

Association fédérative internationale des porteurs d'emprunts russes (AFIPER)

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Florence E. Harmon, Acting Secretary,
Securities and Exchange Commission.
100 F Street NE,
Washington DC, 20549-9303, U.S.A.

Friday July 25th 2008.

Comments on S7-13-08: Proposed Rules for Nationally Recognized Statistical Rating Organizations

(Release No. 34-57967)

Dear Ms. Harmon,

Holders of defaulted sovereigns have known for a long time that the business model through which credit rating agencies (CRAs) are paid by the very entities whose issues they rate can cast serious shadows upon the quality of their ratings.

This had been very clearly pointed out by Mr. Helmut REISEN, head of OECD's research division as early as 1998: *"... Furthermore, the rating agencies derive most of their revenue from those states that use their services; they are therefore reluctant to downgrade their ratings. The fear of displeasing their clients and of witnessing a reduction in the demand for their services and in the associated revenue can lead to some rigidity in downgrading country ratings in times of excessive capital influx."*

In 2007 it became apparent that poor-quality housing loans had been repackaged and rated as investment grade obligations in massive quantities and unclear conditions.

We welcome the recognition, in the wake of the subsequent market turmoil, by regulatory bodies and investors worldwide, of the necessity to closely scrutinize the credit rating process for potential conflicts of interest and fully support the ongoing enquiries.

We are, however, concerned to see that this scrutiny is mainly limited to the rating process of *structured products*, when other conflicts of interest have also been and are presently at work and influence the ratings of *sovereign issues* worth hundreds of billions of dollars.

As a result, in March 2008 I submitted a response to the Committee of European Securities Regulators' (CESR) consultation on the role of credit agencies in structured finance.

We agree it is crucial that credit rating agencies, who are essential landmarks in the global financial landscape, urgently regain the trust that, as a consequence of what has come to light in the wake of the subprime meltdown, market participants can no longer place in their opinions.

Yet how can this trust ever be restored if CRAs claim to satisfactorily address potential conflicts of interest yet simultaneously remain in denial of massive defaults on the part of sovereign issuers such as the Russian Federation, bearing on securities worth hundreds of billions of dollars, and if they do so in the face of constructive notice of these defaults?

We have petitioned the European Parliament on this matter and urge the SEC, the CESR, IOSCO, and other relevant parties to include the rating process of *sovereign issues* in the scope of their enquiries and studies.

With this in mind, I am sending you the following comments because I believe they can bring relevant information, pertaining to conflicts of interest affecting the ratings of *sovereign issues*, to those whose task it is to examine and regulate the actions of the credit rating agencies.

These comments have been formatted to answer some of the questions asked in the Commission's proposal. Our comments do not preclude on any further communications, statements or complaints we may direct to the Commission or other parties in the future.

We are grateful for the Commission's invitation to comment and remains at your disposal.

Yours truly,

Eric SANITAS
Président

Comments from

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on

Proposed Rules for Nationally Recognized Statistical Rating Organizations.

(Release No. 34-57967)

1. Preliminary statement

AFIPER is a group of holders of defaulted Russian government bonds issued prior to 1917.

A 1999 French government census identified 316000 French holders of such bonds, which until October 24th 2007 were listed on the regulated "Eurolist by Euronext" list of the Paris bourse.

By virtue of the universally accepted *successor government* doctrine of settled international law, the Russian Federation is liable for this debt. In addition, France's highest administrative court, the Conseil d'Etat, has repeatedly and recently found that the rights of the bondholders against the Russian Federation are not extinct.

AFIPER estimates the present value of monies due to bondholders to be well in excess of US\$ 100 billion.

Despite constructive notice of this massive and unresolved default, the Russian Federation is rated investment grade by the main CRAs.

AFIPER believes this inexplicable discrepancy is the result of a conflict of interest which has been neither addressed nor resolved.

2. Warning

We realize the proposed rules are intended, essentially, "*to address concerns about the integrity of [the credit rating agencies'] credit rating procedures and methodologies in the light of the role they played in determining credit ratings for securities collateralized by or linked to subprime residential mortgages*".

But we also bear in mind that the final goal of the current worldwide appraisal of Credit Rating Agencies (CRA) activity is to restore confidence in the credit markets and their essential players.

And we believe this confidence cannot be restored without in addition addressing the major subject of potential conflicts of interest within the rating process of sovereign issues.

Our comments appear in blue below, after the relevant SEC text in black.

3. Comments

1. Addressing the Particular Conflict Arising from Rating Structured Finance Products by Enhancing the Disclosure of Information Used in the Rating Process.

a. The Proposed amendment.

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"In the case of structured finance products the Commission preliminarily believes this "issuer/underwriter-pay" conflict is particularly acute because certain arrangers of structured finance products repeatedly bring rating business to the NRSROs. As sources of constant deal based revenue, some arrangers have the potential to exert greater undue influence than, for example, a corporate issuer that may bring far less ratings business to the NRSRO."

This conflict is also particularly acute in the case of sovereign issues: in much the same way that NRSROs risks shutting the door on a flow of rating business by displeasing certain arrangers when attributing unsatisfactory ratings to some of the products they have submitted to a rating, NRSROs will forfeit the rating business from an entire country if they ascribe a speculative grade rating to a sovereign issuer - since all private or public issuer from that state know they cannot achieve a better rating than the sovereign.

In the case of the Russian Federation (and also of the People's Republic of China) attributing a speculative grade to the sovereign would have resulted in massive revenue shortfalls for the NRSROs.

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"To address this conflict, proposed new paragraph (a)(3) would require that as a condition to the NRSRO rating a structured finance product the information provided to the NRSRO and used by the NRSRO in determining the credit rating would need to be disclosed (...)"

We strongly believe that all relevant information provided to the NRSRO should be disclosed, **including relevant information that the NRSRO has not used**; in addition we believe that when the NRSRO does not use a given item of information - such as for example constructive notice of an unresolved default - the NRSRO should **provide the detailed rationale leading to that item not being used.**

(...)

"The proposed amendment would require the disclosure of information provided to an NRSRO by the "issuer, underwriter, sponsor, depositor, or trustee." The Commission preliminarily believes that, taken together, these are the parties that provide all relevant information to the NRSRO to be used in the initial rating and rating monitoring processes."

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"To further these goals, the proposal would require the disclosure of the following information:

- All information provided to the nationally recognized statistical rating organization by the issuer, underwriter, sponsor, depositor, or trustee that is used in determining the initial credit rating (...)"

We believe the NRSRO should also disclose information provided by other parties, such as defaulted creditors, when such information is, or could have been, relevant to the determination of a rating; when the information could have been relevant to that determination but has not been used in that determination the NRSRO should also disclose the rationale for not using the information.

The Commission then requests comments on the following questions related to the proposal (as stated above, AFIPER is aware that the questions relates essentially to the rating of structured products. However, as explained above we believe them to be also highly relevant to the rating of sovereign issues, and we answer them in that perspective):

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- "Would the information proposed to be required to be disclosed sufficient to permit the determination of an unsolicited credit rating? (...) Commenters believing more information should be disclosed should specifically describe the additional information and the practicality of requiring its disclosure (...)"

No. Concerning sovereign issues it is crucial for investors to have knowledge of the figures included - or not included - in the sovereign's public accounts by the NRSROs prior to rating the sovereign. For example, the Russian Federation does not include amounts due to bondholders as a consequence of its unresolved defaults in the public accounts it provides to NRSROs when requesting a rating. Neither do the NRSROs reformat the Russian Federation's public accounts to include the amounts due to defaulted bondholders although they have knowledge of the unresolved default. NRSROs must disclose this information in order to allow other NRSROs to provide an accurate unsolicited rating.

- "The proposed amendment would require the disclosure of information provided to an NRSRO by the "issuer, underwriter, sponsor, depositor, or trustee" based on the Commission's preliminary belief that these would be the parties relevant to an NRSRO's performance of the ratings process, i.e., that taken together, these are the parties that would provide all relevant information to the NRSRO. Are there other entities that should be included in this category?"

Yes. As far as bonds are concerned we strongly believe the bondholders are clearly a party which would provide relevant information to the NRSRO - most particularly so in the case of an unresolved default which is highly significant with respect to the **willingness to pay** criteria - and we strongly believe they should be included in the list of parties who can provide relevant information to the NRSROs.

- "Should the Commission provide a "safe harbor" so that an NRSRO that obtained a representation from one or more parties to a transaction to disclose the required information would not be held in violation of the rule if the party did not fulfill its disclosure obligations under the representation?"
No. Considering it is deemed necessary that required information be disclosed, we believe someone should be accountable for ensuring that disclosure has materialized.
- "Should the Commission also require the disclosure of information about the steps, if any, that were taken by the NRSRO, issuer, underwriter, sponsor, depositor, or trustee to verify information about the assets underlying or referenced by the security or money market instrument, or, if no such steps were taken, a disclosure of that fact?"
Yes. It is our view that the knowledge of steps (or absence of) taken by the NRSRO to verify information about the assets and liabilities of any rated issuer is an essential item which will allow the final investor to form his own opinion on the basis upon which the rating has been attributed, and on the degree of reliability of the data underpinning the rating.

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- "Should the Commission also require the disclosure of information about the steps, if any, that were taken by the NRSRO, issuer, underwriter, sponsor, depositor, or trustee to verify information about the assets underlying or referenced by the security or money market instrument, or, if no such steps were taken, a disclosure of that fact?"
Yes. It is our view that the knowledge of steps (or absence of) taken by the NRSRO to verify information about the assets **and liabilities** of any rated issuer is an essential item which will allow the final investor to form his own opinion on the basis upon which the rating has been attributed, and on the degree of reliability of the data underpinning the rating.
- "Should the Commission also require the disclosure of the results of any steps taken by the NRSRO, issuer, underwriter, sponsor, depositor, or trustee to verify information about the assets underlying or referenced by a structured finance product? Alternatively, should the Commission require a general disclosure of whether any steps were taken to verify the information and, if so, a description of those steps?"
Yes. It is our view that the knowledge of steps (or absence of) taken by the NRSRO to verify information about the assets **and liabilities** of any rated issuer is an essential item which will allow the final investor to form his own opinion on the basis upon which the rating has been attributed, and on the degree of reliability of the data underpinning the rating.

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- "Should the proposed prohibition also be extended to cover participation in fee negotiations by NRSRO personnel with supervisory authority over the NRSRO personnel participating in determining credit ratings or developing or approving procedures or methodologies used for determining credit ratings?"

Yes. Otherwise the conflict is not resolved, but expresses itself with ill effects in the asymmetrical relationship whereby the analyst, who must produce accurate ratings, remains under the authority of a supervisor who has conflicting interests in incremental fees.

- "Instead of prohibiting this conflict outright, would disclosure and procedures to manage the conflict adequately address the conflict? If so, what specific disclosures should be required? What other measures should be required in addition to disclosures?"

No. A party responsible for delivering independent advice or opinion must remain precisely that: independent. Whenever he, or his supervisor, becomes responsible for business development the commercial aspect will always find a way to adversely affect the independence of the advice or opinion delivered, particularly when important fees, such as they are levied by NRSROs, are at stake.

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3. Records Concerning Third-Party Analyst Complaints

"The Commission is proposing an amendment to Exchange Act Rule 17g-2 to add a requirement that an NRSRO retain records of any complaints regarding the performance of a credit analyst in determining credit ratings. Specifically, the proposed amendment would add a new paragraph (b)(8) to Rule 17g-2 to require an NRSRO to retain any communications that contain complaints about the performance of a credit analyst in initiating, determining, maintaining, monitoring, changing, or withdrawing a credit rating."

AFIPER fully supports this amendment, it being understood that complaints should be retained whatever the source of the complaint.

"For example, the examiners could review the complaint file that would be established by this proposed amendment and follow-up with the relevant persons within the NRSRO as to how the complaint was addressed."

Particular attention should be paid by the examiners to complaints pertaining to unresolved defaults where the issuer is inexplicably attributed any rating other than those normally attributed to defaulted issuers.

Eric SANITAS,
Président de l'AFIPER
July 25th 2008.