



CreditSpectrum Corp.
3830 31st Street
Long Island City, NY 11101

February 22, 2023

Vanessa A. Countryman, Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

RE: File Number 07-01-23, Response to the Proposed Prohibitions against Certain ABS Short Sales

Dear Ms. Countryman:

It is my pleasure to respond to the Securities and Exchange Commission (SEC) request for comment on the proposed Prohibition Against Conflicts of Interest in Certain Securitizations. My name is Ann Rutledge. I am the founder and CEO of CreditSpectrum Corp. (2015) and predecessor firm, R&R Consulting (2000), both non-NRSRO rating agencies. I left Moody's Investors Service at the end of 1999 to address certain deficiencies in ABS ratings that later came into prominence as ABS became a traded instrument. From 2006 to 2019, my firm, led by myself and my co-founder, Sylvain Raynes, both Daubert-qualified experts, played a large and extensive role supporting many institutional investor and government agency plaintiffs seeking to recoup damages resulting from misleading NRSRO ratings on ABS, RMBS, ABCP and CDOs of RMBS, by providing interpretive guidance and reliable ABS ratings.

I am also the co-author of two scholar-practitioner books on ABS published by Oxford University Press; the consultant-builder of a 17-g-5 structured finance testing and training website for an NRSRO; a board member and head of the Education Committee for the largest U.S. trade association of structured finance investors, The Fixed Income Investor Network (FIIN); and a quoted expert on RMBS and CDO market microstructure in the Financial Crisis Inquiry Commission (FCIC) 2011 report.

All opinions expressed herein are my own.

As I understand the new Section 27B, it is designed to prevent the sale of ABS tainted by material conflicts of interest, whereby sell-side ABS transactors (underwriters, placement agents, initial purchasers, sponsors), or their affiliates or subsidiaries, attempt to structure deals unfairly vis-à-vis ABS investors ("conflicted transactions") without constraining short-selling for legitimate hedging, market-making, or liquidity provision purposes.

The proposal's protective mechanisms are the following—

- a) For a specified period, prohibit short selling that would result in a material conflict of interest between [an ABS buyer and seller];
- b) Define the persons subject to the rule;
- c) Define the ABS that would be subject to the prohibition; and
- d) Provide certain exceptions to the prohibitions

I believe the proposal will either stop all ABS short selling or do nothing. First, it is untested. Second, it appears to shift the burden of determining intent to the very people it is designed to protect or support. Third, it overlooks the design flaw in ABS market's microstructure at the root of the short sale problem.

The mechanism is untested

This proposal differs from other short-sale rules, which function as circuit-breakers so the market can respond to new information without bringing on chaotic, cascading sell orders. Having worked in exchange reform and ops prior to joining Moody's ABS teams, I am familiar with the benefits of typical short sale mechanics. Will this untested proposal deliver the desired result? I remain unconvinced.

The trigger is circular

Further to its untested nature, the proposal appears to define the criteria for determining intent while shifting the burden of identification to ABS investors and regulators: the very parties it is designed to protect and support. In practice, if we expect sell-side institutions to initiate actions, nothing will happen because self-interest dictates that they will do nothing. If it works at all, but ABS investors and regulators cannot discern intent, short selling will shut down without regard for the paper exceptions.

Shutting down ABS short-selling would not be in the best interest of ABS market development. Half a century of empirical market studies tend towards the conclusion that controlled short selling is healthy for market order, stability, liquidity and informational symmetry. However, the ruling would inevitably end ABS short sales, not just because of circular logic but because all ABS shorts are inherently biased to one side or the other, regardless of the intent, for reasons spelled out below:

The symptom is not the cause

What is essential for a market with short selling to be fair is that the long and short positions cancel out. In stock, commodity and derivative markets, this condition is fulfilled automatically because prices move symmetrically in a Wiener process (random-walk) fashion.

For stocks, the short (seller) borrows the shares to be shorted, places a short sale order, and buys them back—ideally at a lower price. For derivatives, the short sells an exchange contract on margin and eventually reverses the short with a long position or delivers spot at termination.

Shorting fixed income instruments is trickier because they are nonstandard: their intrinsic value varies considerably. Further, ignoring the impact of changing rates, fixed income has downside but no upside. Payoff and informational symmetries between longs and shorts are not organic. They must be curated.

The contract market in Treasury Bond futures with physical delivery (cash bond delivered against an open long position at termination) is an outstanding example of a curated market. In the original market design, sellers took advantage of the cheapest-to-deliver (CTD) option. They made money by delivering instruments of lower value against the future. That should not have happened.

But no one criminalized CTD traders for trying to make an extra buck from a market design flaw. The Chicago Board of Trade owned the flaw. Their fix was a system of conversion factors to match each bond with the future. Later, futures markets bypassed the CTD problem altogether by replacing physical with cash delivery.

Herein lies the real problem for ABS short selling in my view. As a buy-and-hold market, ABS superficially resembles corporate bonds, but when it comes to secondary market valuation, despite the shorter term structure and credit risk, ABS securities are much closer to T-Bond futures. The intrinsic value of ABS and the price of T-Bond futures each depend on the behavior of a large number of contractual parties over time. They are directly influenced by time value, which is maximal in the primary market but decays with seasoning. If there is price symmetry, the risk decay process allows spot and futures prices to converge.

In ABS, the market relies on credit ratings as convergence factors, but they are a poor substitute. They are non-analytic for legacy reasons: opinions, not measures. The dollar value of the risk implied by a credit rating in relation to the three criteria of the proposal—seasoning, issuers (*persons subject to the rule*) and assets (*ABS subject to the rule*)—will vary widely between NRSROs. Gross inconsistencies were there all along, but they became explicit and obvious with synthetic replication and re-securitization. CTD traders piled in, as they had for early T-Bond futures, for the arbitrage (see Annex I).

Logically, mechanism a) seems exactly backwards: the reference rating for a swap doesn't change after origination, but most credit rating agencies will update tranche ratings periodically. Therefore, basis risk between spot and derivative ABS contracts is real. The passage of time exacerbates it. Few if any shorts will be true hedges, even if such were the intent. And as a matter of fact, the only properly hedged ABS is one where the ratings are updated in real time on both legs of the hedge. Only then can markets price appropriately and rationally for risk decay.

Why focus on the cause?

I strongly believe that NRSROs own the ABS short-selling problem, just as the CBOT owned the physical delivery problem. And while I understand the below temptations for addressing symptoms, namely—

- (1) **EXPERIENCE:** Markets encounter similar problems at similar stages of development. But the deep and constructive cross-market dialogue that would enable the stewards of America's formidable capital markets to learn best practices from one another has not taken place; and
- (2) **INERTIA:** The NRSROs are under no pressure to upgrade their ratings to bona fide risk measures because they are immune from litigation so long as ratings are treated as opinions; and they are immune from competition. They need an incentive to own, and fix, the problem of credit ratings that fail to respond to risk in the true financial sense of volatility.

—there has never been a better time than the present to fix the real problem, make short-selling work, and give the market a push for better resilience in an era of rising interest rates and widening spreads.

In sum

I believe the practical effect of Section 27B will be to stop all ABS short selling, and I believe this outcome is suboptimal for the ABS market for the following reasons:

- a) In general, short selling with circuit-breaker mechanics is good for capital market efficiency;
- b) ABS short selling doesn't work due to a pervasive design problem rooted in antiquated credit ratings that cannot support market completeness to the same degree as achieved in exchanges;
- c) The essential non-rule based system for exchanging structured debt is not only a latent system risk but also an invisible barrier to capital circulation and financial equitability; and
- d) Given that, from 1972 to 2008, the United States was the unquestioned global leader in financial innovation, our legacy and strategic self-interest will be better served by making our markets deeper and more liquid than with rules that constrain their future growth potential.

As the head of a woman-owned free-market rating agency who has spent the past 44 years working in markets, I am unabashedly pro-market and pro-fairness. I believe these two good goals are compatible, and the U.S. is very fortunate to have the enlightened leadership of Chairman Gensler, whose cross-market experience uniquely equips the SEC to lead forward-looking structural change in the ABS market.

Sincerely,



Ann Elaine Rutledge
CEO, CreditSpectrum Corp.

Annex I: Risk Decay Illustrated

The table below illustrates the lagging ratings problem using the 1980s S&P factor method, which defines the rating as a simple ratio of contingent capital available to each tranche (“Credit Enhancement”) divided by the estimated total principal loss on the collateral pool (“Expected Loss”), such that a 5x coverage defines AAA, 4x coverage defines AA, 3x coverage defines A, 1.5-2x coverage defines BBB, and below 1.5, the ratings dip into non-investment grade territory. We used this rating method in several successful expert mandates because it is simple to understand but sufficiently responsive to reflect rating dynamics with amortization and time decay.

Below are two treatments of a simple A-B structure where the collateral (undefined) terminates in 24 months. The left case (gray) shows what happens when the realized loss is about equal to the Expected Loss (EL=2%). The right case (pink) shows what happens when the realized loss is considerably higher. In this case, the Class A has a 93% advance rate and 7% subordination. Both classes have 3% Total Excess Spread (XS=the difference between the collateral earning rate and the weighted average capital structure funding rate x the Average Life, AL). The waterfall is sequential. Class A repays at month 15.

At closing, Class A is AAA: 10%/2% = 5x coverage. Class B is BBB: 3%/2%=1.5x coverage. But note that Class B credit quality changes automatically. Where EL is properly assessed, the rating should move up from BBB to BBB+ in month 14, and more rapidly, to AAA, after the Class A is retired. Where the EL estimate is too low, Class B quality slips in month 5. Principal is lost before the half-life, at month 11.

Note that the ABS microstructure problem is completely described in this table without introducing the complicating factor of synthetic short sales with CDS. If this potential arbitrage problem is nipped in the bud, there is no informational reason for the market to form short positions with CDS—though equally there is no harm if the ratings are refreshed inside the CDS—because asset managers now have enough real-time risk information to price ABS symmetrically based uniform quality standards, so that long and short positions cancel out, just like in bond futures markets.

T	Loss Curve (Blue)	CE-B	CE-A	Updated REL	Updated RF_A	Rating_A	Update RF_B	Rating_B	Actual Loss Curve (Red)	Actual CE_B	Actual CE_A	Updated REL	Updated RF_A	Rating_A	Updated RF_B	Rating_B
0	0.00%	3.00%	10.0%	2.00%	5.0	AAA	1.5	BBB	0.00%	3.00%	10.00%	2.00%	5.0	AAA	1.5	BBB
1	0.07%	2.93%	9.9%	1.93%	5.2	AAA	1.5	BBB	0.33%	2.67%	9.67%	1.93%	5.0	AAA	1.386	BBB
2	0.10%	2.90%	9.9%	1.90%	5.2	AAA	1.5	BBB	0.44%	2.56%	9.56%	1.90%	5.0	AAA	1.346	BBB
3	0.13%	2.87%	9.9%	1.87%	5.3	AAA	1.5	BBB	0.58%	2.42%	9.42%	1.87%	5.0	AAA	1.292	BBB
4	0.17%	2.83%	9.8%	1.83%	5.4	AAA	1.5	BBB	0.77%	2.23%	9.23%	1.83%	5.0	AAA	1.220	BBB
5	0.22%	2.78%	9.8%	1.78%	5.5	AAA	1.6	BBB	1.01%	1.99%	8.99%	1.78%	5.1	AAA	1.121	BBB-
6	0.29%	2.71%	9.7%	1.71%	5.7	AAA	1.6	BBB	1.31%	1.69%	8.69%	1.71%	5.1	AAA	0.988	BB
7	0.37%	2.63%	9.6%	1.63%	5.9	AAA	1.6	BBB	1.69%	1.31%	8.31%	1.63%	5.1	AAA	0.824	B
8	0.48%	2.52%	9.5%	1.52%	6.2	AAA	1.7	BBB	2.14%	0.86%	7.86%	1.52%	5.1	AAA	0.630	B
9	0.59%	2.41%	9.4%	1.41%	6.7	AAA	1.7	BBB	2.67%	0.33%	7.33%	1.41%	5.1	AAA	0.406	CCC
10	0.73%	2.27%	9.3%	1.27%	7.3	AAA	1.8	BBB	3.28%	-0.28%	6.72%	1.27%	5.1	AAA	-0.065	CC
11	0.87%	2.13%	9.1%	1.13%	8.1	AAA	1.9	BBB	3.93%	-0.93%	6.07%	1.13%	5.1	AAA	-0.227	D
12	1.03%	1.97%	9.0%	0.97%	9.2	AAA	2.0	BBB	4.62%	-1.62%	5.38%	0.97%	5.1	AAA	-0.409	D
13	1.18%	1.82%	8.8%	0.82%	10.8	AAA	2.2	BBB	5.31%	-2.31%	4.69%	0.82%	5.1	AAA	-0.605	D
14	1.33%	1.67%	8.7%	0.67%	12.9	AAA	2.5	BBB+	5.97%	-2.97%	4.03%	0.67%	5.1	AAA	-0.808	D
15	1.48%	1.54%	8.5%	0.54%	15.8	AAA	2.9	A-	6.57%	-3.57%	3.43%	0.54%	5.1	AAA	-1.010	D
16	1.58%	1.42%		0.42%			3.4	A+	7.11%	-4.11%	2.89%	0.42%	5.1	AAA	-1.200	D
17	1.68%	1.32%		0.32%			4.1	AA	7.56%	-4.56%	2.44%	0.32%	5.1	AAA	-1.489	D
18	1.76%	1.24%		0.24%			5.2	AAA	7.93%	-4.93%	2.07%	0.24%	5.1	AAA	-1.784	D
19	1.83%	1.17%		0.17%			6.9	AAA	8.24%	-5.24%	1.76%	0.17%	5.1	AAA	-2.084	D
20	1.88%	1.12%		0.12%			9.6	AAA	8.48%	-5.48%	1.52%	0.12%	5.1	AAA	-2.388	D
21	1.93%	1.07%		0.07%			14.4	AAA	8.66%	-5.66%	1.34%	0.07%	5.1	AAA	-2.696	D
22	1.96%	1.04%		0.04%			24.4	AAA	8.81%	-5.81%	1.19%	0.04%	5.1	AAA	-2.998	D
23	1.98%	1.02%		0.02%			55.2	AAA	8.92%	-5.92%	1.08%	0.02%	5.1	AAA	-3.294	D
24	2.00%	1.00%		0.00%			1000000	AAA	9.00%	-6.00%	1.00%	0.00%	5.1	AAA	-3.584	D

Annex II: The Inadequacy of Credit Ratings as Convergence Factors

The table below shows the weakness in ABS infrastructure revealed through Moody's bond default data for the period 2006 – 2016, as self-reported on Form NRSRO. Results are similar for S&P and Fitch.

Bond default studies are required disclosures under Dodd-Frank. It is very good that we have these self-reports made publicly available under oath. Yet for the most part, their meaning has been left to the market to interpret. I share the results here since, in my experience, few market participants in fact actually read Form NRSRO.

Pairing the idealized bond default numbers (claims or Norms, second column) with empirical experience offers the deepest insight available on capital efficiency in credit markets. Credit ratings that function well as “conversion factors” are those in which ideal and empirical numbers are closely matched.

But below, the realized default percentages wildly exceed the claims. An extraordinarily large number of ratings have been withdrawn. I have not been able to find time series data on ABS CDS to overlay on this analysis, but this smoking gun tends towards a conclusion that “conflicted transactions” are only a symptom of a more fundamental market design problem, which will not disappear without explicit work on modernizing the market's microstructure for secondary market trading and hedging.

Ratings	Ideals	Corporate			Structured									
	Norms	Banks, Broker Dealers	Insurers	Corps	Defaults					Withdrawals				
					CLOs	CDOs	ABS	RMBS	CMBS	CLOs	CDOs	ABS	RMBS	CMBS
Aaa	0.01%	0%	0%	0%	0%	16%	0%	22%	1%	29%	13%	37%	54%	25%
Aa1	0.1%	0%	0%	0%	0%	11%	0%	52%	5%	27%	1%	46%	38%	5%
Aa2	0.2%	1%	2%	0%	0%	25%	0%	38%	9%	16%	4%	35%	61%	10%
Aa3	0.4%	1%	1%	0%	0%	15%	1%	50%	10%	20%	38%	42%	56%	8%
A1	0.7%	6%	1%	0%	0%	12%	1%	58%	9%	18%	29%	49%	61%	7%
A2	1.2%	5%	1%	0%	0%	36%	1%	52%	15%	22%	6%	36%	47%	9%
A3	1.8%	3%	0%	0%	0%	38%	5%	64%	21%	29%	33%	33%	43%	5%
Baa1	2.6%	9%	0%	0%	0%	14%	6%	68%	26%	25%	50%	56%	47%	5%
Baa2	3.6%	4%	0%	1%	1%	46%	2%	68%	24%	24%	9%	31%	54%	9%
Baa3	6.1%	8%	0%	1%	3%	27%	4%	78%	33%	32%	10%	49%	38%	5%
Ba1	9.4%	20%	0%	11%	11%	45%	1%	84%	43%	36%	11%	32%	40%	5%
Ba2	13.5%	16%	0%	8%	2%	23%	6%	79%	45%	36%	6%	35%	49%	9%
Ba3	17.66%	5%	6%	7%	15%	16%	10%	58%	51%	36%	27%	40%	67%	16%
B1	22.2%	8%	0%	16%	0%	11%	13%	49%	61%	40%	100%	43%	57%	14%
B2	27.2%	30%	0%	19%	40%	10%	23%	77%	62%	38%	0%	55%	49%	13%
B3	34.9%	23%	0%	22%	50%	25%	13%	50%	70%	40%	50%	46%	48%	11%
Caa1	65%	0%	0%	30%	100%	32%	43%	37%	70%	45%	0%	37%	29%	27%
Caa2		0%	0%	49%	40%	29%	6%	48%	76%	27%	40%	46%	25%	18%
Caa3		0%	0%	69%	0%	36%	47%	63%	87%	19%	0%	12%	27%	5%
Ca	-	0%	0%	33%	100%	54%	61%	41%	81%	67%	0%	20%	16%	16%
C	-	0%	0%	0%	75%	65%	68%	69%	76%	100%	25%	19%	6%	8%