Stephen A. Keen

[redacted]

December 15, 2009

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

**File Number S7-19-08**

Dear Ms. Murphy:

I am writing to comment on proposals by the Securities and Exchange Commission (the "Commission") to excise all references to credit ratings issued by nationally recognized statistical rating organizations ("NRSROs") from its regulations. Although my comments apply to the regulatory use of NRSRO ratings generally, I will limit my discussion to the regulations promulgated under in Investment Company Act of 1940 (as amended, the "ICA"), with which I am most familiar. My familiarity is the result of nearly twenty years experience interpreting investment company regulations, particularly those applicable to money market mutual funds ("MMFs").[1] I believe that investment company regulations provide examples of how NRSRO ratings can be practically indispensible for effective regulation, as well as examples of ill-advised uses of NRSRO ratings in regulations.

## 1. Referring to NRSRO Ratings in Regulations Did Not Cause Undue Reliance

Before discussing the appropriate use of NRSRO ratings in regulations, I would first like to comment that I have yet to observe either of the "clear disadvantages" of using NRSRO ratings cited in the original release. First, I have never heard an investment professional suggest that "the use of [NRSRO ratings] in laws and regulations [is] an endorsement of the quality of the credit ratings issued by NRSROs." Investment Company Act Release No. 28327, 53 Fed. Reg. 40124, 40125 (July 11, 2008). I have been in many meetings in which the quality of credit ratings was debated and the extent to which ratings should be relied upon discussed. Never during these meetings did anyone cite an NRSRO designation or the Commission's reliance on NRSRO ratings as a relevant factor. The investment professionals I deal with understand the nature and limitations of credit ratings better than the Commission and its staff, and therefore have no need to rely on the Commission's designation of a rating agency as an NRSRO in forming their own judgment about the quality of its ratings.

The Commission also expressed concern that "by referencing ratings in the Commission's rules, market participants operating pursuant to these rules may be vulnerable to failures in the ratings process." *Id*. This may be a logical concern where a regulation *requires* a market participant to obtain a rating. When the Commission uses ratings "to provide a clear reference point to both regulators and market participants," however, the extent of reliance on an NRSRO's rating remains the choice of the market participants rather than the Commission. More significantly, investment professionals will con-

[1] These comments express my personal views, and should not be attributed to my firm or to my current or former clients. I have never represented or otherwise received compensation from any NRSRO.

tinue to rely on credit ratings to the same extent regardless of whether the Commission chooses to refer to NRSRO ratings in its regulations. I have sometimes been asked whether a client can use the same NRSROs for regulatory purposes as it already uses for other purposes; I have yet to be asked if an NRSRO's ratings should be relied upon simply because the ratings must be tracked for regulatory purposes.

Of course, the Commission must consider the effects of its regulations on the general investing public, not just professional advisers, dealers and brokers. Most of the regulations that refer to NRSRO ratings, however, only apply to such investment professionals. I doubt that many non-professional investors are aware that the Commission incorporates NRSRO ratings into its regulations, and fewer still base their assessment of credit ratings on this fact. In my experience, public understanding of credit ratings is based primarily on reports in the financial press, which will continue to report on credit ratings regardless of whether the Commission refers to NRSROs in its regulations. Therefore, I remain skeptical that continued use of NRSRO ratings in regulations will have the disadvantages envisioned by the Commission.

## 2. NRSRO Ratings Are Sometimes the Best Means of Controlling for Credit Risks in Regulations

In the broadest terms, the Commission has four alternatives when it comes to regulating the credit risks taken by investment professionals, either on their own account or on behalf of their clients. First, the Commission could not regulate credit risks at all ("No Regulation"). Second, it could attempt to regulate credit risks using the investment professional's own assessment of credit risks ("Self Rating"). Third, it could attempt to use credit assessments prepared by the staff of the Commission or another public agency ("Public Rating"). Fourth, it could attempt to regulate credit risks using credit assessments prepared by third-party professionals ("3rd Party Rating").

Although there may be circumstances in which the Commission should follow the No Regulation approach, it should keep in mind that this approach can encourage risk-taking behavior by market participants. Any time a regulation limits or conditions an activity involving credit risks without regard to such risk, market participants seeking to maximize their returns from the activity will take greater risks. This is due to the positive correlation between risk and return, and is particularly the case when the investment professional does not bear the losses incurred by the activity.

The abysmal performance of the NRSROs in recent years forced me to consider seriously the Public Rating alternative. I strongly suggest that the Commission do the same, so that it will gain a greater appreciation of the rating activities that the Commission now regulates. How would the Commission attract and retain credit analysts? How would it deal with the credit cycles and fluctuations in the amount and type of debt securities being issued? If a company wanted to know how to improve its rating, would the staff provide guidance, or would this be rating its own work?

Most importantly, how would the Commission handle the ramifications of rating downgrades? If the Commission had been providing public ratings in March of 2008, would it have downgraded Lehman Brothers immediately following the rescue of Bear Stearns, which may have triggered Lehman's bankruptcy and the ensuing financial crisis six months earlier? If not, what event would have prompted a downgrade before Lehman's eventual bankruptcy, and how might other agencies have sought to influence that decision? Finally, how would the Commission prevent market participants from becoming as dependent on the Public Ratings as they are on NRSRO ratings?

This analysis leaves Self Rating and 3rd Party Rating as the only viable alternatives when the Commission needs to regulate the credit risks taken by market participants. These alternatives are not mutually exclusive; it may be appropriate to required Self Ratings in some cases, to rely on 3rd Party Ratings in other cases, and to impose both on occasion. Of the current regulations under the ICA, I believe that Rule 2a-7 provides an example of how the Self Rating and 3rd Party alternatives can be combined effectively. In contrast, I believe that Rule 3a-7 provides an example of the inappropriate use of 3rd Party Ratings.

## 3. Rule 2a-7 Illustrates an Appropriate Use of 3rd Party Ratings

Currently, Rule 2a-7 incorporates both the Self Rating and 3rd Party Rating alternatives. Self Rating takes the form of the minimal credit risk determination that an MMF must make regarding every portfolio holding. Third-Party Rating takes the form of the Requisite NRSRO requirements in the definition of an “Eligible Security.” It is important to appreciate that, although Eligible Securities are not required to have 3rd Party Ratings (see the definition of an “Unrated Security”), there have never been any exceptions to the Self Rating requirement of Rule 2a-7. In fact, an explicit statement that MMFs could not rely solely on 3rd Party Ratings to satisfy the Self Rating requirement was added to Rule 2a-7 in 1991.

Self Rating and 3rd Party Ratings serve different functions in Rule 2a-7. Self Rating requires the MMF’s investment adviser to provide the resources necessary to conduct an independent credit analysis of every investment and make a critical determination: does the investment present credit risks appropriate for a fund that seeks to maintain a stable NAV? If the MMF wants to invest in Unrated Securities, then the adviser must also determine whether the credit risks presented are comparable to a specified rating category (First or Second Tier).

Rule 2a-7 uses 3rd Party Ratings, *when they are available*, to control the adviser’s determination. The dependence on available ratings explains, in large part, the breadth of the rule’s definition of a “Rated Security.” Even securities that have never received short-term credit ratings from an NRSRO are treated as “Rated” if they are comparable in priority and security to rated obligations of the same issuer. This prevents the adviser from avoiding the rule’s risk control by acquiring an unrated obligation that clearly presents the same credit risk as a rated obligation. The rule’s exclusion of certain long-term rated securities from the definition of an Eligible Security serves much the same purpose—it expands the scope of NRSRO ratings available to serve as a risk control on MMF advisers.

The proposal to do away with NRSRO ratings in Rule 2a-7 illustrates the difficulty of controlling credit risk without reference to 3rd Party Ratings. As proposed, the adviser would have to, in addition to determining whether a security presented minimal credit risks, classify the security as First or Second Tier based on its own credit standards. Superficially, this would move Rule 2a-7 to an entirely Self Rating approach. In reality, the changes would produce either a circuitous form of 3rd Party Rating or loss of any control on credit risk. The purpose of a risk control is to establish an objective, determinable standard for the degree of risk permitted. Thus, if First Tier Securities represents a limit on the degree of credit risks that a MMF may take, then it is necessary to define what qualifies as a “First Tier Security.”

If the Commission told advisers to define First Tier by comparison to credit rating standards (as was proposed in the release), then it would revert to a 3rd Party Rating approach. If the Commission told advisers to concoct their own standards, then First Tier Security requirements would not longer act as controls on the adviser's risk assessment.

In summary, I think it clear that Rule 2a-7 uses NRSRO ratings appropriately to control credit risks. Controlling credit risks is an essential condition for the exemption provide by Rule 2a-7. Use of credit ratings is a common method of defining the risk parameters of an investment mandate—the Commission did not invent the 3rd Party Rating approach. The ratings serve as a direct control when they are available (as broadly defined in "Rated Security") and an indirect control by defining the standard against which Unrated Securities are to be measured. With two exceptions (which are harmless, but should probably be eliminated on principle), Rule 2a-7 does not interfere with the market place by requiring issuers to obtain NRSRO ratings in order to access financing from MMFs. All-in-all, Rule 2a-7's use of NRSRO ratings appears well tailored to the Commission's regulatory objective.

## 4. Rule 3a-7 Illustrates an Inappropriate Use of 3rd Party Ratings

In contrast to Rule 2a-7, Rule 3a-7 *requires* issuers to obtain credit ratings from an NRSRO in order to exempt asset-backed securities from the registration requirements of the ICA.[2] Although the rule provides exceptions to this requirement for asset-backed securities offered exclusively to accredited investors and qualified institutional buyers, it has the effect of deputizing NRSROs to protect the interest of the investing public.

There are several problems with this use of 3rd Party Ratings. First, the Commission has no right to force this responsibility on NRSROs. Despite the similarity in acronyms, NRSROs are not self-regulatory organizations. They were not established for the public's benefit, and have no obligation to advance the interest of the investing public ahead of the interest of their shareholders. The Commission has only itself to blame if the NRSROs fail to limit the public market for asset-backed securities in the manner it anticipated.

Second, the rule directly supports the business of the NRSROs by requiring a rating as a condition to an exemption. Unlike Rule 2a-7, Rule 3a-7 provides no means of offering asset-backed securities to the general public without obtaining an investment grade rating. I believe that the Commission should generally try to avoid granting regulatory franchises to market participants.

Finally, it is not clear what this rating requirement is intended to accomplish. To the extent that an investment grade was intended to prevent average investors from taking "too much risk," it would seem to be an example of ill-considered paternalism. The Commission is charged with making sure that investors are fully informed as to potential investment risks, not merit regulation of what securities should be offered to investors. To the extent that the rating requirement was prompted by the complexity

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2 Rule 3a-7(a)(2) requires that any exempt security be "rated, at the time of initial sale, in one of the four highest categories assigned long-term debt or in an equivalent short-term category (within either of which there may be sub-categories or gradations indicating relative standing) by at least one nationally recognized statistical rating organization …."

of asset-backed securities, recent events have shown that it is as important for investors in highly rated tranches to understand the structure of their asset-backed securities as it is for investors in lower rated tranches. A rule that effectively tells investors that they can judge the quality of a security by its ratings encourages precisely the type of investing behavior that Commission now seeks to avoid.

It might be argued that, without this rating requirement, the Commission was left with the alternatives of either banning the offering of asset-backed securities to non-accredited investors or allowing unlimited access to the general market. I am not sure that adopting the first alternative would have made much difference; currently most non-agency asset-backed securities are sold to institutional investors. If the Commission was concerned about restricting the market for asset-backed securities unduly, however, it would have been better advised to address the difficult disclosure and suitability issues directly, rather than hoping that the NRSROs would find some solution on their own.

**5. The Commission Should Set an Example by Improving Its Understanding and Use of NRSRO Ratings**

As my examples demonstrate, there is no single answer to the question of how the Commission should reform the used of NRSRO ratings in its regulations. I think that the Commission should eliminate references to NRSRO ratings altogether in some cases, and retain or modify them in others. There is one principle that should guide these reforms, however: the Commission should never refer to an NRSRO rating in a regulation without clearly defining the objective that it intends for the rating to serve. Where an appropriate objective cannot be defined, then the reference should be eliminated. Otherwise, the reference to NRSRO ratings should be tailored to the objective.

This approach requires the Commission and its staff to fully understand the nature and limits of NRSRO ratings. Credit ratings were not developed for use in regulations, and the Commission has no logical basis for assuming that they will serve its regulatory objectives. In other words, it is incumbent on the Commission to adapt its regulations to the ratings, and not to expect NRSROs to change their practices to suit the Commission.

Rule 2a-7 again provides an excellent example of why the Commission needs to raise the standards for using ratings in its regulations. The rule currently assumes that NRSRO ratings will remain forever frozen as they were in 1991: with a clear division between long-term and short-term ratings, and the two highest short-term rating categories corresponding to a minimal level of credit risks. This is already not the case, as at least one NRSRO's lowest gradation of its highest short-term rating corresponds to the second highest rating category of the three dominant NRSROs, and its second highest short-term rating corresponds to their third highest. In addition, the Commission has no reason to suppose that new NRSROs will continue to employ rating categories similar to existing ones.

What is needed is for the Commission to determine what level of credit risks it is willing to allow a stable value mutual fund to take, and then identify the credit ratings of each NRSRO corresponding to that level of risk. The Commission's current regulatory authority over NRSROs should give it access to the information necessary to make these comparisons. The Commission could compile its findings into a table of equivalent ratings, and refer to this table rather than to a generalized "xth highest rating category." This process should also alert the Commission to circumstances in which a particular NRSRO's rating should not be relied upon for regulatory purposes, because it does not perform the function that the Commission intended.

## 6. Conclusion

Winston Churchill once said that democracy was "the worst form of Government except all those other forms that have been tried from time to time."[3] I suspect that the same can be said of relying on NRSRO credit ratings to define regulatory standards for credit risks. Although Self Rating may be appropriate in some limited circumstances, 3rd Party Ratings are still probably the best common reference points for defining credit standards. I do not see any benefit to using NRSRO credit ratings surreptitiously (*e.g.*, stating "low credit risks" in the regulation and then noting in a footnote to the release that this corresponds to an A rating) rather than expressly. I would not, however, recommend requiring, directly or indirectly, an issuer to obtain a rating as a condition of regulatory compliance.

One final thought: if the Commission reforms its regulations so that there is no longer any benefit to an NRSRO designation, why would any rating agency register as an NRSRO? Does the Commission really think that a return to fully deregulated credit ratings is appropriate for the securities market at this time?

Cordially,

Stephen A. Keen

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3 *Winston S. Churchill: His Complete Speeches, 1897–1963,* ed. Robert Rhodes James, vol. 7, p. 7566 (1974).