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Providing timely, accurate credit ratings to Institutional Investors

May 26, 2005

Mr. Jonathan G. Katz, Secretary
Securities and Exchange Commission
450 Fifth Street NW
Washington, DC 20549

Comments on Proposed Rule Nationally Recognized Statistical Rating Organization – File#S7-04-05

A Step in the Wrong Direction

The major rating firms have failed miserably in providing warning to investors for the Enron, Worldcom and Parmalat failures. Nonetheless, the SEC is forcing every rating firm it recognizes to adopt the same failed business model by pushing firms towards issuer compensation. Under the proposed rules for recognizing new NRSRO rating firms, the rating firm is required to publicly provide its ratings at no charge, which makes it extremely difficult to collect compensation from institutional investors (why would the investors pay for such ratings if they are publicly available at no charge?). The SEC has regularly avoided setting fees in other areas, yet in the rating area the SEC is setting the most draconian of fees - that the service be delivered without compensation since issuer compensation is unrealistic for all but the long-established, long entrenched firms. Another irony is the fact that there have been no complaints lodged against rating firms that are supported by investor fees for the pricing of their services in contrast to the numerous complaints about high rating fees charged by issuer supported firms. Justifying the proposal via comments from major broker/dealers and major rating firms is fundamentally flawed since such participants are benefiting from the industry's conflicts. Investors were hurt, but the broker/dealers, major rating firms and issuers benefited.

Given the SEC's mandate for protecting investors ("The primary mission of the SEC is to protect investors" from sec.gov – Who We Are), one would expect the SEC to aid and encourage those firms that have succeeded in provided timely, accurate ratings. Unfortunately the proposal does the exact opposite. If rating firms are dependent on issuers for support, they will bow to the wishes of those issuers, particularly the large, important ones such as Enron and WorldCom.

A far better approach would be to recognize the essentially different characteristics of issuer-supported and investor-supported rating firms and to allow rating firms to choose between the alternatives; issuer-supported rating firms must provide their ratings to the public at no charge and investor-supported rating firms must provide their ratings to issuers at no charge. (Our bet is that the investor-support rating firms will beat the issuer-supported rating firms with early upgrades and early downgrades.) Regarding monitoring rating firms, we support the Code of Standard Practices for Participants in the Credit Rating Process published by the Association of Corporate Treasurers (United Kingdom), The Association of Financial Professionals (United States), and Association Francaise Des Tresoriers D'Entreprise (France).

The existing NRSRO rating firms have and should applaud the SEC's proposal as it currently is drafted since it further entrenches them and their conflicted business models. The irony of ironies is that failure has never been so well rewarded.

Regarding Egan-Jones Ratings, we have provided warning for the Enron, Genuity, Global Crossing, and WorldCom failures (we did not rate Parmalat). Furthermore, we regularly identify improving credits; most of our ratings have been higher than S&P's and Moody's over the past two years thereby providing issuers with more competitive capital. Our success has been recognized by the Federal Reserve Bank of Kansas City which compared all our ratings since inception in December 1995 to those of S&P and concluded:

> "Overall, it is robustly the case that S&P regrades from BBB- moved in the direction of EJR's earlier ratings. It appears more likely that this result reflects systematic differences between the two firms' rating policies than a small number of lucky guesses by EJR."
>
> Source: Research Division, Federal Reserve Bank of Kansas City, Feb. 2003
> Link: http://www.kc.frb.org/publicat/reswkpap/RWP03-01.htm

Stanford University and the University of Michigan drew similar conclusions:

> "we believe our results make a strong case that the non-certified agency [Egan-Jones] is the leader and the certified agency [Moody's] is the laggard."
> Link: aaahq.org/AM2004/display.cfm?Filename =SubID_ 1213.pdf&MIMEType =application%2Fpdf

The SEC's main mission of protecting investors is not consistent with encouraging issuer compensation. We have no problem with S&P and Moody's receiving the fees they do. However, the SEC should wean the firms it recognizes from issuer compensation because of the significant conflicts of interest. The conflicts of interest were at the heart of the equity research scandal. Unfortunately in the ratings industry the problems are more acute than those that existed in the equity research area because of the paucity of alternatives; Jack Grubman was one of approximately 20 equity analysts covering Worldcom whereas there were only two or three major rating firms covering Worldcom. Until the fundamental problems in the rating industry are addressed, investors, employees, pensioners, and ultimately issuers will be needlessly harmed.

Additional Comments on the proposal:

Insider trading – The proposal addresses the misuse of non-public information given to rating firms but does not address the misuse of information generated by the rating firms themselves such as Moody's informing CitiGroup of its intention to downgrade Enron below investment grade.

Sever ties between rating firm personnel and issuers and dealers- the ex-chairman of Moody's should not have served as a director of WorldCom nor should ratings firm personnel be tied to broker/dealers or broker/dealer industry associations such as the NASD.

Notification of Influence – NRSRO's should disclose all payments to academics, lobbyist, and law firms.

Financials – Smaller rating firms should be able to substitute tax returns in lieu of audited financials.

Egan-Jones Ratings Company

Selected Quotes – Egan-Jones Ratings Co.

New York Times
Gretchen Morgenson (Pulitzer Prize Winner July 7, 2002
"Egan-Jones makes a practice of alerting investors to corporate credit problems well before they are acknowledged by management… As early as November 2000, for example, Egan-Jones cut its ratings on WorldCom to the lowest investment-grade level, citing its deteriorating profit margins and credit quality."

Fortune's "Against the Grain"
Herb Greenberg January 21, 2002
"The best balance-sheet snoops are often way ahead of the pack in finding signs of trouble. Sometimes, however, the big credit-rating firms, Standard & Poor's and Moody's, which get paid by the companies they rate, are slow off the mark--slower, as a rule, than independent bond-rating services like Egan-Jones.

Investment Dealers Digest (cover)
Dave Lindorff August 13, 2001
"It didn't take long for Sean Egan, managing director of Egan-Jones Ratings Co., a small ratings agency outside Philadelphia, to figure out last fall's California power crisis would eventually put the state's utilities in a bind. "We saw a train wreck ahead for these companies," recalls Egan, who says his analysts quickly fired off two reports to clients warning them of the troubles facing the state's two utilities-Pacific Gas & Electric Corp. and Edison International, the parent company of Southern California Edison. On Sept. 27, the firm lowered EIX's rating from A- to BBB-, and PG&E's rating from A to BBB+."

Bloomberg News
Mark Gilbert October 14, 2004
"S&P wouldn't be the first to pin a non-investment grade rating on Ford. Egan-Jones Ratings Co., a private company run by Sean Egan in Pennsylvania, cut the automaker's grade in January 2002."

Grant's Interest Rate Observer
Jim Grant Annual Conference, October 2002
"The big two-and-a-half rating agencies have not exactly covered themselves in glory during the current credit debacles. Sean Egan, co-founder of Egan-Jones Ratings Co. (which saw many disasters coming before they landed in the newspapers), will discuss debacles and opportunities yet over the horizon."

Enron's Senior Unsecured Ratings

The bold indicates non-investment grade

Date	Egan-Jones*	S&P	Moody's
4/19/2001	BBB+	BBB+	Baa1
→**6/27/2001**	**BBB**	BBB+	Baa1
8/15/2001	BBB/ BBB-	BBB+	Baa1
10/16/2001	BBB/ BBB-	BBB+	Baa1 (neg.)
10/23/2001	BBB-	BBB+	Baa1 (neg.)
10/24/2001	BBB-/ BB+	BBB+	Baa1 (neg.)
10/26/2001	**BB+**	BBB+	Baa1 (neg.)
10/29/2001	**BB+/ BB**	BBB+	Baa2 (neg.)
10/31/2001	**BB+/ BB**	BBB+	Baa2 (neg.)
11/1/2001	**BB**	BBB (neg.)	Baa2 (neg.)
11/6/2001	**BB**	BBB (neg.)	Baa2 (neg.)
11/7/2001	**BB-/ B-**	BBB (neg.)	Baa2 (neg.)
11/9/2001	**BB**	BBB- (neg.)	Baa3 (neg.)
11/21/2001	**BB/ BB-**	BBB- (neg.)	Baa3 (neg.)
11/26/2001	**BB-/ B+**	BBB- (neg.)	Baa3 (neg.)
11/28/2001	**B+/ B-**	**BBB- (neg.)**	**Baa3 (neg.)**
11/28/2001	**C/ D**	**B-**	**B2 (neg.)**
11/29/2001	**D**	**B-**	**B2 (neg.)**
11/30/2001	**D**	**CC (neg.)**	**B2 (neg.)**
12/3/2001	**D**	**D**	**Ca**

* Current and projected ratings

WorldCom's Senior Unsecured Ratings

The bold indicates non-investment grade

Date	Egan-Jones*	S&P	Moody's	Action
11/1/2000	A- (neg. watch)	A-	A3	EJR issued neg. watch (A-)
11/ 3/00	A- (neg. watch)	A- (neg. watch)	A3	S&P issued a neg. watch (A-)
11/17/2000	BBB+ (neg. watch)	A- (neg. watch)	A3	EJR cut A- to BBB+ (neg. watch)
2/8/2001	BBB	A- (neg. watch)	A3	EJR cut BBB+ to BBB
2/27/01	BBB	BBB+	A3	S&P cut A- to BBB+
6/25/2001	BBB-	BBB+	A3	EJR cut BBB to BBB-
7/26/2001	**BB+ (neg. watch)**	BBB+	A3	EJR cut BBB- to BB+ (neg watch)
1/29/2002	**BB (neg. watch)**	BBB+	A3	EJR cut BB+ to BB (neg watch)
2/ 7/02	**BB- (neg. watch)**	BBB+	A3	EJR cut BB to BB- (neg watch)
2/ 7/02	**BB- (neg. watch)**	BBB+	A3 (neg. watch)	Moody's issued a neg. watch (A3)
2/19/2002	**B+**	BBB+	A3 (neg. watch)	EJR cut BB- to B+
4/12/02	**B+**	BBB+ (neg. watch)	A3 (neg. watch)	S&P issued a neg. watch (BBB+)
4/22/02	**B+**	BBB	A3 (neg. watch)	S&P cut BBB+ to BBB
4/23/02	**B**	BBB	A3 (neg. watch)	EJR cut B+ to B
4/23/02	**B**	BBB	Baa2	Moody's cut A3 to Baa2
4/25/2002	**B-**	BBB	Baa2	EJR cut B to B-
5/ 9/02	**B-**	BBB	**Ba2**	Moody's cut Baa2 to Ba2
5/10/02	**B-**	**BB**	**Ba2**	S&P cut BBB to BB
6/14/2002	**B- (neg. watch)**	**BB**	**Ba2**	EJR issues neg. watch
6/17/02	**B- (neg. watch)**	**B+**	**Ba2**	S&P cut BB to B+
6/20/02	**CCC (neg. watch)**	**B+**	**Ba2**	EJR cut B- to CCC (neg. watch)
6/20/02	**CCC (neg. watch)**	**B+**	**B1**	Moody's cut Ba2 to B1
6/26/02	**D**	**B+**	**B1**	EJR cut CCC to D
6/26/02	**D**	**CCC-**	**B1**	S&P cut B+ to CCC-
6/26/02	**D**	**CCC-**	**Ca**	Moody's cut B1 to Ca
7/ 1/02	**D**	**CC**	**Ca**	S&P cut CCC- to CC
7/17/02	**D**	**D**	**Ca**	S&P cut CC to D

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WORLDCOM INC
WCOM 8 ¼ 05/31
43.3307/ 44.2307 (19.16/18.78) BGN
MATRIX
Trade Line
WCOM 8 ¼ 05/31 Corp
1/4
Range 10/30/01 - 4/30/02
Period D Daily
Chart: 1 Trade Line
Source
1) News
EJR assigns a Negative Watch to WCOM at BB+ on 10/25/01
Egan-Jones lowered WCOM below investment grade on 7/26/01, over 200 days or 8 months before the bonds were trading below the 90's
EJR cuts BB+ (neg.) to BB (neg.) 1/29/02
EJR cuts BB to BB- (neg.)
EJR cuts BB- (neg.) to B+ 2/19/02
Moodys warns June 1999 A3 rating on Negative Watch 2/7/02
S&P cuts A- (neg.) to BBB+ 2/27/02 and then puts that on Neg. Watch 4/12/02
S&P cuts to BBB (neg.) 4/22/02 and then to BB (neg.) on 5/10/02
Moodys cuts A3 to Baa2 (neg.) 4/23/02 and then to Ba2 (neg.) on 5/9/02
110
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2001 Nov
Dec
2002 Jan
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