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Subj: comments in response to S7-04-09

Hi,

I'm responding to the document published at

<http://www.sec.gov/rules/proposed/2009/34-59343.pdf>

34-59343 Feb. 2, 2009 Re-proposed Rules for Nationally Recognized  
Statistical Rating Organizations File No.: S7-04-09 Comments Due: March  
26, 2009 Federal Register version Submit comments on S7-04-09

I would like to express my general support for any mechanisms that allow the public to act rationally and to reiterate a few specific comments on the facilities I think would best aid this objective. This RFC's first concern is publication of NRSRO rating history[7]. I generally support the ideas being proposed in this area and encourage the concept to be expanded as mentioned in item "7" below. However, I have focused on the issues surrounding this topic,

"The Commission is re-proposing for comment an amendment to its conflict or interest rule that would prohibit an NRSRO from issuing a rating for a structured finance product paid for by the products issuer, sponsor, or underwriter unless the information about the product provided to the NRSRO to determine the rating and, thereafter, to monitor the rating is made available to other persons."

as they concern ability of the public to anticipate broader results rather than just react to the success or failure of a recognized group's prediction.

The public needs access to material input data regardless of its usage by any given NRSRO or other special entity and presumably the existence of suitable data access facilities would largely eliminate the need for "secret knowledge"

by credible rating agencies. At least in the case of real estate linked products, it would seem that anyone buying a home could potentially want the same input data as a rater of a mortgage related security( with the exception of some issue or issuer-specific information which presumably would be revealed at nominally the same time in issuer SEC filings, including prospectus filings or Regulation-FD as per discussion in RFC[7]). Making this information available a priori rather than in reaction to its usage by a particular rater would probably create a more comprehensive solution although demand by a recognized rating entity could help populate a list of data types which should be available to the general public either in independent databases or in issuer SEC filings at nominally the same time. Ideally, any rater should be able to implement their rating scheme without intimate knowledge of the issuer beyond what they can get from public databases or maybe "advance copies" of issuer filings. Specific classes of "revealed secret information" should be rare and would have to be carefully examined.

Probably the easiest way to motivate my comments is to consider the stronger but analogous question, " Would you allow, given what you know about human behavior, a private 'recognized' group to state that a drug is safe and effective for a given indication based on private data? "

Some of the specific regulatory and information needs differ between drugs and credit PRODUCTS but the concerns with context, conflicts, and errors are quite similar. A doctor or patient seeking to achieve some objective would need credible information about both disease and various drug products. Drug trials require data that is both specific to the drug and more general data about the control population that did not get the drug and even extending to issues related to the theoretical concerns about the drug or disease. With financial products, marketed to people trying to achieve financial objectives, you may not have controlled trials but you do need specific information about that product ( which homes are being used as collateral, what is the condition of the issuer, etc) as well as the more general context ( what does the surrounding economy look like now and in the future etc). If you only require that the NRSRO reveals security-specific information, you still can not put their claims into the larger context.

Financial product analysis is complicated by the objective of predicting the future, making it less likely that definitive results can even be obtained by a single party and more likely that self-serving assumptions can be made by a "qualified" party. A requirement for the publication of input data either from a specific NRSRO or a central database, not just model output, in a machine readable format with a vendor neutral retrieval API will facilitate the most analyses by the widest range of competent users and help keep markets efficient. Note that "efficient market" is not just an issue with money as economic signals are supposed to guide concrete actions. More accurate feedback on home valuations may have decreased capital flow into home builders and served to reduce the construction of useless homes. Publication expense is minor once a software standard has been adopted and the investment is paid back by the compelling public benefit from this information.

Reasonable concern is noted for the financial health of involved parties, for example,

"The Commission recognizes that releasing information on all ratings actions could cause financial loss for some firms. For that reason, the proposed amendment would provide that a ratings action need not be made publicly available until twelve months after the date of the rating action."

but input data monopolies ( not the value additions of proprietary models which may even contain innovative and protectable intellectual property of considerable utility ) mostly protect companies or products of no economic value ( would you let a placebo stay on the market for 12 months to protect against "financial loss?" ). Note that I am NOT suggesting a rating group spend effort and money collecting and analyzing data only to have it be given away freely. Please see my comments in [1] and [2] suggesting that much of this input data should be public for additional reasons, including allowing the home buying public to arrive at reasonable home price estimates free of many external biases. None of this would preclude the use of additional proprietary data by a rater but you still need to consider the problems in publishing "marketing claims" resulting from secret methods.

Apparently the publication concept has generated some controversy in the past,

"The intent behind the proposal was to provide the opportunity for other persons such as credit rating agencies and academics to perform independent analysis on the securities or money market instruments at the same time the hired NRSRO determines its rating[...]The Commission received 38 comment letters that addressed the Rule 17g-5 proposal on June 16, 2008.<sup>4</sup> While some commenters expressed support for it,<sup>5</sup> the majority of commenters raised significant legal and practical issues with the proposal.<sup>6</sup> The Commission is re-proposing the amendment, with substantial modifications, to solicit further comment. "

and the immediate problem is best illustrated with problems valuing mortgages,

" The proposed amendments were designed to address concerns about the integrity of the process by which NRSROs rate structured finance products, particularly mortgage related securities. Today, in a separate release, the Commission is adopting, with revisions, a majority of the proposed rule amendments.<sup>2</sup> In addition, in this release, the Commission is proposing ..."

The real estate and mortgage industries have few public disclosure requirements for input data needed to value a given transaction. Industry incentives favor optimistic valuation and the large transaction volumes which can be generated from bubbles. There are few, if any, government computer facilities to let the general public get material information. I would suggest that there is a causal link between lack of public information and the current central role for mortgages in our economic crisis.

These issues will be more critical in the coming years as the historical demographic pyramid<sup>[14]</sup>, which has supported many optimistic valuation models and shaped industry attitudes for a generation, begins to deteriorate( often mentioned as the end of a "Ponzi Scheme" in critical commentaries). Historical observations and statistics, and even "track records" for issuers and raters, which can be used glibly for models when they are advantageous, will have questionable value predicting the performance of various financial products IN THE FUTURE and will need to be critiqued by many people.

Probably the most concise way to state my concerns is by enumerating them in no particular order as I have done in the past [1-3],

1) The term "credit addiction" <sup>[6]</sup> sometimes comes up in the popular press and it suggests that credit is similar to a drug. In fact, the information related issues make drugs a good source of observations and analogies. Much of the scientific and business-relevant drug product information is available free to anyone online and yet people in these industries are still paid. It seems that the need to couple scientific efforts, which generally involve people who are quite candid, with the business interests of actually delivering healthcare, has generated some useful product information resources(<sup>[5]</sup> ,to a lesser extent <sup>[8]</sup> which provides clinical result data but not in a machine-readable, vendor- neutral manner suitable for automated analysis. Perhaps the FDA should take note of XML in preference to allowing scanned PDF submissions ). Legitimate business interests don't require the kind of product-related secrecy that many advocate.

Plenty of precedents exist for mechanisms to protect financial interests in intellectual property with public disclosure and perhaps some of the those familiar to industries with "real products" could be applied to real estate and "paper or plastic" products. If your products are financial, then you need to reveal financial information to let others assess your putative claims.

2) Much of the most material information about a financial product relates to the issuer's industry and is not issuer or issue specific. The public derives many benefits from this general information, presumably it would be material to an NRSRO, and the SEC can provide incentives to make it available. You could argue about the specifics of this concern from industry to industry ( who should pay for and be entitled to access of what information ) but for real estate, where various government agencies already have the information and the bulk of Americans buy homes, it makes good sense to publish it freely. The RFC explicitly references mortgages as being a problem. Much of the data needed to value the securities and underlying collateral or primary residence for the owner exists but it is just not available from public sources. A solution to this problem would need to involve many groups including the IRS, census, and real-estate related local records offices who regulate access to everything from building permits to foreclosure actions. Any SEC action which helps to publish this information in a uniform manner would be welcome. These, like all data types, need to be available in machine readable, vendor-neutral format with an API for automated programmatic access. The SEC itself already offers [13] which would be a good model for business related data if it offered the automated features presented in [5] with the required real-estate related data to let others value mortgage credit products. There is no reason to give a few select ratings entities access to information if government agencies already have the information and an individual needs the same information to decide on buying a home. Perhaps if the SEC could shutdown mortgage securitization in the absence of this data, it could achieve the desired result.

3) Any information available on a website ( from NRSRO, issuer, SEC or other filer ) needs to be vendor-neutral, machine-readable with defined access methods or a standard "API" that can't just assume Internet Explorer as the retrieval tool. There is a bias among many people to assume that a human will be the immediate consumer of data and will be using a Microsoft product to graphically examine artwork in one of the formats dictated by the web designer and software vendor. Note that this problem even exists within technical communities [3]. There are other tools available for more flexible information processing that need to be expressly accommodated in any rules which require the publication of data. A machine readable format like XBRL ( XML) can not be fully utilized without automated mechanisms for retrieval with versatile tools not constrained by commercial software vendors' predictions of "what a user should want to do." The SEC XBRL viewer source code ([9]) included Windoze DLL's which serve as a useful example but can't be the only way in which someone could implement a filing manipulation tool ( I can't resist, "Because it's everybody's business" [18] ) . Rejecting "visual" submissions such as scanned PDF files in favor of XML is a good start but the entire information life-cycle needs to be automation friendly.

4) The full extent and implications of interest conflicts are difficult to determine and this difficulty needs to be repetitively acknowledged as it creates very insidious problems. Any justification for secrecy needs to fully account for the inherent problems in using assumptions to predict the future while harboring specific biases that can guide the choice of those assumptions.

Secret revelations would be more appropriate for the illegal "penny stock pump- and-dump newsletters" [15] than organizations with national influence or some particular legal recognition. The latter would be expected to compete based on accurate analysis offered to clients, not on private, revealed knowledge.

5) We do need input data, not just model output, and it should not be available solely as a reaction to demand by NRSRO other blessed groups. Models are often later found to have bugs or can otherwise conceal unsound practices. Data is generally the result of a low-ambiguity measurement while a model produces derived quantities normally using computer code for rules or laws and other data of unknown validity. Level 3 assets are often suspicious ( see [10] for example), there is no need to allow special entities to make influential "marketing claims" for securities using private data and similar methods. As one example, consider the situation with MCO's attempt to blame an ill-defined "bug " [19] for inflating ratings, producing more comedy than actionable information ( how to correct or prevent in the future). In fact, the account in [11] (Bloomberg on May 21,2008 citing FT, sorry I don't have time to track down original sources ) suggests assumptions were changed simply to "fix" the problem,

"Moody's altered some assumptions to avoid having to assign lower grades after it corrected the error, the paper said. "

a claim which apparently MCO refuted. There is no reason to trust recognized parties or argue in the absence of data when it is so easy to reproduce or at least sanity-check their valid claims. Rather than have specific rules on disclosure from specific rating entities, we need a more general facility for making the relevant information public either through industry-specific databases or issuer filings.

6) A consideration of financial impact needs to explore the economic value of existing companies. [7] is rightfully concerned with the economic impact of any rules the SEC makes. However, a decision needs to be based on the economic value a given entity contributes and not just on how much money circulates through it.

Indefensible optimism, fraud, and gnosticism[17] do not appear to create positive economic value. While rule making should not be a way of inflicting "value judgments" upon the nation, or a taking of intellectual property, any concern about the income potential of entities effected by data disclosure needs to be carefully considered against the net impact of their business on everyone else. You wouldn't let a drug company sell placebo out of concern for financial impact on the manufacturer, baseless claims for products of no value are no different with financial products. Certainly the publication of factually accurate information can do no economic harm, the only question would be how much time and effort and other resources are needed to make it available while preserving any economic rights associated with it. While you are worried about paying a webmaster

\$200/hr, other people are writing \$700 billion checks for unknown ultimate recipients.

7) The NRSRO's are not unique within the financial product arena and "track records" or similar information would be helpful for "financial adviser companies" that present themselves as offering valuable investment advice to naive clients in a one-on-one setting while having various conflicts. Company or individual adviser track records are analogous to those for drugs or other products with important utility or safety concerns. You wouldn't let a drug company make marketing claims for an uncharacterised drug when you could quantify efficacy and side effects, claims regarding financial services are no different. You could even consider documenting success in giving advice or ratings in "controlled trials" before allowing a group or person to give "recognized" advice or opinions to the public. Controlled trials prior to "recognition" would not demonstrate an ability to resist interest conflicts which are only found in the "real world" but a statistically significant decline in fortune telling ability may reflect a response to interest conflicts. For automated models, double blind tests against SEC datasets would not be unreasonable to consider.

8) Personally, I am very much against government interference in any decision making process and cumbersome regulation. The creation of any special group such as a NRSRO or a licensed adviser always creates new regulatory issues. In general, I would advocate a position such that the government works against fraud and ignorance while not making decisions for people. Official recognition amounts to a government decision that this person or that person can be trusted but there is no reason to trust when many Americans can now verify with minimal incremental costs. A requirement for a public "track record" is always helpful when a product is advice to a non-expert audience. While controlled trials are not always possible for the "fortune telling" required of rating groups, most other ideas used for regulating "real" products are directly applicable. Most of these ideas depend on free access to industry-specific product-relevant data. Disclosure requirements for financial products should be similar to those that would apply to tangible products such as drugs or asbestos or tobacco.

As a computer programmer who makes some effort to make sure my products work, I am insulted by claims from organizations about programming errors that caused them to grossly flatter their clients' products for extended periods of time.

Even if you aren't designing autopilot code or controlling life support systems, unless you have very limited resources, you at least sanity check your results.

There is no legitimate basis for paying these special people and giving them special access to data unless they can contribute unique value additions.

Independent replication of their claims earlier could have prevented many problems due to "errors" for which they were well paid.

I am generally happy to see that the SEC is pursuing these disclosure ideas ahead of some related industries like real estate. However, there are some useful ideas from unrelated industries like drugs which may be helpful to consider.

Thanks .

## References

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