John Rutherfurd, Jr.

March 8, 2007

Ms. Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090.

**By Internet Comment Form**

Comments on Proposed Rules on Rating Agencies: File Number S7-04-07

Dear Ms. Morris:

Thank you for the opportunity to comment on the Proposed Rules on Rating Agencies ("Rules"). I am a retired rating agency executive. These comments represent my own views as a private citizen. I represent no other person or organization.

In this comment I urge that there are three areas of the Rules requiring clarification: (1) Record Keeping, (2) Prohibited Behavior – Structured Finance; and (3) Prohibited Behavior - Unsolicited Ratings.[1]

1) Record Keeping - Drowning in Records: Unless the Commission narrows the scope of record keeping required of rating agencies registered with the Commission as nationally recognized statistical rating organizations ("NRSROs"), NRSROs may drown in the required records. NRSROs are, for example, required to retain:

   i) Credit analysis reports, credit assessment reports, and private rating reports and internal records, *including non-public information and work papers, used to form the basis for the opinions expressed in these reports* (Emphasis added). **§ 240.17g-2(b)(3)**

      In order to clarify NRSROs authority to discard materials, I recommend adding clauses to the rules stating that an NRSRO may discard materials which it reasonably determines were not of substantial importance in forming the basis for their opinions.

[1] The application of the Rules outside the United States and the interactions, if any, between the Rules and laws and regulations of other countries is beyond the scope of this comment. Also beyond the scope of this comment is the extent and nature of cooperation between the Commission and Staff with other national securities regulators to further investor protection and market integrity and efficiency while reducing unnecessarily duplicative costs on NRSROs.

ii) All external and internal communications, including electronic communications, received and sent by the rating organization and its employees relating to initiating, determining, maintaining, changing, or withdrawing a credit rating. § 240.17g-2(b)(7)

This clause substantially broadens the duties required of NRSROs by the clause cited above as (i) in two respects. First, (i) refers to rating agency work papers; (ii) broadens that requirement to include materials provided by third parties; Second, (ii) does not have the "form the basis" limitation. I recommend that (ii) be qualified by the authorization to discard recommended for (i).

While the recommended authorization to discard could be subject to abuse by NRSROs, the Commission has a control against such abuse through the ability to inspect the practices of an NRSRO.

iii) The Rules provide that records supporting credit opinions must be retained "for three years after the date of the last receipt by the person in the record of a service or product of the rating organization."

Required record retention may be over fifty years in the case of a long-dated bond, or (nearly) forever in the case of a government "consol". The proposed record keeping periods are excessive. I recommend that the Commission establish less lengthy required record retention such as three to five years.

2) Prohibited Behavior - Structured Finance: Rule 17g-6(a)(4) follows the language of the Credit Rating Agency Reform Act of 2006 ("Statute"). The Rule provides:

(a) Prohibitions. It shall be unlawful for a nationally recognized statistical rating organization ("rating organization") to engage in any of the following unfair, coercive, or abusive practices: . . .

(4) Issuing or threatening to issue a lower credit rating, or lowering or threatening to lower an existing credit rating, or refusing to issue a credit rating or withdrawing a credit rating, with respect to securities or money market instruments issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction, unless a portion of the assets which comprise the asset pool or the asset-backed or mortgaged-backed securities also are rated by the rating organization.

(b) A rating organization refusing to issue a credit rating or withdrawing a credit rating with respect to an asset pool or the asset-backed or mortgaged-backed security must document in writing the reason for the refusal or withdrawal.

In "plain talk" the purpose of the Statue and Rule is to protect sponsors of structured products against NRSROs demanding to rate a portion of their assets under the threat

of refusing to rate issues of the structured product or lowering the rating of issues of the structured product.

In this context the rule merely extends to structured finance the principles already stated in Paragraphs (a) 1 -3 of proposed Rule 17g-6 that NRSROs should make no promises or threats to the existence or level of the rating based on commercial arrangements. Those principles are already included in international securities regulators' (IOSCO) standards, to which major rating agencies have subscribed, so they should not be controversial. [2],[3]

Also in this context the Commission recognizes that NRSROs are entitled to payment for their ratings. The commentary states at page 97:

> An NRSRO would be allowed to condition the issuance and maintenance of a credit rating on the issuer or obligor paying for the service of determining and monitoring the credit rating. As noted above, this is a longstanding business model in the credit rating industry.269

Therefore, the question which requires clarification is exactly what behavior(s) the Commission is prohibiting by the Rule, since NRSROs cannot demand payment for certain acts, but are entitled to payment for their ratings. The Commission should clarify this question taking into consideration both: (i) investor protection and market integrity and efficiency; and (ii) protection of sponsors of structured products.

In order to address issues of possible ambiguity and unintended consequences, I recommend that the Commission accept the following explanatory information and adopt the following interpretations for use by the Commission and its staff, industry participants and NRSROs.

1. Normally sponsors of structured products seek to achieve specified rating levels for the various issues of securities ("tranches") backed by the assets in the structure. They engage in iterative discussions with a rating agency. The sponsors propose specified assets and structures of seniority within the tranches to achieve the desired rating levels, and the rating agency indicates whether or not the specified assets and structures achieve those rating levels

[2] The SEC commentary at pages 98 and 100 states:

> "The credibility and reliability of an NRSRO and its credit ratings depends on the NRSRO developing and implementing sound methodologies for determining credit ratings and following those methodologies. The fact that an issuer or obligor agrees or refuses to purchase a credit rating or other service or product from theNRSRO and its affiliates should have no bearing on the NRSRO's credit assessment of the issuer or obligor.274"

[3] The SEC commentary to the Rules introduces a different issue which is not specifically addressed in the statute or the rules. That issue is "notching", described as "discounting" the ratings of another credit rating agency (see SEC Rules, page 101) for the purpose of determining the creditworthiness of the assets rated by the other credit rating agency in the structured products. That issue is also addressed below.

consistent with the methodologies of the rating agency. These long-standing practices when followed by an NRSRO are not inconsistent with the Rules.

2. The most frequent situation where a rating agency does not rate the securities of a structured product is when the proposed assets and structures of the issuer and the proposed ratings of the sponsor do not meet the credit requirements of the rating agency following its specified methodologies. Normally, in this situation another credit rating agency, which may be an NRSRO, has concluded that the proposed ratings of the sponsor do meet the credit requirements of such agency. In this manner, sponsors of structured products "shop" for the ratings they desire. Occasionally, there are other reasons for non-rating a structured product, including, but not limited to: (i) operational risk of the structured product, (ii) rating agency concerns about the willingness of the manager of the structured product to discharge the specified credit obligations, and (iii) the unwillingness of the structured product to pay the customary fees of the rating agency for the type of product and its securities. These practices of NRSROs are not inconsistent with the Rules, but the circumstances of an NRSRO refusing to offer a rating must be documented in writing under the Rules.

3. The Commission is required to make a statutory determination whether or not a practice is unfair, coercive or abusive. The Commission should determine that an NRSRO making an evaluation of the creditworthiness of all the assets in a structured product in accordance with its published methodologies is not per se unfair, coercive or abusive, provided that the methodologies comply with the Rules, as discussed below. Evaluating the creditworthiness of all the assets in a structured product is an appropriate practice in providing credit information to investors and the market because even a small amount of "toxic waste" in a structured product can negatively affect ratings. Far less than the 15% suggested in the Rules can have a negative effect. Rating agencies should be encouraged to detect that toxic waste. The evaluation of the creditworthiness of all assets in a structured product is necessary to provide investors and the market with the information that they customary receive from rating agencies on structured products. The practice of NRSROs in forming a creditworthiness opinion on all the assets in a structured product is not inconsistent with the Rules.

   Here is a simple example of the problems created if the Statute and the Rule were interpreted to forbid NRSROs making an evaluation of the creditworthiness of all the assets in a structured product (subject to the proposed 15% exception):

   > An existing structured product with NRSRO rated securities substitutes 14% market value of low credit quality assets unrated by any NRSRO in for 14% high quality rated assets? If the Rule were interpreted as providing that no NRSRO should change the credit rating of the structured

product, investors and the market would be deprived of important information. At least some of the securities of the structured product are likely to be of lower credit quality after the substitution than before the substitution. It is likely to benefit investors and the financial markets for NRSROs to lower the credit ratings of some of the securities in the structured product.

4. The Commission should determine whether or not an NRSRO demanding to provide a stand-alone published rating of any of the assets in a structured product that the NRSRO did not previously rate is an unfair, coercive or abusive practice. The burden should be placed on NRSROs to justify this practice because, as explained above, NRSROs may form a credit opinion on such assets without a stand-alone published rating. Of course, the sponsor of a structured product might, completely on its own volition, request such a stand-alone published rating and in such circumstances NRSROs could provide such a rating without violating the Rules.[4]

5. The Statute and Rules do not specifically refer to "Notching". Notching, as normally practiced by some NRSROs, is one of several options provided for making an evaluation of the creditworthiness of assets which the NRSRO has not rated. The option can be described as "discounting" the ratings of another credit rating agency, which may be an NRSRO, for the purpose of determining the creditworthiness of the assets rated by the other credit rating agency in the structured product.[5] Other options which rating agencies offer for determining creditworthiness are various rating estimates performed by quantitative and/or qualitative means. Sponsors of structured products generally disfavor notching, because notching is never "up"; it is always "down". Nevertheless, sponsors of structured products may choose Notching or "discounting" rather than rating estimates because of faster rating agency response time and/or lower cost. Rating agencies defend Notching because of structured product sponsors' shopping for higher ratings as described above. If the Commission should determine that the detriments to competition from such discounting practices are greater than the benefits of faster response and lower cost, then it could make the statutory determination that the practice is unfair, coercive or abusive. If the Commission makes this determination, I recommend that the Rule should specifically prohibit NRSROs from using such discounting or Notching as part of their methodologies.[6]

6. The commentary to the Rules should specifically state that the Rules do not require NRSROs to recognize the credit ratings of other credit rating agencies,

[4] If the Commission makes the specified determination and prohibits the practice, generally or in specific situations, in the Rules, it is beyond the scope of this comment whether or not an NRSRO could issue an "unsolicited credit rating" on such assets. See comments below on unsolicited credit ratings.
[5] See SEC Commentary at page 101
[6] Whether or not such a prohibition would offend the First Amendment is beyond the scope of this comment.

whether or not NRSROs, on an asset in a structured product as their own for purposes of rating the securities issued by the structured product.[7]

7. The commentary to the Rules should clearly state that the general commentary pertaining to fees charged by NRSROs applies to fees charged for ratings of securities issued by structured products.[8] Each NRSRO may charge its fees for making credit evaluations of the assets included in structured products and issuing ratings on the securities issued by the structured product. Fees may be higher or lower depending on the amount of work anticipated by the NRSRO in making such credit evaluations and ratings and the value provided by the NRSRO to the issuer and the market in making such credit evaluations and ratings.

3) Prohibited Behavior – Unsolicited Ratings: The Rules prohibit "Issuing an unsolicited credit rating and communicating with the rated person to induce or attempt to induce the rated person to pay for the credit rating or any other service or product of the rating organization or a person associated with the rating organization." Unsolicited is defined on page 45 of the commentary:

"An "unsolicited" credit rating is one the credit rating agency decides to initiate without being requested to do so by an issuer, obligor, underwriter, or other interested party."

In some cases the Rule can provide for an extremely long time period. In the case of an unsolicited rating of a sovereign, the period could easily be decades. I recommend that the Commission establish a less lengthy prohibition such as three to five years.

I thank the Commission for this opportunity to comment on the Rules. I believe that with the indicated changes, the Rules will contribute to investor protection and the proper functioning of capital markets.

Sincerely,

John Rutherfurd, Jr.

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cc: Chairman Cox
Commissioner Atkins
Commissioner Campos
Commissioner Nazareth
Commissioner Casey

[7] As previously stated, An NRSRO should make its own determination of the creditworthiness of all the assets included in a structured product in accordance with its own methodologies, provided that such methodologies are permissible under the Rules

[8] Commentary to the Rules at page 97