



Via Facsimile

October 22, 2009

The Honorable Barney Frank  
Chairman, House Committee on Financial  
Services  
United States House of Representatives  
2129 Rayburn House Office Building  
Washington, DC 20515

The Honorable Spencer Bachus  
Ranking Member, House Committee on  
Financial Services  
United States House of Representatives  
2129 Rayburn House Office Building  
Washington, DC 20515

The Honorable Paul E. Kanjorski  
Chairman, Subcommittee on Capital  
Markets, Insurance, and Government  
Sponsored Enterprises  
United States House of Representatives  
2129 Rayburn House Office Building  
Washington, DC 20515

The Honorable Scott Garrett  
Ranking Member, Subcommittee on  
Capital Markets, Insurance, and  
Government Sponsored Enterprises  
United States House of Representatives  
2129 Rayburn House Office Building  
Washington, DC 20515

Dear Chairman Frank, Subcommittee Chairman Kanjorski, Ranking Member Bachus and Subcommittee Ranking Member Garrett:

I am writing on behalf of the Council of Institutional Investors (“Council”), a nonprofit association of public, union and corporate pension funds with combined assets that exceed \$3 trillion. Member funds are major shareowners with a duty to protect the retirement assets of millions of American workers.

As a leading voice for long-term, patient capital, the Council welcomes the issuance of the discussion draft—the “Accountability and Transparency in Rating Agencies Act”—and look forward to the Committee’s planned mark-up of the bill next week. The underlying purpose of the discussion draft appears to be consistent with our view that the failure of the dominant credit rating agencies to alert investors to the risks of many structured products underscores the need for significant change in how those agencies are regulated.

The Council believes that any legislation reforming the credit rating agencies, specifically those registered as Nationally Recognized Statistical Rating Organizations (NRSROs), should advance the following basic goals:

- Securities and Exchange Commission (SEC) oversight authority over credit rating agencies should be enhanced;
- Internal controls and governance should be strengthened;
- Transparency and disclosures should be expanded;
- Standards of accountability should be raised; and
- Reliance on ratings should be reduced.

These basic goals stem from both the Council's general statement on financial gatekeepers<sup>1</sup> and the relevant recommendations of the Investors' Working Group (IWG) in its July 2009 report – *U.S. Financial Regulatory Reform: The Investors' Perspective* (IWG Report).<sup>2</sup> The IWG is an independent blue ribbon panel of industry and market experts created by the CFA Institute Centre for Financial Market Integrity and the Council to study and report on financial regulatory reform from the viewpoint of investors. The Council membership endorsed the findings and recommendations of the IWG Report at its meeting earlier this month.

We are pleased to provide our general support for the discussion draft given its adherence to our basic principles. We respectfully offer the following specific comments for your consideration as you move to mark-up this important legislation.

### **SEC oversight authority over credit rating agencies should be enhanced**

Despite the semi-official status of NRSROs as financial gatekeepers, the rating agencies have historically, in our view, faced minimal federal scrutiny. Although the Credit Rating Agency Reform Act of 2006 standardized the process for NRSRO registration and gave the SEC new oversight powers, those powers are far too limited.<sup>3</sup> Bolstering the SEC's authority to regulate NRSROs' practices, including disclosure regimes and management of conflicts of interest, is thus imperative to repairing the integrity of these financial gatekeepers.<sup>4</sup>

Specifically, the Council strongly supports the provisions of the discussion draft that direct the SEC to conduct periodic reviews of the policies, procedures and methodologies of each NRSRO to ensure that they have not only established and documented a system of internal controls, including due diligence for determining ratings, but also that each NRSRO adheres to and properly discloses the details of its system. Because simply reviewing the NRSROs' practices is not sufficient, however, it is imperative in order to ensure that ratings remain current and reliable that Congress reaffirm the SEC's ability to fine any NRSRO or associated person that has failed to sufficiently monitor ratings and sanction managers who fail to reasonably supervise employees.

In addition, the Council whole-heartedly supports the establishment of a new office within the SEC charged with coordinating NRSRO regulations for the protection of investors. In order to carry out its duties effectively, however, we urge the Committee to consider adding language to explicitly require that the office be staffed sufficiently. Finally, while the Council supports the

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<sup>1</sup> Council of Institutional Investors, Statement on Financial Gatekeepers (adopted May 16, 2008), <http://www.cii.org/UserFiles/file/council%20policies/Statement%20on%20Financial%20Gatekeepers%205-7-09.pdf>.

<sup>2</sup> Investors' Working Group, *U.S. Financial Reform: The Investors' Perspective* 21 (July 2009), [http://www.cii.org/UserFiles/file/resource%20center/investment%20issues/Investors'%20Working%20Group%20Report%20\(July%202009\).pdf](http://www.cii.org/UserFiles/file/resource%20center/investment%20issues/Investors'%20Working%20Group%20Report%20(July%202009).pdf) [hereinafter IWG Report].

<sup>3</sup> *Id.* at 19.

<sup>4</sup> *Id.* at 21 (“Congress and the Administration should bolster the SEC's position as a strong, independent overseer of NRSROs.”).

enumeration of specific areas of expanded oversight authority, we strongly encourage the Committee to consider adding language affirming the SEC's broad rulemaking authority.

### **Internal controls and governance should be strengthened**

Under current regulations, an NRSRO is required to designate a compliance officer responsible for administering the requisite policies and procedures and for ensuring compliance with the securities laws and rules and regulations. As evidence recently presented to Congress demonstrates, there is an immediate need to expand the authority and responsibilities of the compliance officer. Therefore, the Council strongly supports the provision of the discussion draft that expands and enumerates specific responsibilities of the compliance officer, specifically the requirements that the compliance officer establish procedures to ensure that ratings reflect all of the information that comes to the attention of and is believed by the NRSRO to be relevant, prepare and sign an annual compliance report for the SEC and meet specific independence standards.

As the Council advocated in its July 24, 2008 comment letter to the SEC<sup>5</sup> and consistent with the recommendations in the IWG Report,<sup>6</sup> the Council also supports the elevation of the compliance officer to the executive level. As written, the discussion draft requires that the officer report directly to the NRSRO's board of directors. The Committee may wish to consider including language to provide NRSROs with greater flexibility in this area, such as allowing the compliance officer to report to a committee of the board or equivalent thereof.

The New York Stock Exchange (NYSE) has adopted a similar level of flexibility in relation to the board's responsibility of risk oversight.<sup>7</sup> The NYSE requires that the audit committee of each listed company discuss policies with respect to risk assessment and management, but provides the option of delegating these responsibilities to another body, such as a risk committee, so long as the audit committee discusses the guidelines and policies to govern the process by which this is handled.<sup>8</sup> Considering the wide range of size and structures of the current ten NRSROs, this allowance may also be appropriate for NRSROs' lines of compliance reporting.

In addition to strengthening the position of the compliance officer, the discussion draft places new oversight responsibilities in the hands of the board. We have long maintained that independence is critical to a properly functioning board. Therefore, while we support these

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<sup>5</sup> Letter from Amy Borrus, Deputy Director, Council of Institutional Investors, to Florence E. Harmon, Acting Secretary, Securities and Exchange Commission 2 (July 24, 2008), [http://www.cii.org/UserFiles/file/comment%20letter%20SEC%20re%20CRA%20FINAL%20\(2\)%2007-24-08.pdf](http://www.cii.org/UserFiles/file/comment%20letter%20SEC%20re%20CRA%20FINAL%20(2)%2007-24-08.pdf).

<sup>6</sup> IWG Report, *supra* note 2, at 21 ("As an immediate step, NRSROs should be required to create and executive-level compliance officer position.")

<sup>7</sup> NYSE's Listed Company Manual, § 303A.07(c)(iii)(D) (July 2009) (Commentary), <http://nysemanual.nyse.com/LCMTTools/PlatformViewer.asp?selectednode=chp%5F1%5F4&manual=%2F1cm%2Fsections%2F1cm%2Dsections%2F>.

<sup>8</sup> *Id.*

provisions, we respectfully request that the Committee consider strengthening them by requiring that two-thirds of the board consist of independent directors.<sup>9</sup> We also encourage the Committee to narrow its definition of an independent director to meet or exceed the standards adopted by the Council.<sup>10</sup>

### **Transparency and disclosures should be expanded**

Establishing more robust systems of internal controls and governance practices must be followed up by holding NRSROs accountable for fully disclosing information related to potential conflicts of interest<sup>11</sup> and credit rating methodologies and procedures.<sup>12</sup> The Council and many other investors agree that the conflicted issuer-pays model of many NRSROs contributed to their poor track record.<sup>13</sup> Investors currently do not have access to the information that would allow them to appreciate and understand fully the potential conflicts of interest faced by NRSROs and how those conflicts may influence ratings. In the same vein, investors are not always provided with sufficient information to understand the scope or meaning of ratings or the methodologies used to derive them.

If armed with this vital information, investors could not only better judge the quality of the NRSRO's evaluation of a particular security, but also consider whether pressure from issuers or the agency's business considerations may have influenced a particular rating.<sup>14</sup> The Council therefore strongly supports the numerous provisions of the discussion draft that provide investors with information on conflicts of interest and rating procedures and methodologies, including information related to personal and business relationships, the type and number of credit ratings an NRSRO has issued to a particular issuer, the potential shortcomings of a rating, the reliability and quality of the information reviewed for a rating and whether a third-party due diligence service was used.

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<sup>9</sup> Council of Institutional Investors, Corporate Governance Policies, § 2.3 (updated May 1, 2009), <http://www.cii.org/UserFiles/file/council%20policies/CII%20Full%20Corp%20Gov%20Policies%205-7-09.pdf>.

<sup>10</sup> Council of Institutional investors, Corporate Governance Policies, § 7 (updated May 1, 2009), <http://www.cii.org/UserFiles/file/council%20policies/CII%20Full%20Corp%20Gov%20Policies%205-7-09.pdf>, ("Basic Definition of an Independent Director: An independent director is someone whose only nontrivial professional, familial or financial connection to the corporation, its chairman, CEO or any other executive officer is his or her directorship. Stated most simply, an independent director is a person whose directorship constitutes his or her only connection to the corporation.").

<sup>11</sup> IWG Report, *supra* note 2, at 21 ("More complete, prominent and consistent disclosures of conflicts of interest are also needed.").

<sup>12</sup> Letter from Laurel Leitner, Analyst, Council of Institutional Investors, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission 2-3 (March 25, 2009), <http://www.cii.org/UserFiles/file/resource%20center/correspondence/2009/03-25-09%20comment%20letter%20to%20SEC%20on%20NRSROs%20FINAL.pdf>.

<sup>13</sup> IWG Report *supra* note 2, at 20.

<sup>14</sup> Letter from Laurel Leitner, *supra* note 12, at 2-3.

### **Standards of accountability should be raised**

Providing the SEC with additional oversight authority and enhancing internal controls and disclosure requirements will not alone create an adequate system of checks and balances. NRSROs must be subject to a credible risk of liability for negligent, reckless or fraudulent behavior. While their inaccurate and unreasonable ratings played a central role in the current financial crisis, the NRSROs have generally escaped accountability for their shoddy performance and poorly managed conflicts of interest, at least in part, because of their statutory exemption from liability.<sup>15</sup>

The Council supports provisions of the discussion draft that firmly subject NRSROs to high standards of accountability for their actions and inactions by holding the agencies legally liable through private rights of action. We believe that those provisions will cause NRSROs to be more diligent about their ratings processes and management of conflicts of interest. We note that we would also support provisions that would eliminate the effective exemption from liability provided to credit rating agencies under Section 11 of the Securities Act of 1933 for ratings paid for by the issuer or offering participants.<sup>16</sup>

### **Reliance on ratings should be reduced**

NRSROs' role in the global credit crisis has called into question the reliance on ratings in laws and regulations. Statutes and rules that require certain investors to hold only securities with specific ratings encouraged some investors to rely too heavily on credit ratings. We agree that gradually eliminating official references to ratings while clarifying that reliance on ratings does not satisfy due diligence obligations is a necessary step for reform.<sup>17</sup>

The Council strongly supports the provisions of the discussion draft that require federal agencies to conduct reviews and report findings on their regulations, policies and practices that reference ratings in order to determine if another credit measure would be more appropriate. Those provisions would, in our view, properly force investors to seek additional and alternative assessments of credit risk.<sup>18</sup>

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As indicated, the Council and many other investors agree that credit rating agencies failure to alert investors to the risks of many structured products underscores the need for significant change in their regulation. The discussion draft offers an important set of reforms to produce such needed change.

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<sup>15</sup> IWG Report *supra* note 2, at 20.

<sup>16</sup> *Id.* at 21.

<sup>17</sup> *Id.* ("Reliance on NRSRO ratings should be greatly reduced by statutory and regulatory amendments.").

<sup>18</sup> *Id.*

October 22, 2009  
Page 6 of 6

We again very much appreciate your leadership in pursuing this legislation and offer our general support for its prompt passage. If you have any questions, please feel free to contact me at (202) 261-7081 or [jeff@cii.org](mailto:jeff@cii.org), or Council Senior Analyst Laurel Leitner at (202) 261-7086 or [laurel@cii.org](mailto:laurel@cii.org).

Sincerely,

A handwritten signature in cursive script that reads "Jeff Mahoney". The signature is written in black ink and is positioned to the left of the typed name and title.

Jeff Mahoney  
General Counsel  
Council of Institutional Investors