclosures regarding NRSRO methodologies for rating structured finance products (discussed below), this information also will provide users of ratings with a more complete picture of an NRSRO’s rating process and expose that process to greater scrutiny. This exposure, in turn, should promote the issuance of more accurate, high-quality ratings, and could prevent arrangers of structured finance products from unduly influencing NRSROs by seeking higher than warranted ratings in exchange for future business.

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<sup>8</sup> As used in the proposal, an arranger would include the issuer, sponsor or underwriter of the security.

<sup>9</sup> The Institute seeks greater clarity from the Commission on the definition of “structured finance products.” The broad application of the term, as described in Footnote 15 of the Release, may create challenges and confusion in interpreting aspects of the proposal.

The Institute recommends that the proposed disclosures not be limited to the rating process for structured finance products. The conflict of interest being targeted is not confined to the ratings of these instruments and therefore should be extended to the issuers of municipal securities.<sup>10</sup> Enhanced transparency and disclosure of information also is particularly critical to investors if the Commission pursues its recent proposal to remove ratings from certain SEC rules and regulations, as investors will need access to additional information to permit them to conduct a thorough analysis of the credit quality of the offering.<sup>11</sup>

## 2. Additional Institute Recommended Disclosures

We believe that further disclosures are required to sufficiently provide users of ratings with an understanding of an NRSRO's conflicts of interest and its management of those conflicts. Specifically, the Commission should require an NRSRO to disclose:

- any material ancillary business relationships between the NRSRO and an issuer;
- the number of other products rated by an NRSRO for a particular arranger;
- information regarding the separation of an NRSRO's consulting and rating activities (this disclosure would be independent of the proposed prohibition against rating a product in which the NRSRO has been consulted on the structure of the product); and
- the fees paid for a rating (within ranges).

We believe improving the understanding of each of these potential conflicts of interest would further stimulate investor confidence in ratings and ratings processes.

## 3. Responsibility For Disclosures

As proposed, the new disclosure requirements would apply to information provided to an NRSRO by the "issuer, underwriter, sponsor, depositor, or trustee." The proposal does not specify the

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<sup>10</sup> The Institute recognizes that changes would have to be made to the Tower Amendment to allow the SEC to require such disclosures of municipal issuers. As discussed below, the Institute favors a review of the Tower Amendment and the disclosure regime for municipal securities. The Institute does not recommend extending this proposed disclosure to corporate debt securities. We recognize that federal securities laws establish a detailed registration and periodic disclosure system for corporate debt securities that requires issuers to electronically file information with the SEC, which is then made publicly available to all persons for free and is provided to a variety of information vendors for further dissemination.

<sup>11</sup> The Release requests comment on whether the Commission should provide more guidance on the relationship between the proposed disclosure requirements regarding information about the underlying assets provided to, and used by, the NRSRO to perform ratings surveillance and the requirements of Regulation FD in the context of a public offering. We believe the Commission should clarify that Regulation FD should not impede any obligation of the issuer to disclose the information that would be required under the proposal (and in the Institute's recommendations).



party that would be required to disclose this information. The Institute recommends that the NRSRO be required to disclose the information,<sup>12</sup> because it would have the most ready access to the information and would be best able to oversee the uniform dissemination of the information. The NRSRO could post the information on its website to meet the proposed requirement that such information be disclosed through a means designed to provide reasonably broad dissemination.<sup>13</sup>

The proposal only requires disclosure of information that is used by the NRSRO in determining the initial credit rating or in undertaking credit rating surveillance. The Institute recommends that an NRSRO be required to disclose *all* information that it is provided to aid in its determination of an initial credit rating and to perform credit rating surveillance. If the amount of information to be disclosed is left to the discretion of an NRSRO, it is foreseeable that information provided to investors would vary depending on the rating agency. Specifically, each NRSRO uses its own particular model to determine a credit rating and makes its own determination as to which information should be incorporated into the model for that purpose. If adopted as proposed, each NRSRO may disclose to investors a different set of information.<sup>14</sup> The lack of uniformity in this disclosure likely would undermine the Commission's goal of allowing others to conduct independent analyses of the actual ratings provided.

The Release requests comment on whether the Commission should require the disclosure of information about the steps (and results of those steps), if any, that were taken by the NRSRO, issuer, underwriter, sponsor, depositor, or trustee to verify information about the assets underlying or referenced by the security or money market instrument, or, if no such steps were taken, a disclosure of that fact. The Institute supports such a requirement. Currently, a user of a rating cannot gauge the accuracy of the information being analyzed by the NRSRO and, thus, the NRSRO's ability to assess the creditworthiness of the debt product. NRSROs are not required to verify the information underlying a structured finance product or to compel issuers to perform due diligence or to obtain reports concerning the level of due diligence performed by issuers. Therefore, there is no assurance that the

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<sup>12</sup> The Institute believes that the NRSRO should not be held accountable for the accuracy of the information that it posted in compliance with this requirement, so long as it did not make changes to the information. It would act as a conduit from the initial provider of the information to the end-user – the investor. Recommendations concerning the quality of the provided information and the performance of due diligence reviews on that information are discussed below.

<sup>13</sup> As an alternative to the NRSROs disclosing the information, the Commission could create a depository for such information.

<sup>14</sup> Our recommendations are not intended to interfere with the Commission's stated intention to exclude personal information on individual borrowers or properties or the proposed timing and scope of disclosures as dependant on the nature of the offering.

information NRSROs receive or use to determine their ratings is accurate. We strongly support the Commission's proposal to require appropriate disclosures in this area.<sup>15</sup>

We also recommend that the Commission impose additional accountability on the issuers, underwriters, and sponsors of structured finance products by requiring that they take reasonable steps to ensure that information provided to NRSROs and investors is accurate and robust, and that these steps are disclosed to investors and NRSROs.<sup>16</sup> In addition, NRSROs should be required to have policies and procedures in place to reasonably assess the credibility of this information, and to disclose these policies and procedures to facilitate understanding of an NRSRO's actions in this area.<sup>17</sup>

#### 4. New Prohibitions

The proposed amendments would include three new prohibitions relating to the issuance of ratings due to conflicts of interest. Specifically, the proposal would prohibit: (1) an NRSRO from issuing a credit rating with respect to an obligor or security where the NRSRO, or a person associated with the NRSRO, made recommendations about the corporate or legal structure, assets, liabilities, or activities of the obligor or issuer of the security; (2) the participation of certain NRSRO personnel in fee discussions, specifically when a fee paid for a rating is discussed or arranged by a person within the NRSRO who has responsibility for participating in determining credit ratings or for developing or approving procedures or methodologies used for determining credit ratings; and (3) an NRSRO from issuing or maintaining a credit rating where a credit analyst who participated in determining or monitoring the credit rating, or a person responsible for approving the credit rating, received gifts from the obligor being rated, or from the issuer, underwriter, or sponsor of the securities being rated.

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<sup>15</sup> The Release requests comment whether, alternatively, the Commission only should require general disclosure of whether any steps were taken to verify the information and, if so, a description of those steps. The Institute believes that there would be only minimal value to such boilerplate disclosure.

<sup>16</sup> Similar requirements were recently agreed to by three rating agencies. In their agreement with the New York State Attorney General ("NYAG"), the rating agencies must require investment banks to provide due diligence data on loan pools for review prior to the issuance of ratings. The rating agencies also must disclose their due diligence criteria on their website. Further, they must require a series of representations and warranties from investment banks and other financially responsible parties about the loans underlying residential mortgage backed securities. See Office of the New York State Attorney General Andrew M. Cuomo, press release "Attorney General Cuomo Announces Landmark Reform Agreements with the Nation's Three Principal Credit Rating Agencies," June 5, 2008.

<sup>17</sup> This disclosure would be in addition to the proposed amendments enhancing disclosure on NRSRO methodologies used to rate structured finance products (discussed below).

The Institute supports the second and third new prohibitions. As the Release notes, the proposal would address concerns relating to, most significantly, the objectivity of an NRSRO and improper incentives for NRSRO personnel when issuing and maintaining ratings.<sup>18</sup>

The Release requests comment whether the proposed prohibition on the participation of certain NRSRO personnel in fee discussions should be extended to cover participation in fee negotiations by NRSRO personnel with supervisory authority over the NRSRO personnel participating in determining credit ratings or developing or approving procedures or methodologies used for determining credit ratings. The Institute believes the proposal should be extended in this manner. The potential for persons with supervisory authority to influence those involved in the ratings process is too great to ignore.

The Release also requests comment whether the three activities described above could be addressed through disclosure and procedures to manage the conflicts instead of prohibiting them. The Institute believes that the second and third activities should be prohibited. As the Release notes, it would be very difficult to effectively manage these conflicts. In addition, as illustrated in the recent SEC Staff Report, merely having procedures in place to address these conflicts is insufficient. The Institute believes the first activity – the prohibition on recommendations – would be better addressed through disclosure and procedures to manage this particular conflict. NRSROs often play a gatekeeping role in the development of a structured product. Thus, eliminating the interaction and information exchange between the NRSRO and the issuer, underwriter or sponsor could be counterproductive.

## **B. Recordkeeping Requirements**

The Commission is proposing to amend Rule 17g-2 to require NRSROs to make and retain certain additional records and to require that some of these proposed new records be made publicly available.

### **1. Material Deviations and Analyst Complaints**

The proposed amendments would require NRSROs to make and retain certain additional records including: (1) a record of the rationale for any material difference between the credit rating implied by a model and the final credit rating issued, if a quantitative model is a substantial component

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<sup>18</sup> A recent Commission Staff Report addressed several issues relating to certain of these conflicts of interest. For example, it found that analysts were aware, when rating an issuer, of the rating agency's business interest in securing the rating of the deal, despite each NRSRO having policies and procedures restricting analysts from participating in fee discussions with issuers. The Report also found that analytical managers at some NRSROs could and did engage in fee discussions, even directly with issuers. *See* Securities and Exchange Commission, "Summary Report of Issues Identified in the Commission Staff's Examination of Select Credit Rating Agencies," July 2008 ("SEC Staff Report").

in the process of determining the credit rating; and (2) a record of any complaints regarding the performance of a credit analyst in determining credit ratings. As proposed, neither of these records would be publicly disclosed. Instead, the Release states that the first set of records to be maintained would facilitate the review by Commission examiners (and any internal auditors of the NRSRO) of whether an NRSRO followed its disclosed and internally documented procedures for determining credit ratings. In the case of analyst complaints, the proposed record would be designed to allow the Commission to better assess whether analyst reassignments or terminations were for reasons unconnected to a conflict of interest (*e.g.*, the analyst's poor performance) or as a result of the "arranger-pay" conflict of interest.

The Institute believes that a more robust SEC oversight regime is necessary to ensure that an NRSRO complies with its stated practices and procedures for issuing ratings and addressing conflicts of interest. Accordingly, we support the proposed new recordkeeping requirements. By requiring a record of any material deviations from a stated model, the proposed record should assist the Commission in evaluating whether an NRSRO operates in a manner consistent with its policies and procedures.<sup>19</sup> The record of analyst complaints should assist in determining whether an NRSRO was impartial in its rating.

We believe, however, that the Commission should expand the scope of the proposal and require that both of these reports be publicly disclosed. Mandating public disclosure of these reports would increase the accountability of NRSROs for their ratings and facilitate the analysis by users of ratings of the integrity and compliance record of NRSROs.

## 2. Ratings Actions

The proposed amendments would require an NRSRO to make and retain a record showing all ratings actions (*i.e.*, initial rating, upgrades, downgrades, and placement on watch for upgrade or downgrade) and the date of such actions identified by the name of the security or obligor and, if applicable, the CUSIP for the rated security or the Central Index Key number for the rated obligor. The amendments would require that the record be made publicly available no later than six months after the date of the rating action on the NRSRO's corporate web site in an interactive data file that uses eXtensible Business Reporting Language ("XBRL") in electronic format ("Interactive Data File"). The Release states that the goal of the proposal, among other things, is to make NRSROs more accountable for their ratings by enhancing transparency of the results of their rating processes as well as to encourage competition within the industry by making it easier for users of credit ratings to judge the output of NRSROs.

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<sup>19</sup> The SEC Staff Report found that NRSROs did not always document significant steps in the ratings process, including the rationale for deviations from their models. *See* SEC Staff Report at 14.

Access to this information would be valuable to the evaluation of the accuracy of an NRSRO's performance in assessing creditworthiness. We therefore support the enhanced transparency surrounding this segment of the rating process, particularly when combined with the requirements for greater specificity about how credit ratings performance statistics must be generated (discussed below). Together, this information will aid investors in assessing the capability, accuracy and operations of an NRSRO.

We oppose, however, the provision that would allow a six-month delay before requiring disclosure of ratings actions. Such a lengthy delay would largely defeat the purpose of the proposal and make such information stale and ineffectual for users of ratings. Increased disclosure to investors must be timely in order to be meaningful and to allow an investor to evaluate an NRSRO's rating accuracy and to make investment decisions.

With respect to the proposed XBRL requirements, we note as a preliminary matter that this would necessitate the development of a taxonomy and presumably tools to enable users to view and sort the information. Based on the Institute's experience developing the taxonomy for the mutual fund risk/return summary, this is a time-consuming endeavor that could delay the implementation of the proposal and therefore the availability of the information. More importantly, we question whether this is the best format for providing the required information to a broad spectrum of potential users. Such users would need either the expertise to import XBRL data themselves or access to a commercial viewer that could render this information. And it is not clear that most commonly cited benefits of interactive data, such as the ability to extract and sort data, would be useful in this context. For these reasons, we urge the Commission to consider whether another data format might be appropriate. In addition, we believe the Commission should consider the inherent reduction in the potential utility of this information for investors due to the six-month delay provision when weighing the costs associated with developing and imposing an XBRL regime on ratings actions information.<sup>20</sup>

### **C. Form NRSRO**

The proposed amendments would require certain additional information to be submitted with Form NRSRO, the means by which credit rating agencies apply to the Commission to become NRSROs.

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<sup>20</sup> The proposed amendments also would amend Rule 17g-3 to require an NRSRO to furnish the Commission with an annual report of the number of credit rating actions (upgrades, downgrades, and placements on watch for an upgrade or downgrade) during the fiscal year in each class of security for which the NRSRO is registered. We believe the proposed amendment is redundant in light of the proposed amendments to Rule 17g-2 and would impose an unnecessary burden on the NRSROs.

## 1. Rating Performance Measurement Statistics

The proposed amendments would provide more detailed credit ratings performance statistics by requiring NRSROs to disclose separate sets of default and transition statistics for each asset class of credit rating for which an applicant is seeking registration as an NRSRO (or for which an NRSRO is registered) and any other broad class of credit ratings issued by the NRSRO. The proposed amendments would require that the class-by-class disclosures be broken out over 1, 3, and 10-year periods. In addition, the proposed amendments would specify that the required default statistics show defaults relative to the initial rating and incorporate defaults that occur after a credit rating is withdrawn.

The Institute supports the proposed amendments to enhance disclosure surrounding performance statistics. Access to information surrounding an NRSRO's rating decisions is significant to funds. Our members report that increased disclosure in this area is necessary and would facilitate the evaluation and comparison of the accuracy of ratings and an NRSRO's ability to assess the creditworthiness of debt.

We believe the proposed enhancements also would allow users of ratings to evaluate how the credit ratings of an NRSRO perform within a particular class of ratings generally and compared to other NRSROs. To ensure the full value of this performance data, we recommend that the Commission clarify that NRSROs disclose not only default rates but also, for example, the number of notches in a downgrade to allow users to better understand the reported information. It is critical that this type of information, *i.e.*, regarding the degree of accuracy of an NRSRO's ratings, be included in the performance statistics. We also recommend that the Commission require increased disclosure on Form NRSRO of policies and procedures articulating how and when NRSROs conduct downgrades, the potential severity of downgrades, ratings stability, staleness of ratings, and withdrawal of ratings. As noted above, such information would be extremely useful to investors in evaluating NRSROs and their ratings. Finally, we recommend that the Commission adopt standardized performance measurement statistics to facilitate the comparability of measurement statistics across all NRSROs.<sup>21</sup>

## 2. Ratings Methodologies

The proposed amendments would add three additional areas to the required disclosures about the procedures and methodologies an NRSRO uses to determine credit ratings. Specifically, an NRSRO would be required to disclose: (1) whether (and how) it considers in its ratings process for structured finance products information about verification performed on the assets underlying the

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<sup>21</sup> In our letter commenting on the Commission's proposed rules for oversight of NRSROs, the Institute urged the Commission to adopt standardized performance measurement statistics, noting that comparability would be particularly useful to investors as the number of NRSROs increases. *See supra* note 6.

structured finance product; (2) whether (and how) it considers in its ratings process for structured finance products qualitative assessments of the originator of assets underlying the structured finance product; and (3) the frequency of its surveillance efforts and how changes to its quantitative and qualitative ratings models are incorporated into the surveillance process.<sup>22</sup> The Release states that the amendments are designed to enhance the disclosures NRSROs make in these areas and, thereby, allow users of credit ratings to better evaluate the quality of their ratings processes.

We support the proposed amendments to increase transparency surrounding the methodologies used by NRSROs. We agree with the Commission's assessment that these disclosures should assist users of credit ratings in determining the potential accuracy of an NRSRO's credit ratings, including the ability of an NRSRO's model to predict the performance of the underlying assets in a structured finance product.<sup>23</sup>

We note, however, that the first two proposed disclosures are limited to structured finance products. As discussed above, we believe the proposed improvements to the disclosure and transparency surrounding credit ratings should not be confined to structured finance products. We therefore recommend that the Commission adopt, or support legislative proposals designed to provide, similar detailed disclosures for other types of debt instruments. While the purpose of the current proposal is to address concerns that have arisen relating to structured finance products, we believe the Commission's disclosure requirements should be sufficiently comprehensive and flexible to address concerns that may arise in the future relating to other debt instruments.

Investors would benefit greatly from increased disclosure and explanation of the methodologies used to evaluate the material risks involved with various types of financial instruments.<sup>24</sup> Such information should include information about the assumptions underlying a rating or the manner in which an NRSRO compensates for limited information in forming its opinion.<sup>25</sup>

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<sup>22</sup> These disclosures specifically would include: how frequently credit ratings are reviewed, whether different models or criteria are used for ratings surveillance than for determining initial ratings, whether changes made to models and criteria for determining initial ratings are applied retroactively to existing ratings, and whether changes made to models and criteria for performing ratings surveillance are incorporated into the surveillance process.

<sup>23</sup> We support the "loan originator review" requirement agreed to by the rating agencies in their agreement with the NYAG. *See supra* note 16. We believe the Commission should consider, as in the agreement, requiring all NRSROs to establish criteria for reviewing individual mortgage lenders and their origination processes, as well as requiring the NRSROs to disclose their originator evaluations on their websites. This information would allow investors to evaluate the quality, character, and credibility of the originator and, consequently, the quality of the information provided to the NRSRO by that individual.

<sup>24</sup> The SEC Staff Report found that NRSROs did not have specific policies and procedures to identify or address errors in their models or methodologies. *See* SEC Staff Report at 17.

<sup>25</sup> We also recommend that the Commission require increased disclosure on Form NRSRO regarding staffing issues such as personnel turnover; resource levels; experience levels with new products; and surveillance structures for the classes of rated

## V. Differentiating Credit Ratings for Structured Finance Products

The Commission is proposing a new rule, Rule 17g-7, that would require an NRSRO to publish a report describing how the credit ratings procedures and methodologies and credit risk characteristics for structured finance products differ from those of other types of rated instruments (such as corporate and municipal securities) each time an NRSRO publishes a credit rating for such products. As an alternative to publishing a report, an NRSRO would be required to use ratings symbols for structured finance products that differentiated them from the credit ratings for other types of debt securities.

As discussed above, the Institute supports the goal of increasing transparency in the ratings process for structured finance products and believes the report proposed by the Commission achieves this goal. We are concerned that the alternative to allow differentiating rating symbols for these products will have adverse consequences for the markets and market participants.<sup>26</sup> We therefore oppose this alternative.

Most significantly, we believe users of ratings will gain very little from a special identifier or symbol,<sup>27</sup> because such a device will not add to the quality, integrity or clarity of a structured finance product credit rating. In addition, it is questionable whether simply identifying a security as a structured finance product would achieve the Commission's goal of "spur[ring] investors to perform more rigorous internal risk analysis on structured finance products so that they do not overly rely on NRSRO credit ratings in making investment decisions." Rather, 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.

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securities. Such information would assist investors in evaluating the NRSROs' abilities to comply with their obligations under the Credit Rating Agency Reform Act of 2006 and their own policies and procedures. The importance of these disclosures is highlighted by the finding in the SEC Staff Report that a lack of resources negatively impacted NRSRO surveillance efforts. *See* SEC Staff Report at 21.

<sup>26</sup> Moody's recently sought comment from industry participants on a similar concept. The dominant reason provided by respondents for not supporting a modification of the existing structured finance scale was a concern that a different scale would hurt, rather than help, the structured finance market. This was followed by the related issue of the costs investors would incur to accommodate modifications to the existing scale, the loss of ratings comparability, and the belief that the change would be "merely cosmetic." Respondents noted how deeply embedded ratings are in their systems, processes, and investment guidelines. *See* Moody's Investors Service, Moody's Global Credit Policy, "Survey Results on Differentiating Structured Finance from Corporate Ratings" (May 2008) ("Moody's Request for Comment").

<sup>27</sup> Seventy-one percent of U.S. buy-side respondents in the Moody's Request for Comment opposed proposals that were comparable to the symbology alternative proposed by the Commission (*e.g.*, "add a modifier to all structured ratings utilizing the existing ratings scale ... thereby designating the issue as a structured financing"). Instead, they voiced a desire for more information on key components of structured finance risk, including the degree of certainty in the assumptions behind a structured finance rating and the sensitivity of a rating to losses in the underlying loan pools. *Id.*



The proposed modifier alternative also does not mandate the form of the identifier. This means that NRSROs could choose different methods and different symbols to indicate that a product is a structured finance product. It is not clear to us how this would improve transparency and clarity regarding structured finance products for investors, particularly if there could be numerous different modifiers or symbols representing these products.<sup>28</sup>

## **VI. Increase Municipal Securities Disclosure**

As discussed above, the Commission's proposals would increase disclosure and transparency surrounding credit ratings of structured finance products only. While we are supportive of these enhancements, we strongly urge the Commission to increase the disclosure to users of ratings for other types of instruments, particularly municipal securities.

Currently, 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. Because of these restrictions, the disclosure regime for municipal securities is woefully inadequate,<sup>29</sup> and the regulatory framework is insufficient for investors in today's complex marketplace.<sup>30</sup> 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.

While legislative action regarding the Tower Amendment will be necessary to fully develop an adequate disclosure regime for municipal securities, there are some steps that can be taken now, without legislative action, to improve disclosure within the current regulatory regime. For example, the notice of material events provision in Rule 15c2-12(b)(5)(i)(C) under the Securities Exchange Act of 1934 should be modified to more fully reflect the types of events that are material to today's investors.<sup>31</sup>

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<sup>28</sup> In the Release, the Commission has estimated that approximately thirty credit rating agencies would be registered as NRSROs.

<sup>29</sup> See, e.g., Letter to Martha M. Haines, Director, Office of Municipal Securities, U.S. Securities and Exchange Commission, from Amy B.R. Lancellotta, Senior Counsel, Investment Company Institute, November 12, 2001.

<sup>30</sup> 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).

<sup>31</sup> In contrast to the registration requirements for corporate securities, Rule 15c2-12 under the Securities Exchange Act of 1934 requires only limited disclosure and dissemination of information by underwriters in municipal securities offerings. Specifically, it sets forth certain obligations of (1) underwriters to receive, review and disseminate official statements

Since the rule was adopted, our members have identified additional events that can have a material adverse effect on their investments (*e.g.*, material litigation or regulatory action, pending or threatened, or failure to meet any financial covenants contained in the bond documents (especially the failure to make any monthly/quarterly payments due under the bond documents)).

Further, the Institute recommends that the Commission require that issuer financial information be provided more frequently to the public than is currently required under Rule 15c2-12. Information about municipal securities issuers is currently only required to be provided annually, in contrast to corporate issuers, which are subject to quarterly reporting requirements. The financial status of an issuer can change materially during the course of a year. Consequently, failure to make interim financial information available deprives investors of the opportunity to react in a timely manner to any such changes. Moreover, the rule does not provide any outside deadline for the disclosure of financial information, thus leaving the timing completely to the discretion of the issuer, which can occur anywhere from three months up to twelve months, or even longer, following the end of a fiscal year. As a result, investors are provided financial information that is often stale upon receipt.<sup>32</sup>

In order to improve the overall disclosure regime in this area, the Institute also recommends that Congress clarify the legal responsibilities of officials of municipal issuers for the disclosure documents that they authorize. In particular, Congress should spell out the responsibilities of underwriters with respect to the offering statements in municipal offerings and the legal responsibilities of bond counsel and other participants in offerings. Congress also should consider imposing certain disclosure requirements directly on municipal issuers.<sup>33</sup>

## **VII. Unified Ratings Scale**

Numerous regulatory, legislative and other proposals would have NRSROs adopt a single

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prepared by issuers of most primary offerings of municipal securities, (2) underwriters to obtain continuing disclosure agreements from issuers and other obligated persons to provide material event disclosures and annual financial information on a continuing basis, and (3) broker-dealers to have access to such continuing disclosure in order to make recommendations of municipal securities in the secondary market.

<sup>32</sup> We note that the Municipal Securities Rulemaking Board continues to develop a centralized, Internet-based system for free, real-time public access to all primary market, secondary market and trade price data for municipal securities submitted to it. This is a positive step towards increasing transparency of information about municipal securities within the current regulatory regime.

<sup>33</sup> We note that many of the weaknesses of the current system stem from the Commission's inability to impose requirements directly on municipal issuers due to restrictions related to the Tower Amendment.

Ms. Florence Harmon

July 25, 2008

Page 19 of 20

ratings scale for municipal and corporate debt securities.<sup>34</sup> If the ratings scales become unified, resolving the disclosure inadequacies in the municipal securities markets will be even more imperative. At this time, 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 (*e.g.*, their risk profiles, their disclosure regimes, and the methodologies employed in determining their ratings.)<sup>35</sup>

We also believe that a unified rating scale would align corporate and municipal ratings in name only. Despite a single scale, many market participants (*i.e.*, institutional investors) will continue to differentiate between issuers. A single scale may, however, create confusion for retail investors. It would result in the widespread upgrade of tax-exempt debt while simultaneously eliminating the distinctions between municipal issues. For these reasons, a single rating scale may create uncertainty in an already unsettled marketplace. Municipal default rates are currently low by corporate standards, and the municipal market, which is substantially larger, more heterogeneous, and more opaque than the corporate bond market, has to this point used its own scale to provide qualitative indicators to the market.

At the very least, if the Commission determines to propose rules that would, in effect, result in a single ratings scale for municipal and corporate ratings the disclosure requirements for both sets of issuers first must be similar for comparative purposes. Further, the Commission must ensure clarity regarding which ratings are to be used in the case of multiple scales and structured securities and/or municipal securities with underlying bond issuances.

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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

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<sup>34</sup> See *e.g.*, H.R. 6308, "Municipal Bond Fairness Act," 110<sup>th</sup> Congress, 2<sup>nd</sup> Session, introduced by Representative Barney Frank (D-MA) and Moody's Investment Services, "Moody's U.S. Public Finance, Announcement: Moody's Extends Comment Period on U.S. Public Finance Rating Scale," June 2008 (both discussing a single ratings scale).

<sup>35</sup> See National Federation of Municipal Analysts, *A Comment on the Current Market Dialogue Regarding Municipal Bond Ratings*, May 2008 (raising issues regarding the timing and merit of a single rating scale).

Ms. Florence Harmon

July 25, 2008

Page 20 of 20

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The Honorable Kathleen L. Casey  
The Honorable Elisse B. Walter

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