CreditSights

July 29, 2008

Ms. Florence Harmon
Acting Secretary
U.S. Securities and Exchange Commission
100 F Street N.E.
Washington D.C. 20549-1090

Re: Proposed Rules for Nationally Recognized Statistical Rating Organizations
File No. S7-13-08

Dear Ms. Harmon:

CreditSights appreciates the opportunity to provide comments to the Securities and Exchange Commission on the Proposed Rules for Nationally Recognized Statistical Ratings Organizations ("Proposed Rules"). CreditSights operates an investor-pay research firm with well over 800 institutional clients and over 6000 subscribers across those institutions. Our firm has been an advocate of lowering the artificial regulatory barriers to entry for new NRSROs for some time, and since 2002 we have testified on the topic before the Senate, House, and the SEC on multiple occasions. To date we have never applied for NRSRO status.

Our view on the evolving NRSRO rules remain rooted in convictions we have developed as a firm that are shared by many of our employees who have worked in the commercial banking sector, in the securities industry, and in asset management, and who have observed how the rating agencies operate as a critical link in the underwriting chain. In fact, the credit rating agencies have come to be the most powerful and pervasive parts of that chain and have been, in substance, totally unregulated and completely unchecked. The significance of the Proposed Rules is far-reaching, but much of the debate still has not zeroed in on the needs for greater access to the information that will allow competition to develop and allow for greater transparency in the marketplace. If the main result of the Proposed Rules is that some process guidelines and behavioral safeguards and conflict-of-interest checks are put in place with some enhanced disclosure around methodologies, the Proposed Rule will have been in substance a relatively minor "administrative tax" for bad behavior. If all that comes of the Proposed Rules in the end is just some process changes, the NRSROs will be quite relieved. The marginally higher "cost of doing business" is a minor factor to a dominant oligopoly with outsized profit margins and is more likely to deter competition than inspire it. The dominant agencies will most likely just pass the cost on in pricing.

The real challenge is creating a level playing field for information and document disclosure for the underlying pools of assets that will foster less conflicted ratings in the structured finance space and allow more firms to deliver value-added products to investors. The crisis created out of the subprime debacle is the first stage of a multi-year challenge to sort through the downside risks of an unbridled origination cycle. On the horizon is the next crisis in the form of structured products with leveraged loans, high yield bonds, and credit derivatives serving as the underlying assets. Much more focus has to be directed toward making it possible for more intensive analysis to be done in the NRSRO framework, including by new competitors that did not create the problem in the first place. That will only be possible to the extent all NRSROs can gain access to the information that they currently are prevented from gaining while the two key links in the chain—the incumbent NRSROs and the underwriters themselves—maintain control over that data. Most of our comments below are directed toward the general topic in the Proposed Rule about

disclosure and the availability of information for new NRSROs. In our view, the immediate challenge is ongoing risk surveillance of the recent wave of structured products placed in the market this past cycle. To the extent that is made impossible due to disclosure limitations and the failure of the Commission to act on this problem, the foxes will remain the guards in the hen house.

As we comment on how the Proposed Rules will influence the current market reality, the comments we make below are rooted in the following beliefs born out of our experiences:

- **Barriers to entry remain daunting for any new NRSRO**. The artificial regulatory barriers to entry have had the economic effect of entrenching the incumbent rating agencies in all aspects of the underwriting chain in the past few decades. That dominance has extended to the imbedding of the "brand" Moody's and S&P across loan agreements, mutual fund prospectuses, and pension investment parameters to name just a few. So the moniker "NRSRO" is just a part of the picture. Despite any new rules that are proposed and new entrants that may come into the space, the incumbent agencies' dominant position is unlikely to be whittled down for some time. With respect to the Proposed Rules, it is critical to see that without more transparency and access to data on a non-discriminatory basis, there is virtually no hope for any meaningful competition in the structured product and loan markets. That fact of that ongoing dominance—if allowed to go unchecked by the failure to establish more open information channels—will inherently reduce the diversity of views, reduce alternatives for investors, stifle innovation, and constrain capital inflows into the ratings industry. Given the NRSROs' role in rating the structured products that have put an estimated $1 trillion hole in the balance sheet of US banks and brokers, we believe that the SEC has a strong interest in bringing some new voices to the table and attracting capital to the effort.

- **The risks of such an industry structure have never been greater**. As the market moves toward restoring confidence in the securitization markets, some additional and burgeoning disasters from CMBS to CLOs to synthetic CDOs potentially loom. These will require a much higher level of information content than some of the incumbent NRSROs will look to provide given the legal and regulatory prism through which they may view their output and reevaluation of past criteria. Structural change that brings higher levels of information value apart from a few more assigned alphanumeric ratings from a few more NRSROs really should be the end goal of policy initiatives. The systemic risks we have seen in subprime are certainly mirrored in other credit structures that have a longer gestation period to stress. As the default cycle continues to approach what could be record default rates in coming years, the need for more disclosure and more organizations weighing in will only get more pressing. If they are not armed with the same data and information as the NRSROs, they will not be able to compete.

- **Data, detail, and documentation are critical**. Whether it is mortgage-based structured product, corporate-credit-based structures or asset backed commercial paper, any NRSRO should have access to the same pool of data and documents that the incumbent NRSROs have. That does not extend to confidential meetings with management, but at the very least the underlying data points required to form an opinion on structural risks and potential loss exposure should be made available. The idea that such a process would be too costly is ludicrous in this age of advanced technology. The new NRSROs that receive such information access could be governed by all the same rules of confidentiality as any investor (e.g. bank loans) or current rating agency, so the "proprietary and confidential" red herring should be dismissed as just that.

- **The debate is also around disclosure on legacy deals, not just new issue**. In an increasingly complex market that requires more focus on credit risk surveillance than we have ever seen in the modern credit markets, greater transparency around the *legacy deals* placed in the market will be every bit as important as new issues and new underwritings.

Accordingly we would recommend that the Commission make every effort to bring much more transparency and broader documentation availability to promote more intensive analysis of the outstanding structures and bring a level of focus on these deals that will promote more critical thinking around valuation and relative risk.

- **Reform will not come easy and resistance will remain high.** Obstructionism by the entrenched NRSROs, the underwriters, and their daisy chain of law firms and trade group allies will remain a barrier to change. They will attempt to water this Proposed Rule down to some partially symbolic behavioral and reporting requirements that will be viewed as a cost of doing business. We saw the desire to stall competition in structured finance when the structured finance asset class was carved out of the Credit Rating Agency Reform Act as the incumbents sought to slow competition entering their highest margin business. Of course the lack of critical analysis in the structured finance part of the asset class has now led to arguably the worst financial crisis since the Great Depression and a massive increase in systemic risk. We also believe that the incumbent NRSROs will use all means to undermine greater access to the documentation and data under a range of guises that are all part of the process of restricting information flows and an attempt to resist transparency.

  The NRSROs that rated past structured finance deals and the underwriters and banks that traffic in them will look to narrow the availability of such information only to those that pay them for such access through trading volumes or ratings fees. Given the sharp retrenchment in staffing in structured finance areas, those same players will be looking to retain control of as much of that information as possible not only to develop their own ancillary revenue streams, but also to prevent more inroads by well-capitalized data and analytics companies.

  We have never viewed the evolution of the NRSRO space as being about a handful of boutiques being "let into the club." Competition will be driven by a growing convergence of the efforts of boutiques, displaced personnel, and the major financial media companies and data providers. The incumbent NRSROs see the risks to their pricing power and supernormal profit margins in such an industry evolution and they accordingly worked very hard to get the 3-year holding period into the Reform Act as well as to lobby for the final legislation to carve out the structured finance business. Given the lack of access to data, the structured business was the hardest to enter with a viable product, so the instinct was to make sure the clock kept ticking for at least another three years. Market entry was more realistic in the corporate universe of issuers (industrials, bank and finance, insurance, utilities) and in sovereigns and municipals. That impulse to slow the development of competition is likely to be very much in evidence in the area of disclosure, data, and documentation.

"Information" is a critical linchpin to improving transparency and competition in the ratings business, and the current system is stacked against it.

The information required to rate and analyze the wide array of structured finance products and asset classes varies considerably. The more established structured asset classes include commercial real estate, residential mortgages, auto retail contracts, and credit cards. More off the-run structures (aircraft leases) can entail even more arcane disclosure and specialized data needs (including from third party vendors) to rate structures effectively.

Some of the more critical challenges today can be found in corporate-based structures and notably those that have packaged cash or synthetic structures using loans, high yield bonds, or credit default swaps. With the default cycle approaching a critical inflection point and most likely heading toward record default rates in coming years, the time to lay down more disclosure and document requirements is *now*, and the Proposed Rules could go a long way toward improving transparency in the market, upgrading the level of information content from new competitors, and promoting the next evolution of ratings products. That will require more specific and detailed follow-through by the commission on information and disclosure.

There are some basic requirements to effectively rate the full range of risks away from the relatively more straightforward metric of default risk. The next generation of ratings products will focus on recovery rate research, volatility scoring and related analytics, and will include an ongoing reevaluation of correlation risk across various macro conditions. Historical assumptions must be tested and retested. This positive evolution in ratings products requires analytics, intellectual as well as financial capital, and experienced professionals from the macro to micro level. Without disclosure, this innovation and competition will be stalled, and it is a safe assumption that the incumbent NRSROs will look to slow it down. After all, they seek to control that evolution and make the market a "price taker" from their seats in a concentrated oligopoly that had been protected by the regulatory framework for decades.

The credit boom has set the table for the next major crisis in CLOs and CDOs, and the time to make information and disclosure more available and risks more transparent is now

In the case of traditional corporates and commercial paper, at the very least public companies offer a wide range of information under SEC disclosure requirements and additional information under Reg FD. With respect to Reg FD, we would highlight that such reform was opposed by many of the same parties that will also look to water down the Proposed NRSRO Rules. In the case of Reg FD, there was an economic advantage to be derived from the Street having material advantages in extracting information based on their relationship power, and the parallel to what occurs among the agencies, borrowers, and underwriters is hardly contrived. The Proposed Rules could be a vehicle to promote many of the same goals fostered by Reg FD, since the closed information channels fostered by the underwriters of structured finance product and the incumbent NRSROs could be addressed in part. The investing public—from institutional investors to the retail investors that have suffered major losses in this current structured finance crisis—certainly deserve a level playing field. They also deserve more critical analysis from more objective, less conflicted sources.

Even for public companies, to extract information that rolls up into structured finance product is a problem. For private companies it is almost prohibitive. With public companies, there is some disclosure that is not available such as loan documents (in many cases) and private placements. These documents are often available to investors and always to the underwriters and incumbent NRSROs to the extent they are rated. In the case of private corporations (notably leveraged loan issuers in LBOs) or non-US corporations, the barriers to gathering information are much greater for newer NRSROs who were not part of the original issuer-pay arrangement (inevitably one of the Big Three but usually the Big Two of Moody's and S&P).

Problems in the leveraged loan and high yield market lurk as the next major threat. Specifically, the analysis and ratings of underlying assets and how those underlying credit exposures are rolled up into various cash and synthetic rated structures presents another major risk that the banks will face in various CLO and CDO transactions. That entire asset class deserves immediate focus as part of the Proposed Rule's disclosure requirements. The incumbent agencies possess massive amounts of data and documentation that were gathered to rate such deals, and we would question the level of rigor being applied to conduct surveillance on such structured finance products. The detailed underlying data on most structured finance deals is not available to other NRSROs but it is to investors in the products, the underwriters, or the agencies that rated them in the first place. New NRSRO's looking to enter the space cannot gain access to such private company or confidential information. The simple exercise of accessing a loan document can be a major obstacle and the same is true of gaining access to financial statements of the many private companies in such structures (led by the LBOs of the past credit cycle). The inability to receive ongoing updates filed with the rating agencies and/or with loan investors prevents additional NRSROs or investor-pay research firms from tackling many challenges in the structured finance and CDO/CLO markets.

This problem is mirrored in the lack of availability of updates on detailed line items within the CDOs and CLOs or additional detailed tranche information. The agencies have it, the Street firms

have it, and investors in the structures have it, but outside parties looking to build an investor pay model cannot gain access to it. There are several vendors who, through their alliances with the street and CDO managers, update and track the tranches. Those vendors either refuse to sell the information to aspiring NRSROs or only do so using highly discriminatory and punitive pricing that the underwriters and incumbent NRSROs do not face.

The closed information loop is part of an almost insurmountable barrier to entry in many asset classes with structured finance right near the top of the list

One of the natural barriers that have developed over time in structured finance includes what we call a "closed information loop" that cuts across numerous asset classes but most notably the CLO and CDO asset classes. This loop includes the major incumbent NRSROs and the underwriters and small group of major vendors that traffic in related database products including structured finance tranche data and securities pricing. Some of the vendors were started by the underwriters themselves in exchange for equity. The economic interests across this closed loop will dictate that they advocate the maintenance of as much of the NRSRO status quo as possible. Their responses will be both understandable and certainly predictable.

This small group of lead structured finance players and raters are a relative handful when framed against the broad global distribution of the highly rated structured finance products. We have all too painfully observed the breadth of their end market. That breadth was evident in the magnitude of the write-downs and the fallout in all ends of the market from intermediaries/banks/brokers to institutional investors to US State Pension Funds to investors in every state and municipality at home and abroad. This small group constructs and rates the vehicles and then they closely control how much information flow can be made available on the vehicles. When a market implodes on the order of magnitude we have seen, the downside to such a lack of transparency is even greater.

Proposed Rules and some Recommendations for Disclosure

We believe the Proposed Rules offer a far better solution to improving transparency, enhancing the ability of market participants to have access to more sources of input—and less conflicted sources—for their risk assessment needs. The Proposed Rules will arm investors and intermediaries with more information generated by research and ratings firms that do not stand to profit the most from the mere generation of a deal. Analytical second (and third and fourth) opinions can only benefit the market when the first opinion (the firm rating the new issue) is printing the issuer-based ratings fee that does not even exist without the deal. Of course the second opinion historically has come from the firm that prints the underwriting fee in the given structure (or in comparable structures they underwrite). That should hardly be the only other source.

To help promote the goals set forth in the Proposed Rules, we recommend the following information sources be made available broadly:

- **CDOs (regardless of underlying collateral asset).** We recommend full access to all CDO trustee reports and waterfall/offering documentation as well as disclosure of all CDO inputs into deal ratings. Most importantly, full access to all structure documents should be made available under the same terms and conditions as the issuer-pay NRSROs, the underwriting groups, and tranche investors. NRSROs should have access to financial statements of the special purpose entities on the same terms and conditions as those that rate the vehicles, the underwriters, and tranche investors. Currently potential NRSRO and investor-pay research firms are not granted access to cash flow waterfalls, offering documentation, or trustee reports either during deal construction or after the deal has been structured and placed. At the same time, a number of vendors more closely aligned with the underwriting process are able to gain such access, and the incumbent NRSROs have full access to structure documentation and trustee reports for various deals. The barrier to entry is thus absolute and

insurmountable and a function of the long-established “partnership” between the bulge bracket underwriting community (who after all, structure and help set up the issuing entities and distribute the securities) and NRSRO oligopoly.

- **CLOs' underlying loan collateral.** Potential NRSRO and investor-pay research firms are not granted access to Intralinks or SyndTrak on the grounds that agreements with issuing entities prevent that access. At the same time, a number of vendors more closely aligned with the underwriting process are able to gain direct or equivalent access to information, and the incumbent NRSROs have full access to loan documents and financial statements of leverage loan issuers than can be rated either on a single-name basis or as part of a CLO structure. The barrier to entry here is doubly insurmountable since not only the structure but also the underlying collateral cannot be analyzed outside of the bulge bracket underwriting community and NRSRO oligopoly.

- **General loan market data.** The Loan Syndications and Trading Association (LSTA), a nonprofit organization, uses the S&P/LSTA Loan Index (LLI) to track the performance of the leveraged loan market. S&P will not make the components of the index available to independent research providers on the basis that it is governed by agreements that do not allow such access other than to potential loan investors. We would not agree that closing off information on the benchmark leveraged loan index to existing or new NRSROs is in keeping with a fair, efficient, and liquid market that the LSTA has as its mission statement. Such data should be made available at the same cost or on the same terms to all market participants. Considering that the S&P/LCD service, which administers the LLI data, is distinct from the S&P ratings business, we would argue once again that the NRSROs use the artificial barriers of their entrenched position in ratings to establish new data operations and then in turn raise the natural barriers in the ratings business. Building database products to stack those natural barriers higher and allowing access only on a discriminatory basis raises some interesting question on how the traditional NRSRO framework has been used to impair market transparency even as more complex products were rated.

- **Asset backed commercial paper**. Perhaps the least scrutinized of the market fiascos over the past year has been the chaos in the asset backed commercial paper (ABCP) market and the role the rating agencies played—or more to the point did not play—in raising the visibility around how many structured investment vehicles (SIVs) were funded in the ABCP market at A-1+/P-1 ratings despite the concentration of subprime mortgage investments and the severe asset liability mismatches. The issue gained very little transparency until the SIVs started to reach the financial crisis point. That in turn set off a market liquidity crisis and general fear of massive collateral auctions that only drove prices and relative market liquidity lower. It also compounded the balance sheet crisis at a number of major banks that took the funding for various SIVs back onto their balance sheets.

  The only parties outside the SIVs themselves and agent banks that had detailed access to the various legal documents and portfolio updates for ABCP programs were the major rating agencies. To the extent such data would have been made available to any investor-pay NRSROs (who clearly could not receive such data), it is safe to assume that their interests in looking out for the interests of the ABCP holders may have been somewhat different. We recommend that all NRSROs be eligible to receive access to all of the same documents as the issuer pay NRSROs and under the same conditions of use as the incumbent NRSROs that rate such structures for a fee. The ABCP fiasco of 2007-2008 should not be repeated, and that will require more independent sources of analysis.

Sincerely,

/s/ Glenn Reynolds

Glenn Reynolds
CEO
CreditSights, Inc.

/s/ Peter Petas

Peter Petas
President
CreditSights, Inc.