Council of Institutional Investors
The Voice of Corporate Governance

Via Email

September 13, 2011

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

Re: Solicitation of Comment to Assist in Study on Assigned Credit Ratings, File No. 4–629[1]

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.[2] 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, we welcome the opportunity to respond to the Securities and Exchange Commission's (SEC or Commission) request for comment regarding its study on assigned credit ratings and alternative means for compensating Nationally Recognized Statistical Rating Organizations (NRSROs) to create incentives for accurate credit ratings. Our comments are based on both the Council's general statement on financial gatekeepers[3] and the relevant recommendations of the Investors' Working Group (IWG) in its July 2009 report, U.S. Financial Regulatory Reform: The Investors' Perspective.[4]

While the Council has not publicly endorsed a specific business model or system of assigning NRSROs to rate securities, we believe that in order to establish appropriate incentives for NRSROs to issue accurate credit ratings, the following characteristics must be present within any such model or system:

Robust Management and Transparency of Conflicts of Interests

NRSROs should be required to avoid or tightly manage conflicts of interest.[5] The Council has consistently supported SEC efforts to reign in the conflicts of interest rampant in the ratings industry, whether by complete prohibition or strict regulation of certain activities. For example, the Council supported the SEC's recent proposal prohibiting sales and market considerations

[1] Solicitation of Comment to Assist in Study on Assigned Credit Ratings, 76 Fed. Reg. 28,265 (May 16, 2011), http://www.gpo.gov/fdsys/pkg/FR-2011-05-16/pdf/2011-11877.pdf.
[2] For more information about the Council of Institutional Investors (Council) and its members, please visit the Council's website at http://www.cii.org.
[3] Council of Institutional Investors, Statement on Financial Gatekeepers (updated Apr. 13, 2010), http://www.cii.org/UserFiles/file/Statement%20on%20Financial%20Gatekeepers.pdf.
[4] Investors' Working Group, U.S. Financial Regulatory Reform: The Investors' Perspective (July 2009), http://www.cii.org/UserFiles/file/resource%20center/investment%20issues/Investors'%20Working%20Group%20Report%20(July%202009).pdf. Following its issuance, the Investors' Working Group (IWG) Report was reviewed and subsequently endorsed by the Council board and membership. For more information about the IWG, please visit the Council's website at http://www.cii.org/iwgInfo.
[5] Statement on Financial Gatekeepers at 1.

from influencing the production of ratings and rating methodologies.[6] In addition to avoiding or tightly managing conflicts of interest, NRSROs should be required to provide more complete, prominent and consistent disclosure of conflicts.[7] As discussed in the Council's most recent letter to the Commission regarding NRSROs, we believe users of credit ratings would benefit greatly from robust disclosure relating to the conflicts of interest individual rating agencies face, as well as how the agencies manage those conflicts.[8] Through regulatory oversight and public disclosure, investors would be given the means to develop their own assessment of the independence of an NRSRO's ratings.

Transparency of Methodologies

In addition to unchecked conflicts of interest, flawed methodologies and inadequate, inaccurate data were among the core reasons some NRSROs continued to issue inflated ratings on structured finance products during the financial crisis.[9] The Council believes that increased transparency requirements concerning rating methodologies and the processes, procedures and inputs used to arrive at individual ratings would result in more accurate ratings. Increased transparency would provide NRSROs with a disincentive for knowingly issuing ratings based on inaccurate models using insufficient, outdated data.[10] In addition, requiring greater transparency would allow investors the opportunity to analyze the assumptions and methodologies an NRSRO used to develop a particular rating, and evaluate whether the rating may be based on inadequate data or influenced by conflicts of interest.

Comparability of Track Records

To promote the production of accurate credit ratings, NRSROs should compete based on their ratings track record. Although NRSROs are currently required to disclose their credit rating performance statistics over several set time intervals, the rating agencies use a variety of methodologies to calculate those statistics, thus limiting their comparability.[11] Encouraging NRSROs to compete based on accuracy requires a standard method for calculating performance measurement statistics. Moreover, to allow users of credit ratings to evaluate and rank the integrity and accuracy of individual NRSROs, performance measurement statistics should be presented in an easily understandable and accessible format, preferably in a central data repository.[12]

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[6] Letter from Laurel Leitner, Senior Analyst, Council of Institutional Investors, to Elizabeth M. Murphy, Secretary, U.S. Securities and Exchange Commission 2 (Aug. 8, 2011), http://www.cii.org/UserFiles/file/resource%20center/correspondence/2011/08-08-11%20-%20Council%20letter%20to%20SEC%20on%20NRSROs.pdf.

[7] IWG at 21.

[8] Letter from Laurel Leitner at 2.

[9] *See*, *e.g.*, Staff of S. Permanent Subcomm. on Investigations, 112th Cong, Rep. on Wall Street and The Financial Crisis: Anatomy of a Financial Collapse 244 (Apr. 13, 2011), http://hsgac.senate.gov/public/_files/Financial_Crisis/FinancialCrisisReport.pdf.

[10] *See, e.g., Id.* at 289.

[11] U.S. Gov't Accountability Office, GAO-10-782, Securities and Exchange Commission: Action Needed to Improve Rating Agency Registration Program and Performance-Related Disclosures 24 (2010), http://www.gao.gov/new.items/d10782.pdf.

[12] *See*, *e.g.*, Letter from Amy Borrus, Deputy Director, Council of Institutional Investors, to Florence E. Harmon, Acting Secretary, U.S. Securities and Exchange Commission 2 (July 24, 2008), http://www.sec.gov/comments/s7-13-08/s71308-21.pdf.

Time and Performance Based Compensation

The Council has encouraged Congress, the Administration and regulators to consider ways to promote alternatives to the predominant issuer-pays NRSRO business model.[13] As stated above, we have not taken a public position supporting a specific compensation model. Consistent, however, with the recommendations of the IWG report, the Council supports a compensation system in which fees earned by NRSROs are required to vest: 1) over a period of time equal to the average duration of the bonds, and 2) based on the performance of the original ratings and changes to those ratings over time relative to the credit performance of the bonds.[14] We believe that such time and performance-based compensation requirements could motivate NRSROs to strive for greater accuracy.[15]

Genuine Accountability

Without genuine accountability, an environment in which the above-mentioned characteristics were all present would likely not be sufficient to incentivize NRSROs to issue accurate ratings. Although their inflated ratings played a central role in the recent financial crisis, NRSROs have generally escaped accountability for their shoddy performance and poorly managed conflicts of interest. Therefore, the Council strongly believes that NRSROs should be held to a higher standard of accountability for their actions and inactions.[16] A credible threat of fines, sanctions and legal liability for failing to adhere to federal securities laws and related rules and regulations would provide a strong incentive for credit rating agencies to be more vigilant in guarding against negligent, reckless and fraudulent practices. Genuine accountability would encourage NRSROs to properly manage their conflicts of interest and maintain the utmost transparency in their business dealings and ratings practices, thus leading to the production of ratings with integrity.

Thank you for the opportunity to share our views with you. If you should have any additional questions or comments, please feel free to contact me at 202.261.7086 or laurel@cii.org, or General Counsel Jeff Mahoney at 202.261.7081 or jeff@cii.org.

Sincerely,

Laurel Leitner

Laurel Leitner
Senior Analyst
Council of Institutional Investors

[13] IWG at 21.
[14] *Id.*
[15] Frank Partnoy, Rethinking Regulation of Credit Rating Agencies: An Institutional Investor Perspective, 10 (Apr. 2009), http://www.cii.org/UserFiles/file/resource%20center/publications/CII%20White%20Paper%20-%20Rethinking%20Regulation%20of%20CRAs%20April%202009.pdf.
[16] IWG at 21.