Council of Institutional Investors
The Voice of Corporate Governance

Via Email

December 14, 2009

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Concept Release on Possible Rescission of Rule 436(g) Under the Securities Act
(File Number: S7-25-09)

Dear Ms. Murphy:

I am writing on behalf of the Council of Institutional Investors, a nonprofit association of corporate, public and union 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 applauds the Securities and Exchange Commission's (SEC) continuing efforts to bolster the regulatory framework around Nationally Recognized Statistical Rating Organizations (NRSROs) and welcomes the opportunity to comment on the concept release referenced above.

The birth of the SEC's NRSRO designation in the 1970s transformed credit rating agencies from suppliers of information to financial gatekeepers. By registering as NRSROs and accepting the associated quasi-governmental power, credit rating agencies have a responsibility to ensure that their ratings are arrived at fairly and are accurate. However, 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. Rule 436(g) shields only those few rating agencies designated as NRSROs from liability as experts for making untrue or misleading statements when their ratings are included in registration statements.

The Council believes that effective reform of the credit ratings industry hinges on the following steps:

- Enhanced SEC oversight
- Reduced reliance on ratings by all market participants
- Strengthened internal controls of NRSROs
- Expanded transparency of credit ratings
- Heightened standards of accountability for NRSROs

These recommendations stem from both the Council's general statement on financial gatekeepers[1] and the relevant proposals of the Investors' Working Group (IWG) in its July 2009 report, *U.S.*

[1] 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.

Financial Regulatory Reform: The Investors' Perspective, which the Council has endorsed.[2] Consistent with those policies, the Council believes that NRSROs should no longer be exempt from liability under Rule 436(g).

Liability standards for NRSROs have changed since the adoption of Rule 436(g)

As the SEC acknowledged in its concept release, when Rule 436(g) was first adopted, the Commission believed that existing NRSRO liability under both Section 10(b) of the Securities and Exchange Act of 1934 and the Investment Advisers Act was sufficient to protect investors. NRSROs, however, are no longer required to register under the Investment Advisers Act and are rarely held liable under Section 10(b). Originally, the SEC expected that, because of 10(b) antifraud liability, NRSROs would be required "to adhere to the highest professional standards in determining security ratings."[3] But the evidence presented in several recent investigations and Congressional hearings suggested that the largest NRSROs have failed to adhere to those standards.

Consequently, the Council believes that eliminating the exemption from liability afforded to NRSROs under Section 11 would provide an incentive for those select rating agencies to be more diligent in their ratings processes, which in turn, would better protect investors.

NRSRO ratings have come to function as expert opinions

The dominant rating agencies argue that because their ratings are expressions of opinion about risk, not statements of fact, Section 11 liability would violate the NRSROs' First Amendment rights. Ratings issued by NRSROs, however, have widely come to be accepted as expert opinions. We concur with the SEC's view that "NRSROs represent themselves to registrants and investors as experts at analyzing credit risk" and investors rely on that information as a key factor in their investment decisions.[4] NRSROs function similarly to other professional sources that provide opinions upon which investors rely, such as legal opinions, audit reports and non-NRSRO credit ratings. Those expert opinions are subject to the Securities Act's provisions for experts, and so too should NRSRO credit ratings.

Market participants prepare for and adapt to changes in regulation

Some NRSROs warn that imposing Section 11 liability standards would force them to refuse to allow issuers to disclose security ratings in prospectuses and result in considerable market disruption. Throughout history, however, the markets have adapted to changes in regulation. Moreover, it would be painful for one of the dominant players in the ratings industry to voluntarily give up its large

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[2] 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 [hereinafter IWG Report]. 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.

[3] Securities and Exchange Commission, Disclosure of Ratings in Registration Statements, Release No. 33-6336 (Aug. 6, 1981) [46 FR 42024].

[4] Securities and Exchange Commission, Concept Release on Possible Rescission of Rule 436(g) Under the Securities Act of 1933, Release No. 33-9071 (Oct. 7, 2009) [74 FR 53114].

and lucrative market share in order to escape liability. As SEC Commissioner Kathleen Casey stated during the Commission's open meeting on September 17, 2009, "other firms are waiting in the wings, including some with deeper pockets who are presumably poised to more readily compete with established market leaders."[5]

References to credit ratings, specifically NRSRO ratings, appear to a varying degree in the investment guidelines or investment manager agreements of many institutional investors, including those of many Council members. The SEC specifically requested comments on how such investors would be affected if NRSROs refused to provide consent or ceased issuing ratings altogether. After consulting some members, the Council is convinced that if Section 11 liability were phased in with advance notice, institutional investors would have time to prepare and adapt. Already, in response to the NRSROs' failure to alert investors to the risks of many structured products, some Council member funds have taken steps to reduce their reliance on ratings, such as conducting extensive reviews of investment guidelines and agreements and seeking additional and alternative assessments of credit risk.

The Council generally has supported steps the SEC has taken to address rating agency conflicts of interest and to require greater disclosure of NRSROs. Rescinding Rule 436(g) will further empower investors to make more informed investment decisions while lessening over-reliance on rating agencies.

We appreciate the opportunity to comment on this concept release. The Council encourages the Commission to continue its work to improve the transparency, independence and accountability of credit ratings and competition within the ratings industry. Please feel free to contact me with any questions at (202) 261-7086 or laurel@cii.org.

Respectfully,

Laurel Leitner
Senior Analyst
Council of Institutional Investors

[5] SEC Commissioner Kathleen L. Casey, Statement at SEC Open Meeting – NRSROs, Securities and Exchange Commission, Washington, D.C. (Sept. 17, 2009), http://www.sec.gov/news/speech/2009/spch091709klc.htm.