March 30, 2007

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

Re: SEC Proposed Rules Implementing Provisions of the Credit Rating Agency Reform Act of 2006 (File No.: S7-04-07)

Dear Ms. Morris:

We fully support the efforts of Congress to lower barriers to entry in the ratings industry. To achieve this result, Congress mandated that the Securities and Exchange Commission (SEC) simplify its criteria for recognizing and registering rating agencies as nationally recognized statistical rating organizations (NRSROs). The simplification of the criteria for qualifying as an NSRSO would, in our opinion, effectively lower the existing threshold requirements. We applaud this reduction in regulatory barriers to entry for new rating agencies.

Congress also mandated that the SEC should not interfere with the substance of ratings, meaning the SEC should not concern itself with methodologies the agencies use to reach their conclusions. In lowering the barriers to entry, Congress intended that the market should form its own judgments about the quality of ratings issued by different NRSROs. In this context, we would like to discuss the shortcomings of Proposed Rule 17g-6(a)(4). The proposed rule states that NRSROs are prohibited from:

> 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.

The SEC describes its motivation for the rule as "seeking to address a practice, sometimes referred to as 'notching' where a credit rating agency refuses to rate…or discounts the rating for a structured product because it has not rated all the underlying assets." The SEC appears to regard this practice as anti-competitive, but it is in fact the result of healthy competition. As drafted by the SEC the provision applicable to notching seems to require that NRSROs that have not rated some of the collateral assets would be unable to notch—or reduce the rating—of other NRSROs. This would mean, of course, that they would in effect be forced to use the ratings of other NRSROs as if they would have assigned the same ratings to that collateral.

In reality, it is the proposed regulation that is anti-competitive. It fails to recognize that there are legitimate differences in the quality of ratings by different NRSROs, and by forcing some rating agencies to use the ratings of others the SEC is erasing these important market-recognized differences that should legitimately be reflected in securities prices. The fact that one rating agency may have the market power to compel an issuer to use its services for all the securities on offer may be a reflection of superior rating capabilities recognized in the market—something the SEC should encourage rather than obscure.

We believe the SEC should not in any way compel NRSROs to rely on other agencies' ratings. If NRSROs were required to rely on each others' opinions, the market would be harmed by:

1. Diminishing the number of independent opinions in the market;
2. Obscuring differences of opinions among rating agencies; [1]
3. Preventing the market from distinguishing among the agencies by rating quality; and
4. Undermining the market's ability to offset the potential harm caused by rating shopping.

The last point is particularly important. When a rating agency has not rated all of the collateral assets, this is generally not a random event. Indeed, the absence of a rating often implies that the issuer believed that, when some securities are rated by more than one NRSO and some are not, the absent rating would have been less favorable than the single rating actually provided. That is, suppose a security is rated by rating agency A but not by rating agency B, because the issuer believes that agency B would assign a lower rating. If the ratings of agency A are equally credible in the market compared to those of agency B, then the absence of agency B's rating will have no impact on the price of the security in the marketplace. If, however, agency A's opinion is less credible in the marketplace, then the absence of agency B's rating will lead to a lower price on the security and hence a higher spread compared to what is normally expected for a security with that rating. Such price and spread variations across securities rated by different agencies are critical tools for discriminating among agencies based on ratings quality. If each agency were required, unlike the market itself, to rely on each other's ratings interchangeably, then for asset resecuritizations (like CDOs) the market would be prevented from making distinctions based on ratings quality.

[1] Published research by Moody's suggests that rating shopping in structured finance hides large systematic differences in rating opinions across the agencies and well explains why rating agencies may believe they need to heavily notch each other's ratings in certain circumstances. We are not aware of any published research that rebuts the data and arguments put forward in these publications. See, the following Moody's Special Reports: Moody's Views on "Notching" CMBS Ratings in CDOs (June 22, 2001), Moody's Study of Ratings of Non-Moody's-Rated RMBS (April 18, 2002), Moody's Studies Ratings of Non -Moody's-Rated CDOs and Confirms Rating Estimate Approach (March 22, 2002).

Unsurprisingly, Congress explicitly recognized that there were legitimate reasons for rating agencies not to rely directly on other agencies' ratings. At the same time, in response to concerns expressed by some very vocal, but conflicted, market participants, Congress asked the SEC to investigate whether any notching practices in the marketplace were abusive or anti-competitive.

The SEC does not appear to have investigated this issue. On the face of it, the risk of market abuse through notching practices seems low, since there is a natural market remedy. If the market does not agree with how rating agency A notches rating agency B's collateral ratings when rating CDOs, then rating agency B should over time garner a larger share of the CDO rating business, as well as the business of rating the collateral securities.

The SEC has, nonetheless, proposed rules that would constrain rating agencies methodologies with respect to notching. Such proposals are not only harmful, they are totally unnecessary since there are already numerous legal (anti-trust) remedies available to rating agencies that believe they are victims of anti-competitive practices. Ironically, it is the SEC, itself, that risks introducing anti-competitive practices into the industry by requiring rating agencies to use each others' ratings interchangeably.

In conclusion, we recommend that the SEC drop Proposed Rule 17g-6(a)(4) in its entirety.

The recent problems with respect to rating shopping by issuers in the mortgage market and its derivative securitized products reinforce the concerns raised above. It is important to recognize that incentives exist for some rating agencies (particularly those with less valuable reputations at stake) to provide misleadingly positive ratings to temporarily exploit imperfections in the market for ratings, in order to boost the flow of securitizations they rate and thereby increase their fee volume. This may have contributed to overly optimistic ratings of many of the complex, layered products which are currently the subject of much scrutiny in the press. Although, over time, competition should reduce these market imperfections, it is important that the SEC not contribute to the systemic weakening of the market's incentives to recognize and appropriately price risk, which we believe is currently a problem in the market for securitized assets.

Sincerely,

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