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November 12, 2010

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

Dear Ms. Murphy and Commissioners:

Re: Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act," or "DFA")
Title IX Subtitle C — Improvements to the Regulation of Credit Rating Agencies ("CRAs")

Thank you for providing a forum for our comments on the SEC initiatives under the Dodd-Frank Act.

PF2 Securities is a New York-based consulting company, which was formed in early 2008 as an independent alternative for evaluating and measuring the risks inherent in corporate and trust-preferred collateralized debt obligation securities (corporate and TruPS CDOs). With each of our founding members having spent some part of his prior professional career within a CRA, we are particularly sensitive to the importance of ratings accuracy and the deep reliance on ratings throughout our existing financial structure.

Given our credit rating background and our structured finance expertise, we will limit our comments to Sections 931 through 939 of the DFA, and concentrate on improvements we believe would serve to buffer our economy against risks that may otherwise arise from the structured finance market.

We recognize the challenges you face in adopting the required rules within the one year time frame from DFA enactment. In this light, we hope that our submission assists you in meeting your goals and we encourage you to contact us freely should you value further communication.

Sincerely,

Guillaume Fillebeen and Gene Phillips
Directors

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Submission Overview

Part 1 — Detailed Comments

(1) Section 932.(q).(2) – Transparency of Ratings Performance
(2) Section 932.(s) – Transparency of Credit Rating Methodologies and Information Reviewed
(3) Section 933.(b).(2).(B) – Exceptions to State of Mind in Private Actions

Part 2 — The Case for Minimizing External Distractions to CRA Ratings Objectivity

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Detailed Comments

Section 932.(q).(2) – Transparency of Ratings Performance

Section C: For withdrawn ratings, an additional rating attribute should be added to indicate whether the security was paid-in-full ("PIF"), suffered a loss ("SL"), or is awaiting a loss assessment ("ALA").[1]

The PIF measure is important in performing due diligence on, and adding transparency to, ratings performance: it allows a user to identify situations in which, for example, unmonitored speculative-grade[2] securities were fully paid down. Merely denoting a rating as having been withdrawn tends to obfuscate the proliferation of this substantial "Type II" rating error — the providing of too low a rating to an issuer that does not subsequently default.[3]

Section D: We suggest for the following three reasons, among other, that the Commission make the referenced disclosures available to the public through the Commission's website:

(i) the Commission will be able to monitor the regularity of alterations being made to CRA disclosures;
(ii) the Commission will be able to supervise the uniformity of the data being delivered; and
(iii) the users will be afforded the material advantage of being able to access the data from a central, disinterested, location (which additionally engenders market confidence).

Section 932.(s) – Transparency of Credit Rating Methodologies and Information Reviewed

The new disclosure requirements provide material improvements and additionally advance the goal of CRA accountability. The language as it stands, however, leaves the CRAs open to providing only the vaguest of explanations in tandem with their actions, as opposed to ensuring the provision of informative and meaningful justification.

For example, disclosing that "we downgraded security ABC due to a change in the way we treat assumption XYZ in our model" provides little basis for external verification as to the validity of the assumption change.[4]

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[1] At the Commission's determination, it may be feasible for CRAs to estimate losses at a certain measurement date, say 30 days after default, and to further distinguish the abovementioned "SL" category into bands SL1 to SL5, for example. SL1 could represent an estimated loss ranging from (0%-20%]; SL2 could represent an estimated loss ranging from (20%-40%]; etc.

[2] The term speculative grade, synonymous with "junk" or "sub-investment-grade," refers to those securities rated below the "investment-grade" threshold of Baa3, BBB- and BBB- for Moody's, Fitch and S&P, respectively.

[3] Absent disclosure of the Type II error, CRAs are mathematically incentivized to downgrade all ratings to their lowest rating category, such that if or when they do default, they would have been lowly rated at the time of default, resulting in a strong accuracy ratio performance reading for the ratings agency. (Accuracy ratios reflect Type I errors, alone — the ability for ratings to adequately separate those securities that do default from those that do not.)

[4] We have also, for example, seen that an institution's purchase of a foreign company proved a credit positive due to the (geographical) diversification benefits afforded while the same rating agency found in a separate situation that a company's sale of a foreign arm was

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To protect against poorly justified or unverifiable disclosures being made as to the assumptions applied and the data relied upon, the Commission ought to additionally require:

(i) disclosure of the data itself;
(ii) disclosure as to whether the data was provided by an interested or conflicted party; and
(iii) disclosure as to alternative assumptions that were disregarded in favor of the chosen assumptions.

Part (i) solves the problem of the CRAs simply referring to what they're seeing in the marketplace as sufficient justification, as an alternative to being able to provide concrete proof. Further, it improves an investors' ability to perform due diligence and facilitates investors' capacity to reproduce the rating. If investors are able to verify the accuracy of CRA ratings, CRAs will be increasingly pressured to maintain accurate, up-to-date ratings. This will encourage ratings accuracy.

Part (ii) enables an investor to independently gauge the adequacy of the data being relied upon. Together with part (i), part (ii) allows an external user to determine whether the data that supports each rating assumption may alternatively have supported other assumptions, too.

Part (iii) discourages ratings inflation: it mitigates the possibility that CRAs will choose to apply the assumption that results in the most favorable ratings outcome. Such disclosure, in tandem with the specifications of Section 932.(s).(3), may have been powerful enough to have subverted the CPDO failures. Had these requirements been in place, the rating agencies that ultimately provided the faulty AAA ratings may have been required to proffer the following ominous pronouncement:

> "Under assumption X, which we deem to be reasonable for the following reasons, we reach a AAA rating for this security; *however*, if we were to apply assumption Y, *which is not unreasonable*, the resulting rating would have been BBB."[5]

Section 933.(b).(2).(B) – Exceptions to State of Mind in Private Actions

CRAs ought additionally to be held responsible for "knowingly or recklessly" failing to adequately *and consistently* apply their then-current public methodology. The application of asset-level, sector-wide and economic assumptions ought to be identically applied between and among different security types.

considered a credit benefit as it allowed the company to focus in greater depth on its local operations. These disclosures, or reasons, run counter to one another but alone each may seem plausible. As such, verifiable disclosures would prove to be preferable alternatives.

[5] http://ratingsreform.wordpress.com/2010/02/10/economies-of-ratings-scales-part-2/

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The Case for Minimizing External Distractions to CRA Ratings Objectivity

The Financial Standards Board ("FSB") commented recently that "[the] 'hard wiring' of CRA ratings in standards and regulations … is a cause of the 'cliff effects' of the sort experienced during the recent crisis, through which CRA rating downgrades can amplify procyclicality and cause systemic disruptions." [6]

The DFA, too, notes the "systemic importance" of credit rating agencies (Section 931.(1)).

Whether or not the FSB's "Principles for Reducing Reliance on CRA Ratings" are implemented — and our opinion on the matter is beyond the scope of this submission — we will continue to remain utterly dependent on ratings accuracy, from a systemic risk perspective, for at least the near term.[7]

We share the Commission's interest in improving the quality of credit ratings. To this end, we urge the Commission to concentrate its energies on ensuring the CRAs focus on the very serious business of providing accurate credit ratings. In advancing this goal, we recommend the Commission consider carefully removing those barriers that act as impediments to transparent, accurate ratings.

Specifically, CRAs have become increasingly commercial enterprises. Indeed Section 931.(3) of the DFA recognizes that "the activities of credit rating agencies are fundamentally commercial in nature." Copious congressional testimony has been offered to support the hypothesis that ratings quality was affected by the quest for market share. This decline in ratings standards was not limited to market pressures in the arena of structured finance.[8] Nor were their parent companies' short-term profit generation interests limited to the scope of providing ratings. Therein lies the root cause of the problem.

Informational Asymmetries in the Structured Finance Arena

The European Commission appreciates the significant role played by CRA opinions in helping to "overcome the informational asymmetry between those issuing debt instruments and those investing in these instruments."[9] The presence of information asymmetries, like the absence of regulation, enables poorly incentivized parties (often sellers of risk) to take advantage of comparatively less sophisticated market participants (often buyers of risk, or investors).

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[6] http://www.financialstabilityboard.org/publications/r_101027.pdf

[7] In fact, the FSB agrees that "[in some] cases, it may take a number of years for market participants to develop enhanced risk management capability so as to enable reduced reliance on credit rating agencies." *Ibid*.

[8] In their September 2010 draft of "How did increased competition affect credit ratings?" Becker (Harvard Business School) and Milbourn (Washington University in St Louis) explain that within the context of corporate debt ratings, their "interpretation of [their research] findings is not that the rating agencies were intentionally deceiving markets, but instead compromised ratings quality at the margin as competition increased." http://www.hbs.edu/research/pdf/09-051.pdf

[9] "Public Consultation on Credit Rating Agencies," November 2010 http://ec.europa.eu/internal_market/consultations/docs/2010/cra/cpaper_en.pdf

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The harmful effects of informational asymmetries are at least two-fold: first, they create the opportunity for active adverse selection of collateral portfolios; second, they lead to large price discrepancies between fundamental or "intrinsic" value and traded levels, in a time of crisis.

Active adverse selection: The lack of disclosure inherent in structured finance securities, in tandem with the varying degrees of complexity, enabled the creation of vehicles that permitted sellers to obfuscate the true quality of securities being added to underlying portfolios. This informational disconnect allowed (or encourage) sophisticated and technologically savvy institutions in the know to take advantage of less sophisticated, ratings-reliant "accredited" investors.[10]

Price discrepancies: Price discounts appear to be most readily apparent "for those securities where the payoff streams are particularly complex," and indeed are "amplified as we move down the securitization chain to more opaque securities where there is greater scope for information to be asymmetric."[11]

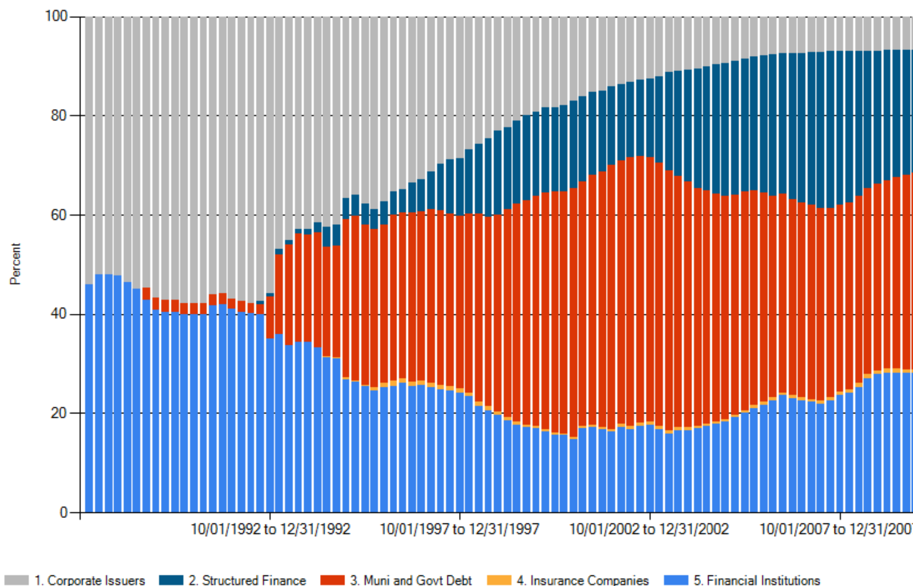

Figure (left): With the securitization market having grown exponentially over time, the informational asymmetries that exist posed, and continue to pose, systemic risk concerns.

In the structured finance market which, as shown, has grown to constitute a significant portion of all debt issuance, CRA ratings help to bridge the abovementioned informational gap. Thus, until or unless a

[10] http://expectedloss.blogspot.com/2010/06/in-due-diligence-we-trust.html
[11] "Could Asymmetric Information Alone Have Caused the Collapse of Private-Label Securitization?" International Finance Discussion Papers Number 1010 of the Board of Governors of the Federal Reserve System, October 2010 http://www.federalreserve.gov/pubs/ifdp/2010/1010/ifdp1010.pdf

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ready alternative exists to CRAs in this space, we strongly urge the Commission to concentrate its energies on promoting transparency in this space, and removing any barriers to CRAs providing objective opinions.

CRAs' Alternative Rent-Seeking Arms

DFA Section 931.(3) recognizes that CRAs perform "evaluative and analytical services on behalf of clients" and it recognizes the potentially harmful effect of these for-profit businesses as it seeks, in Section 932, the "separation of ratings from sales and marketing."

We urge the Commission to investigate the consequences of permitting these supplementary services. We contend that these supplementary services are broader, deeper and more problematic than generally considered and that they serve as a tangible distraction and material impediment to both ratings quality and ratings transparency.

Moreover, our experience has shown us that in the best of cases, though purportedly separate, "Ratings" and "Analytics" departments often apply the same models, and "Ratings" and "Evaluations" divisions often rely on the same assumptions. To the extent investors depend on rating agencies for analytics or evaluations (or both) in addition to the ratings themselves, those investors are exposed to an amplified impact when models or economic assumptions change.

In the worst of cases CRAs might be encouraged to be particularly opaque about their rating assumptions and methodologies as a considered means to generate increased rent in their other divisions. Indeed, for certain classes of securities in which the existing raters' methodologies are particularly lacking in transparency — such as is the case for structured finance securities — we have noticed an additional reliance by investors, including government entities, on their evaluations and analytics.

Rating agencies do not sell only ratings: they sell data, analytics, advisory services, prices and evaluations, research and more.

Certain CRAs are particularly adept at selling analytical tools and consulting services in the space of structured finance: they realize that there are limited alternatives available, especially given the private nature of the market and the subsequent difficulty gaining significant coverage of the issuances that came to market. As such, the data and analytic vendor community is largely oligopolistic in nature, with limited supply lending itself to high costs. In addition to the luster of high cost data and analytics, some CRAs are alive to the significant advantage it affords to a market participant if she is able to anticipate future rating actions.[12] The rating agencies often market this advantage when advertising that the

[12] Estimating the frequency or magnitude of rating actions is important for several market participants. The advantages include: (a) the calculation of margin and regulatory capital reserve requirements to satisfy credit risk-based guidelines; (b) the pricing of certain securities and

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model they're selling is the the same model used by the rating analyst who monitors the security's rating. In this way and other ways, "Evaluations" and "Analytics" departments are able to charge a premium for their services; in other ways, their Evaluations and Analytics departments are able to offer a premium product.

The competitive advantage their ratings services afford for the sale of their evaluations and analytics, however, unfortunately creates a material distraction to the quality of their original ratings service. As such, where rating analysts may historically have opted to provide complimentary transparency — in the form of data, research and analytics — in conjunction with their ratings opinions, the gains sought in their newer divisions encourage business managers to rather sell those complementary tools. The data and analytics are often priced in such a way as to prove prohibitively expensive for smaller market players and for regulators, who are thereby limited in supervising their constituents.[13] The resulting compromised transparency, again, favors the larger and more sophisticated institutions as it allows for increased exploitation of market asymmetries.

Thus, absent a pressure to sell external products, we envision CRAs becoming more transparent[14] in their assumptions and their origins, a situation which will allow investors to be better equipped in performing their internal due diligence.[15]

Given the systemic importance of ratings, we believe that the best solution is to ensure a ratings environment suffers minimal commercial distraction. While we cannot accurately gauge the net impact of parent companies' supplementary divisions on the quality of credit ratings, we argue strongly that they pose a material disservice. Certainly they offer no advantages. We implore the Commission to immediately require that CRAs disassociate, to the extent possible, from their alternative divisions. Ideally, CRAs ought to act as stand-alone companies, where the quality of their ratings can stand unaffected by negative pressures of shareholders, parent institutions or supplementary rent-seeking businesses that serve to jeopardize or otherwise compromise ratings standards. Rather than leaving our economy in a state that is vulnerable to the snowballing effects of self-perpetuating economic forces,[16] we ought to focus our energies on instituting an independent buffer against the realization of imperfect ratings.

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facilities which are based off credit rating pricing grids; and (c) the analysis of certain structured finance notes whose performance — not to mention viability — can be subject entirely to rating changes made to the underlying collateral securities.

[13] According to Prof. Joseph Mason, "[the] reason that regulators did not have that information, quite honestly, [was] equal parts cost and interest. The cost of market data on new products [was] prohibitive to performing research on risks to the financial system. For instance, while working with a regulatory agency in 2006-7 to research mezzanine RMBS CDOs with Intex, the astronomical cost forced us to use only part of the data package. Performance data on individual mortgages [was] priced similarly." http://www.roubini.com/financemarkets-monitor/258017/tbtf_is_not_about_size_its_about_information

[14] http://ratingsreform.wordpress.com/2010/05/14/rating-agencies-transparent-or-not/

[15] Arturo Cifuentes, Ph.D., recommended the following before the U.S. Senate vis-à-vis the elimination of so-called black-box ratings: "… based on a common belief among scientists and engineers: never trust a 'result' that you don't know how to replicate. In other words, 'don't just tell me what the result is, tell me how you did it, and I will check it myself.' In short, trust but verify." http://www.ft.com/cms/s/0/384bb0be-4d4f-11dd-b527-000077b07658.html

[16] http://expectedloss.blogspot.com/2008/11/illiquidity-self-perpetuating.html

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We urge the Commission to engage the CRAs — at least in the short term — to help create a transparent ratings environment which is conducive to independent analysis, and an informed investment environment which values active due diligence, thoughtful risk management and prudent lending. With increased transparency into CRA data, assumptions and models, an informed investor community might be able to gain confidence in the usage of ratings as complementary, objective opinions.

Establishment of Office of Credit Ratings

As it relates to the prior sections of our submission, we humbly recommend that in establishing the Office of Credit Ratings — as per Section 932.(p) — the Commission focuses on candidates who are familiar with the pros, cons and conflicts inherent in the different ratings-pay models, and who possess an intricate understanding of their various modes of revenue generation. Next, the staffers ought preferably to come from diverse financial analysis backgrounds and ought ideally to have degrees of experience working with the ratings agencies and their differing methodological approaches. Last, but equally important, the candidates selected ought to share the opinion that, if well administered, ratings can provide a material public good and they ought to focus on extracting and maximizing the value that ratings provide.

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Addendum — Resources

Credit Rating Agency Research (available at http://www.pf2se.com/Content.aspx?Type=Research)

February 1, 2010: *Economies of (Ratings) Scales Part 1*
January 22, 2010: *A Centralized Solution*
January 8, 2010: *"Gaming" the Ratings System, or the Observer Effect*
September 14, 2009: *Special Report: First Steps Toward Real Rating Agency Reform*

Relevant Regulatory Submissions

August 31, 2010: *Response to FDIC, FRB, OCC, OTS's "Advanced Notice of Proposed Rules (ANPR) on Alternatives to Use of External Credit Ratings"*

Related Credit Rating Postings

RatingsReform: www.ratingsreform.wordpress.com
Expect[ed] Loss: http://expectedloss.blogspot.com/search/label/Rating%20Agency%20Reform

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