CFA INSTITUTE | Centre for Financial Market Integrity

Council of Institutional Investors
The Voice of Corporate Governance

Via Facsimile

October 21, 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
B371a 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
B371a Rayburn House Office Building
Washington, DC 20515

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

As the Committee prepares for its mark-up of the Accountability and Transparency in Rating Agencies Act, we write to highlight the relevant findings and recommendations made by the Investors' Working Group (IWG).

A blue ribbon panel of industry and market experts created by the CFA Institute Centre for Financial Market Integrity and the Council of Institutional Investors to study and report on financial regulatory reform from the viewpoint of investors, the IWG carefully considered the need to improve the regulation of credit rating agencies. That consideration resulted in a number of findings and specific recommendations included in its July 2009 report – *U.S. Financial Regulatory Reform: The Investors' Perspective* (IWG Report).

A summary of the IWG findings about credit rating agencies include:

- The failure of Nationally Recognized Statistical Rating Organizations (NRSROs) to alert investors to the risks of many structured products underscores the need for significant change in the regulation of credit rating agencies.
- Credit ratings issued by NRSROs are widely embedded in federal and state laws, regulations and private contracts.

- Despite the semi-official status of NRSROs as financial gatekeepers, the rating agencies face minimal federal scrutiny.
- The central role that rating agencies played in the financial crisis makes such limited oversight untenable.
- The conflicted issuer-pays model of many NRSROs contributed to their poor track record.
- Credit rating agencies' statutory exemption from liability keeps NRSROs from having to answer for their shoddy performance and poorly managed conflicts of interest.
- Some investors relied too heavily on NRSRO ratings, ignoring warning signs such as the rating agencies' notorious failure to downgrade ratings on Enron and other troubled companies until they were on the brink of bankruptcy.
- Some investors ignored or failed to comprehend the fundamental differences between ratings on structured securities and ratings on traditional debt instruments.
- Statutory and regulatory reliance on ratings encourages investors to put more faith in the rating agencies than they should.
- It is not practical to abolish the concept of NRSROs and erase references to NRSRO ratings in laws and regulations, at least not in one stroke.

The above findings led the IWG to propose the following specific recommendations about credit rating agencies:

1. Congress and the Administration should consider ways to encourage alternatives to the predominant issuer-pays NRSRO business model. In addition, the fees earned by the NRSROs should vest over a period of time equal to the average duration of the bonds. Fees should vest based on the performance of the original ratings and changes to those ratings over time relative to the credit performance of the bonds. Credit rating agencies that continue to operate under the issuer-pays model should be subject to the strictest regulation.

2. Congress and the Administration should bolster the SEC's position as a strong, independent overseer of NRSROs. The SEC's authority to regulate rating agency practices, disclosures and conflicts of interest should be expanded and strengthened. The SEC should also be empowered to coordinate the reduction of reliance on ratings.

3. NRSROs should be required to manage and disclose conflicts of interest. As an immediate step, NRSROs should be required to create an executive-level compliance officer position. More complete, prominent and consistent disclosures of conflicts of interest are also needed. And credit raters should disclose the name of any client that generates more than 10 percent of the firm's revenues.

4. NRSROs should be held to a higher standard of accountability. Congress should 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. This change would make rating agencies more diligent about the ratings process and, ultimately, more accountable for sloppy performance.

NRSROs should not rate products for which they lack sufficient information and expertise to assess. Credit rating agencies should only rate instruments for which they have adequate information and should be legally vulnerable if they do otherwise. This would effectively limit their ability to offer ratings for certain products. For example, rating agencies should be restricted from rating any product that has a structure dependent on market pricing. They should not be permitted to rate any product where they cannot disclose the specifics of the underlying assets. Credit rating agencies should be restricted from taking the metrics and methodology for one class of investment to rate another class without compelling evidence of comparability.

5. Reliance on NRSRO ratings should be greatly reduced by statutory and regulatory amendments. Market participants should reduce their dependence on ratings in making investment decisions. Many statutes and rules that require certain investors to hold only securities with specific ratings encouraged some investors to rely too heavily on credit ratings. Eliminating these safe harbors over time, or clarifying that reliance on the rating does not satisfy due diligence obligations, would force investors to seek additional and alternative assessments of credit risk.

More details regarding the background and basis for the IWG's findings and recommendations about credit rating agencies can be found on pages 19-21 of the IWG Report. The complete IWG Report is available in electronic form at http://www.cii.org/UserFiles/file/resource%20center/investment%20issues/Investors'%20Working%20Group%20Report%20(July%202009).pdf.

Thank you for your leadership in connection with this very critical area of regulatory reform. As always, we would welcome the opportunity to have a member of the IWG discuss these issues with you or your staff at your convenience. Please feel to contact Jeff Mahoney at 202.261.7081 or jeff@cii.org to arrange for such a meeting or if you should have any questions or comments regarding this letter.

Sincerely,

Kurt Schacht, CFA
Managing Director, CFA Institute Centre for Financial Market Integrity
Co-Sponsor, Investors' Working Group

Joe Dear
Chair, Council of Institutional Investors
Co-Sponsor, Investors' Working Group