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BEFORE THE

COMMITTEE ON FINANCIAL SERVICES

UNITED STATES HOUSE OF REPRESENTATIVES

ON

H.R. 2990

CREDIT RATING AGENCY DUOPOLY RELIEF ACT OF 2005

NOVEMBER 29, 2005

EXECUTIVE SUMMARY

The Investment Company Institute commends the House Financial Services Committee for holding this hearing on H.R. 2990, the "Credit Rating Agency Duopoly Relief Act of 2005," in order to gain a better understanding of the role of credit rating agencies in our securities markets.

Mutual funds employ credit ratings in a variety of ways – to help make investment decisions, to define investment strategies, to communicate with their shareholders about credit risk, and to inform the process for valuing securities. Money market mutual funds, which invest a significant amount of their portfolios in securities rated by NRSROs, provide a compelling illustration of the importance of sound credit ratings and rating agencies to investors. Money market funds currently hold $2 trillion in assets.

To promote the integrity and quality of the credit ratings process and, in turn, serve the interests of investors who utilize credit ratings, we believe there are several steps that should be taken. First, the NRSRO designation process should be reformed to facilitate the recognition of more rating agencies and thereby introduce much needed competition in the credit rating industry. Second, there should be appropriate regulatory oversight by the SEC to ensure the credibility and reliability of credit ratings. Third, investors should have regular and timely access to information about NRSROs to provide investors a continuous opportunity to evaluate the ratings they produce. Finally, NRSROs should have some accountability for their ratings in order to provide them with incentive to analyze information critically and to challenge an issuer's representations.

The ICI strongly supports the goals of H.R. 2990. Increased competition, appropriate SEC oversight, greater transparency, and heightened accountability – these are the right objectives for reform of the credit rating industry, from the perspective of mutual funds, other investors, and the securities markets as a whole.

I. INTRODUCTION

Good morning. I am Paul Stevens, President of the Investment Company Institute, the national association of the U.S. investment company industry. ICI members include 8,518 open-end investment companies or "mutual funds," 663 closed-end funds, 148 exchange-traded funds and 5 sponsors of unit investment trusts. Mutual fund members of the ICI have total assets of approximately $8.5 trillion, representing more than 95 percent of all assets of U.S. mutual funds. These funds serve approximately 86.7 million shareholders in more than 51 million households.

Mutual funds and fund shareholders have a significant stake in the soundness and integrity of the credit rating system. I commend the Committee for holding this hearing on H.R. 2990, the "Credit Rating Agency Duopoly Relief Act of 2005," which is intended to improve the quality of credit ratings by fostering competition, transparency and accountability in the credit rating industry and to address concerns regarding the current "NRSRO" designation process. This is my second opportunity as President of the ICI to testify before the House Financial Services Committee, so ably led by you, Chairman Oxley. Under your leadership, and that of Ranking Member Frank, and Capital Markets Subcommittee Chairman Baker and Ranking Member Kanjorski, the Committee has been active in critically important issues affecting not just mutual funds, but our capital markets. I also would like to recognize Congressman Fitzpatrick for his leadership in this important legislation.

Credit rating agencies play a significant role in the U.S. securities markets generally, and vis-à-vis mutual funds in particular. As we have noted in response to several proposals from the Securities and Exchange Commission relating to credit rating agencies and NRSROs and in other statements relating to NRSRO oversight, the ratings published by credit rating agencies help inform the investment decisions of mutual funds and other institutional investors. The SEC and other regulators rely upon these ratings as indicators of investment risk for various regulatory purposes. Maintaining the integrity and quality of the credit ratings process is therefore essential to sustaining investor confidence and to promoting the proper functioning of our capital markets.

We believe it is timely and appropriate for Congress to consider legislation to advance several objectives in this area. First, legislation should facilitate the designation of more rating agencies as NRSROs in order to introduce much needed competition in the credit rating industry. Creating competition would provide NRSROs even stronger incentives to ensure that their ratings are of the highest quality and reliability. Second, legislation should ensure appropriate oversight by the SEC to ensure the continued integrity and quality of these ratings. Third, legislation should assure disclosure of information about NRSROs to investors and provide them a continuing opportunity to evaluate NRSROs, thereby promoting efficient functioning of the credit rating industry. Finally, legislation should assure that NRSROs have some accountability for their ratings processes in order to provide them with incentive to analyze information critically and to challenge an issuer's representations.

II. IMPORTANCE OF CREDIT RATING AGENCIES AND NRSROS TO THE FUND INDUSTRY

A. Use of Credit Ratings

There is no question that credit ratings play an important role in our securities markets. Like other institutional investors, mutual funds utilize these ratings in analyzing the credit risks of securities. In fact, NRSRO-rated securities form an important component of the portfolios that funds manage for the benefit of their shareholders. For example, money market funds currently hold $2 trillion in assets. The Institute estimates that taxable money market funds invest about 50 percent of their non-government portfolio securities in NRSRO-rated securities. In addition, according to one source, tax-exempt money market funds invest an even larger amount, approximately 90 percent of their assets, in securities rated by NRSROs.[1]

Credit ratings also play an important role in communications between funds and their shareholders – communications that inform the purchase decisions of millions of American investors. Many funds incorporate ratings criteria into shareholder disclosures regarding the investment policies and strategies of the fund. For example, such disclosure may include a description in a fund prospectus regarding the percentage of its portfolio invested in bonds rated in a particular category by an NRSRO. Many corporate and municipal bond funds now provide shareholders with a graph or table showing the percentage of the portfolio invested in each rating category of one or more NRSROs. Some funds even provide the ratings of individual securities in the schedule of investments provided to shareholders as a method of communicating with shareholders about the credit risks taken by a fund.

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[1] iMoneyNet, *Money Fund Report* at 28 (October 7, 2005).

Ratings also play an important role in the valuation of mutual fund shares. Many mutual funds use pricing services in valuing debt securities, some of which trade only infrequently. The rating assigned to securities by a rating agency may influence the valuation determinations of pricing services and ultimately the calculation of the net asset value of mutual funds that hold such securities.

Finally, some investment companies, particularly institutional money market funds, obtain credit ratings for their own shares.

B. Money Market Mutual Funds and Investment Company Act Rule 2a-7

The most significant influence of credit ratings on the fund industry is on the $2 trillion invested in money market mutual funds. Money market funds are a truly remarkable chapter in the history of U.S. mutual funds. Initially, money market funds were used as savings vehicles; today retail and institutional investors alike rely on them as a cash management tool, because of the high degree of liquidity, stability in principal value, and current yield that they offer. ICI estimates that between 1980 and 2004, roughly $100 trillion flowed into, and the same amount out of, money market funds.

If money market funds are an industry success story, they also most certainly are an SEC success story. Since 1983, money market funds have been governed very effectively by Rule 2a-7 under the Investment Company Act of 1940. Since Rule 2a-7 was adopted, money market fund assets have grown nearly 1000 percent (from $179 billion to $1.9 trillion).

Rule 2a-7 limits the types of securities in which money market funds can invest in order to help them achieve the objective of maintaining a stable net asset value of one dollar per share. Credit ratings form an integral part of these limitations. For example, money market funds may only invest in securities either rated by an NRSRO in its two highest short-term rating categories or, if unrated, as determined by the fund's board of directors to be of comparable quality. In general, money market funds also cannot invest in certain securities, including most asset-backed securities and certain guarantees, unless they have been rated. Finally, Rule 2a-7 requires money market fund advisers to continuously monitor the ratings of portfolio securities and to take certain actions in the event a security is downgraded. While Rule 2a-7 does not completely limit money market funds to rated securities, it effectively requires fund advisers to incorporate any available ratings into the analysis of appropriate securities to be held by these funds.

It is important to note that no government entity, such as the FDIC, insures money market funds. Nevertheless, despite an estimated $200 trillion flowing into and out of money market funds over the past 25 years, through some of the most volatile markets in our history, only once has such a fund failed to repay the full principal amount of its shareholders' investments. In that case, a small institutional money fund "broke-the-buck" due to extensive derivatives-related holdings.

It is critically important that this record of success achieved under Rule 2a-7 continues for the benefit of money market fund investors. This, in turn, depends on the ratings issued by NRSROs providing credible indications of the risk characteristics of those instruments in which money market funds invest.

III. THE NRSRO DESIGNATION PROCESS SHOULD PROMOTE COMPETITION

The mutual fund industry is one in which intense competition has brought unparalleled benefits to investors. I firmly believe that robust competition for the credit ratings industry is the best way to promote the continued integrity and reliability of their ratings. Unfortunately, the current designation process does not promote -- but, in fact, creates a barrier to -- competition. Since the SEC first created the NRSRO designation in 1975, there have been only a handful of rating agencies that have achieved the designation. Given the competitive advantage and benefits that accompany the NRSRO designation, it is hard to imagine that other existing credit rating agencies or potential new entrants to this market would not want to obtain such a designation. Nor are new rating agencies likely to be able to compete effectively without the NRSRO designation.

As I discussed earlier, money market funds generally must invest in securities rated at a certain level by an NRSRO. It is therefore necessary for many issuers to have their securities rated by an entity designated as an NRSRO (as opposed to a rating agency without such a designation), to avoid losing access to a substantial pool of investment capital. Similarly, ratings from an NRSRO may give issuers access to investments from state and local governments, which often are required by law to invest in securities with specified ratings. Broker-dealers, too, have an incentive to hold NRSRO-rated securities in order to maintain their capital adequacy under the federal securities laws. Given the valuable attributes accompanying the NRSRO designation, issuers and other users of credit ratings have little incentive to pay a rating agency that does not qualify as an NRSRO for its ratings, even if they believe that the ratings themselves may be of superior quality. This lack of competition eliminates an important incentive for NRSROs to maintain and improve the quality of their credit ratings.

To encourage more competition, the NRSRO designation process must be improved. The current SEC process for designating credit rating agencies through the issuance of no-action letters has not worked effectively. We share the concerns of others regarding the length of time necessary to obtain a no-action letter and the limited types of credit rating agencies deemed eligible for NRSRO status. The SEC's vague "national recognition" standard gives rise to the oft-noted "chicken and egg" dilemma: an organization must be nationally recognized to be designated as an NRSRO, but cannot realistically expect to obtain national recognition without the NRSRO designation. These factors all have contributed to the small number of currently recognized NRSROs.

In place of this no-action process, we recommend mandatory, expedited registration with the SEC. We are therefore pleased that H.R. 2990 properly moves the basis for NRSRO designation from a "national recognition" standard to an SEC registration requirement.

While such changes to the NRSRO designation process would be welcome, they also will require the SEC to reassess its existing regulations that rely on and refer to NRSROs. For example, the credit rating requirements in Rule 2a-7 will need to be reexamined if there is a significant increase in the number of NRSROs, to avoid funds having to monitor the ratings issued by each and every one of those organizations.

IV. NRSROS SHOULD BE SUBJECT TO EFFECTIVE REGULATORY OVERSIGHT

While the implementation of a new NRSRO designation process would undoubtedly spur competition, at the same time, to ensure the integrity and quality of credit ratings, there must be effective regulatory oversight by the SEC of NRSROs after their initial designation. We believe this can be achieved through a combination of (1) periodic filings with the SEC, and (2) appropriate inspection by the SEC, coupled with adequate enforcement powers. H.R. 2990 should provide the SEC with authority sufficient to implement such a system.

Currently, the SEC has little basis on which to assess the continued credibility and reliability of credit ratings issued by an NRSRO after it has received its designation through the no-action process. It is my understanding that NRSROs are subject to infrequent, if any, SEC examinations. In addition, under the terms of the no-action letters granted to NRSROs, once a rating agency has been granted the NRSRO designation, it is required to notify the SEC only when it experiences material changes that may affect its ability to meet any of the original recognition criteria. Given the heavy financial impact that a loss of NRSRO designation would have on a rating agency, NRSROs have a strong disincentive to report any such changes. It is unrealistic to premise regulation altogether on self-policing and self-reporting.

H.R. 2990 would require that certain important information – conflicts of interest, the procedures used in determining ratings, ratings performance measurement statistics, and procedures to prevent the misuse of non-public information – be provided to the SEC upon registration. We believe that NRSROs also should be required to report to the SEC, on an annual basis, that no material changes have occurred in these areas. Similarly, NRSROs should be required to report any material changes that do occur on a timely basis, and this information should be made available promptly to investors who rely on NRSRO ratings. We recommend that H.R. 2990 be amended to provide for such additional reporting requirements.

Finally, it is important that the SEC devise an appropriate inspection process with respect to NRSROs. Such a process can and should be tailored to the nature of their specific business activities. Nevertheless, some form of periodic examination seems imperative in light of the important and pervasive role that credit ratings play in the securities markets.

V. TRANSPARENCY OF INFORMATION TO INVESTORS SHOULD BE INCREASED

In discussions with our members, they have emphasized the importance to them, as investors, of access to information about an NRSRO's policies, procedures and other practices relating to credit rating decisions. In particular, it would be helpful for NRSROs to disclose to investors their policies and procedures addressing conflicts of interest (as well as the conflicts themselves), and periodically to disclose information sufficient for investors to evaluate whether they have the necessary staffing, resources, structure, internal procedures and issuer contacts to serve as NRSROs. The call for increased transparency on these subjects is not new. In its report on the role of credit rating agencies, submitted pursuant to the Sarbanes-Oxley Act of 2002, the SEC noted that at its hearings on credit rating agencies, representatives of buyside firms, including mutual funds, had stressed the importance of increasing transparency in the ratings process.

We believe the public disclosure of this information would allow investors a continuous opportunity to evaluate an NRSRO's independence and objectivity, capability and operation. Such disclosure would serve as an effective additional mechanism for maintaining the integrity and quality of credit ratings.

VI. NRSROS SHOULD BE ACCOUNTABLE FOR THEIR RATINGS PROCESSES

NRSROs should assume some accountability for their ratings in order to provide them with incentive to analyze information critically and to challenge an issuer's representations. Under current regulations, the SEC exempts NRSROs, but not other rating agencies, from treatment as experts subject to liability under Section 11 of the Securities Act of 1933 and, thus, allows NRSRO ratings in prospectuses and financial reports. Although the SEC has stated that NRSROs remain subject to antifraud rules, the NRSROs have steadfastly maintained that, under the First Amendment, they cannot be held liable for erroneous ratings absent a finding of malice.

Notwithstanding whether NRSROs can or should be held liable for an erroneous rating itself, we believe that any reforms to the credit ratings process should, at a minimum, make NRSROs accountable for ratings issued in contravention of their disclosed procedures and standards. Even if the First Amendment applies to credit ratings, it does not prevent Congress from requiring rating agencies to make truthful disclosures to the SEC and to the investing public. H.R. 2990 should therefore be modified to provide that if a rating agency obtains an NRSRO designation based on, for example, a specific ratings process, it should be held accountable to the SEC and to investors if it fails to follow that process.

VII. CONCLUSION

The SEC has been aware of issues relating to credit rating agencies for over a decade now. During that time, the SEC has issued two concept releases, two rule proposals and a comprehensive report to Congress addressing credit rating agencies and NRSRO practices. In the process, the SEC has received scores of comment letters, including several from the Institute, urging action in this area. None has been forthcoming. In light of this history, action by Congress is now necessary.

The Institute strongly supports the goals of H.R. 2990. The increased competition that the bill should facilitate, combined with appropriate SEC oversight, greater transparency to investors, and NRSRO accountability, would benefit mutual funds and other investors and help secure reliable and credible ratings.

I very much appreciate the opportunity to share the Institute's views with you today. We have several technical comments about the bill that we will be providing, and do look forward to working with the Committee on these and other issues in the months ahead.