



Via Facsimile

May 12, 2010

The Honorable Harry Reid
Majority Leader
United States Senate
S-221 The Capitol
Washington, DC 20510-7020

The Honorable Mitchell McConnell
Minority Leader
United States Senate
S-230 The Capitol
Washington, DC 20510-7010

The Honorable Christopher J. Dodd
Chairman
Committee on Banking, Housing,
and Urban Affairs
United States Senate
534 Dirksen Senate Office Building
Washington, DC 20510-6075

The Honorable Richard C. Shelby
Ranking Member
Committee on Banking, Housing,
and Urban Affairs
United States Senate
534 Dirksen Senate Office Building
Washington, DC 20510-6075

Dear Senators Reid, McConnell, Dodd and Shelby:

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 advancement of the *Restoring American Financial Stability Act of 2010* (S. 3217).¹ In particular, the Council is encouraged that the legislation includes provisions designed to enhance the oversight and accountability of credit rating agencies registered as Nationally Recognized Statistical Rating Organizations (NRSROs).

The Council believes that in order to be effective, any legislation reforming the credit ratings industry must advance the following basic goals:

- Enhance the Securities and Exchange Commission (SEC) authority to oversee credit rating agencies;
- Strengthen internal controls and governance;
- Expand transparency and disclosures;
- Raise standards of accountability; and
- Reduce reliance on ratings.

These goals stem from both the Council's general statement on financial gatekeepers² and the relevant recommendations of the Investors' Working Group in its July 2009 report, U.S. Financial Regulatory Reform: The Investors' Perspective.³

¹ Restoring American Financial Stability Act of 2010, S. 3217, 111th Cong.
http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:s3217pcs.txt.pdf.

² Council of Institutional Investors, Statement on Financial Gatekeepers (adopted May 16, 2008),
<http://www.cii.org/UserFiles/file/Statement%20on%20Financial%20Gatekeepers.pdf>.

The current legislation aligns closely with these principles. However, we believe that the provisions relating to accountability must be strengthened further. Effective legislation must eliminate NRSROs' unparalleled exemption from liability under Section 11 of the Securities Act of 1933. It has recently come to our attention that Senator Sherrod Brown intends to offer the following amendment which would do just that:

SEC. 939D. EFFECT OF RULE 436(G).

Section 220.436(g) of title 17, Code of Federal Regulations, commonly referred to as "Rule 436(g) under the Securities Act of 1933", shall have no force or effect.

The Council strongly supports this amendment. Rule 436(g) shields from Section 11 liability only those few rating agencies designated as NRSROs. NRSROs cannot be held liable as experts for making untrue or misleading statements when their ratings are included in registration statements. It is imperative that NRSROs face Section 11 liability. As financial gatekeepers, their actions have a significant impact on the health and well-being of the financial markets, both at home and abroad. As experts, they have the ability to analyze and verify mountains of information for investors who do not have the capabilities to do so for themselves. As NRSROs, they are also exempt from Regulation FD and therefore have access to material non-public information. And as financial products have become more complex and opaque, NRSROs, with their expertise and access to material non-public information, have become even more important to the functioning of the market.

Over the last century, NRSRO ratings have become ingrained in the financial system. Their ratings are referenced in countless federal and state laws and regulations, some of which dictate the number and types of securities that many institutional investors, including pension funds, may buy or sell. Thus, their expert opinions influence the ability of issuers to raise capital. NRSROs are market movers. They wield more power than ever before, yet they maintain an inappropriate and unwarranted shield from accountability.

With great power comes great responsibility—a conviction some NRSROs apparently do not embrace. With their quasi-governmental power, minimal accountability and minimal competition, it is not surprising that rating agencies were at the heart of the global financial crisis. NRSROs have proven that they are incapable of managing their conflicts of interest or internal controls. For example, at a recent hearing of the Senate Permanent Subcommittee on Investigations, evidence was presented that illustrated the degree to which both Moody's and S&P fostered a culture among their rating analysts that allowed business considerations to trump the integrity of the ratings process.⁴ Wildly inflated ratings of structured financial products helped to fuel the financial meltdown, yet those responsible face little accountability.

NRSROs often argue that their ratings are merely opinions and thus subject to protection under the First Amendment. At the same time, however, NRSROs present themselves to issuers, investors, lawmakers and regulators as experts at analyzing credit risk. NRSROs function similarly to other professional sources that provide legal opinions, audit reports and other expert opinions on which investors rely. These other professionals, whose ranks include non-NRSRO credit rating agencies, do not enjoy the same immunity from liability for making false or misleading statements in registration statements. The immunity afforded to NRSROs paved the way to the central role they

³ Investors' Working Group, U.S. Financial Reform: The Investors' Perspective (July 2009), at 21, [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).

⁴ Opening Statement of Senator Carl Levin, before U.S. Senate Subcommittee on Investigations, April 23, 2010, at 5.

played in the financial crisis and protected them from direct accountability for their faulty handiwork. Their continued protection is no longer warranted. Simply put, NRSROs are experts and should be held to the same high standards as other experts in similar roles.

Furthermore, the reasoning behind the SEC's initial decision to grant NRSROs an exemption from Section 11 liability no longer holds. Since Rule 436(g) was first adopted in 1981, the credit ratings industry has grown exponentially in volume of ratings issued and the number, types and complexities of securities rated. The SEC's primary goal in adopting the rule was to provide a means to encourage disclosure and use of credit ratings within the market. Without the exemption, the SEC believed that issuers would not voluntarily disclose ratings in their registration statements, as NRSROs would not provide consent. The SEC further reasoned that existing NRSRO liability under both Section 10(b) of the Securities and Exchange Act of 1934 and the Investment Advisers Act of 1940 would provide sufficient protection to investors. NRSROs, however, are rarely held liable under Section 10(b) and are no longer required to register under the Investment Advisers Act. As noted above, the ratings industry has grown; competition within the industry remains low. The use of ratings has increased while the quality of ratings has sunk. These conditions combined with improvements in technology have resulted in the rapid, free-flow of information, and thus a market saturated in often questionable ratings. Exposing NRSROs to liability under Section 11 goes in tandem with reversing the reliance on ratings that has built up in the nearly 30 years that the rule has been in place. In the eyes of investors, regulators and the market at large, rescinding the exemption would remove NRSROs from the pedestal they have come to occupy.

The Credit Rating Agency Reform Act of 2006 laid the foundation for effective, meaningful regulation of the credit ratings industry. The Council applauds the commitment of Congressional leaders and regulators to bolster transparency, oversight and independence further. S. 3217 will surely mark a new chapter for NRSROs—one of integrity. Nevertheless, as written, the legislation will simply not go far enough to instill a sense of accountability within the industry. The market must be able to hold NRSROs accountable for false or misleading statements made in registration statements. Under the status quo, market participants have little recourse for harm done by these powerful gatekeepers. More oversight is not sufficient. With the passage of S. 3217, NRSROs will be more answerable to regulators, and investors will rely less on ratings. Without Senator Brown's amendment, however, the protective barrier guarding NRSROs from the same liability standards other experts must meet will continue to impede the significant progress Congress has made.

Thank you for consideration of the views of investors and for your leadership on financial regulatory reform. We look forward to continuing to work with you to strengthen regulation of the credit ratings industry and the entire U.S. financial system. If you have any questions, please feel free to contact me at (202) 261-7081 or jeff@cii.org, or Council Senior Analyst Laurel Leitner at (202) 261-7086 or laurel@cii.org.

Sincerely,



Jeff Mahoney
General Counsel
Council of Institutional Investors

cc: Members of the United States Senate (via email)