STATEMENT OF PAUL SCHOTT STEVENS

PRESIDENT

INVESTMENT COMPANY INSTITUTE

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

ON

ASSESSING THE CURRENT OVERSIGHT AND OPERATION OF CREDIT RATING AGENCIES

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EXECUTIVE SUMMARY

The Investment Company Institute commends the Senate Committee on Banking, Housing, and Urban Affairs for holding this hearing to examine the current oversight and operation of credit rating agencies.

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, to serve the interests of investors who utilize credit ratings, we believe it is appropriate for Congress to consider legislation to advance several related objectives. 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 over NRSROs 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.

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 U.S. investment companies. ICI members include 8,579 open-end investment companies or "mutual funds," 653 closed-end funds, 162 exchange-traded funds and 5 sponsors of unit investment trusts. Mutual fund members of the ICI have total assets of approximately $9.1 trillion, representing 98 percent of all assets of U.S. mutual funds. These funds serve approximately 89.5 million shareholders in more than 52.6 million households.

Chairman Shelby, Ranking Member Sarbanes, members of the Committee, it is an honor to appear before you today for the first time as President of the ICI. Mutual funds and fund shareholders have a significant stake in the soundness and integrity of the credit rating system. I therefore commend the Committee for holding this hearing to examine the current oversight and operation of credit rating agencies.

As the ICI has 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, credit rating agencies play a significant role in the U.S. securities markets generally, and vis-à-vis mutual funds in particular. The ratings published by credit rating agencies help inform the investment decisions of mutual funds and other institutional investors. In addition, the SEC and other government agencies 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.

As I testified recently before the House Financial Services Committee, we believe it is timely and appropriate for Congress to consider legislation to advance several objectives in this area. First and foremost, 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, to ensure the continued integrity and quality of these ratings, legislation should ensure appropriate SEC oversight of NRSROs. Third, legislation should ensure 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 ensure 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

Reforms to the oversight and operation of credit rating agencies are critical to ensuring the continued proper functioning of our securities markets. Like other institutional investors, mutual funds utilize ratings issued by credit rating agencies 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 ICI 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.

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.

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[1] iMoneyNet, *Money Fund Report* (February 24, 2006).

B. Money Market 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 $2 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, under Rule 2a-7, money market funds may invest only in securities that are rated by an NRSRO in its two highest short-term rating categories or, if unrated, that are 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 insures money market funds, as the FDIC does bank deposits. 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, only a handful of rating agencies have achieved this status. 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.

The advantages and benefits of NRSRO designation are significant. For example, because of the requirements discussed above on the types of investments that money market funds can make, it is 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 for the ratings of an agency that does not qualify as an NRSRO, 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.

We believe the best way to address concerns regarding the current NRSRO designation process is to replace the current no-action process and "national recognition" standard with a mandatory, expedited NRSRO registration process with the SEC.

IV. NRSROS SHOULD BE SUBJECT TO EFFECTIVE REGULATORY OVERSIGHT

The implementation of such a NRSRO registration process undoubtedly would 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 qualification. We believe this can be achieved through a combination of (1) periodic filings with the SEC, and (2) appropriate inspection authority for the SEC, coupled with adequate enforcement powers.

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 impractical to premise regulation altogether on self-policing and self-reporting.

For these reasons, credit rating agencies should be required to provide certain information to the SEC upon registration, such as information relating to conflicts of interest, the procedures used in determining ratings, ratings performance measurement statistics, and procedures to prevent the misuse of non-public information. We believe that NRSROs also should be required to report affirmatively 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.

Finally, it is important that the SEC have inspection authority over NRSROs and 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.

While changes to NRSRO oversight would go far in ensuring that ratings issued by NRSROs are credible and reliable, as part of any changes to the NRSRO regulatory scheme, the SEC should be directed 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 from each of those organizations.

V. TRANSPARENCY OF INFORMATION TO INVESTORS SHOULD BE INCREASED

In discussing these issues 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.

It is therefore important that any legislation in this area ensure disclosure of information about NRSROs to investors. 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.

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.

I very much appreciate the opportunity to share the Institute's views with you today. I look forward to working with the Committee on these and other issues.