

1. Transparency, independence and oversight of financial gatekeepers

The Council of Institutional Investors supports financial gatekeepers that are transparent in their methodology, avoid or tightly manage conflicts of interest and have robust oversight.

Capital markets have come to rely on “financial gatekeepers,” institutions that help provide investors with the timely, accurate information they need to make informed investment decisions. Such gatekeepers include auditors, credit rating agencies and financial analysts.

In recent years, financial scandals on Wall Street and at operating companies from Enron to Tyco have cast a harsh light on flawed structures and practices of gatekeepers. In many instances, gatekeepers’ conflicts of interest, poor disclosure and minimal oversight helped mislead many market participants into investment decisions that produced huge losses. The resulting crisis of confidence in the markets spurred intense scrutiny by regulators and lawmakers. The “global settlement” with Wall Street firms and enactment of Sarbanes-Oxley Act reforms bolstered the accountability of analysts and auditors.

But credit rating agencies were largely untouched. The Credit Rating Agency Reform Act of 2006 eased entry for a few new competitors, but the industry remains overwhelmingly dominated by two players. It is likely that additional regulatory oversight will be needed.

So it is not surprising that once again, credit rating agencies are at the center of the current turmoil in global credit markets. Investors relied on the agencies’ initially high ratings of subprime mortgage bonds and complex structured products--only to see billions of dollars of value go up in smoke when it became clear that the agencies grossly underestimated the risks. And regulators are investigating whether credit rating agencies improperly inflated their ratings of mortgage backed securities to win more business from the companies that issued the debt.

Such conflicts of interest are inherent in nearly all of the agencies designated by the Securities and Exchange Commission as Nationally Recognized Statistical Rating Organizations because they are paid by the issuers of securities they rate. At the least, these conflicts must be minimized and managed with care.

Credit rating agencies have long maintained that their ratings are opinions only. But in practice, the agencies wield quasi-governmental power. Such clout carries a responsibility to ensure that ratings are arrived at fairly and are accurate.

The Council recognizes the steps that credit rating agencies are taking to enhance the clarity and understanding of their ratings. But investors remain wary about the soundness and independence of the ratings. The Council welcomes further examination of the industry by regulators, lawmakers, academics and others, to determine what changes, including new rules and stronger oversight, are needed.

(adopted May 16, 2008)